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(Volume XXXIV)

of the

Expert Advisory Committee

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

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Foreword

Accounting is considered as the language of business. It reflects the effects of business transactions carried on by an enterprise during the accounting period. While ensuring that effects of business transactions are effectively carried out in the financial statements, the accounting professionals are often posed with the challenge of understanding and implementing the accounting pronouncements, particularly, when the business transactions to which these pronouncements are to be applied, are complex. The Expert Advisory Committee, constituted by the Council of the Institute of Chartered Accountants of India (ICAI), extends guidance to the professionals in meeting this challenge by providing opinions to the complex issues faced by them.

Over the years, the role of Expert Advisory Committee has been well established for giving independent opinions on accounting, auditing and allied issues received from the members of the accounting profession. The role of the Committee has also been recognised by the Regulatory and Government authorities for its opinions.

I would like to congratulate CA. Sanjiv Kumar Chaudhary, Chairman, CA. Shriniwas Y. Joshi, Vice-Chairman and other members of the Expert Advisory Committee who have contributed immensely in the working of the Committee.

I am confident that, like all other volumes of Compendium of Opinions, this thirty-fourth volume of the Compendium of Opinions, will be immensely useful to the accounting professionals as well as others concerned.

New Delhi
June 18, 2015

CA. Manoj Fadnis
President

Preface

It gives me immense pleasure to present another volume of the Compendium of Opinions, viz., thirty-fourth volume during my tenure as the Chairman of the Expert Advisory Committee for the current Council Year 2015-16. This volume of the Compendium of Opinions contains opinions finalised by the Committee during the Council Year 2014-15 under the Chairmanship of CA. Dhinal Ashvinbhai Shah. I was part of the Committee when the opinions contained in this volume were finalized. This volume contains opinions on diverse subjects, such as, treatment of interest paid on compensation for lands acquired, disclosure requirements as per AS 15 in respect of employees seconded to subsidiary company by the holding company, accounting treatment of borrowing costs, administrative and other general overhead expenses incurred during the period when the construction work of the project is interrupted, applicability of paragraph 46A of AS 11 to buyer's credit/suppliers' credit repaid through a long-term liability, accounting for unspent expenditure towards Corporate Social Responsibility and sustainability activities as per Revised DPE Guidelines, accounting treatment of lease deposits received for lease of land by the company engaged in development of software technology parks, restatement of foreign currency monetary liabilities covered (hedged) by plain vanilla call option, treatment of foreign exchange fluctuations and interest cost on issuance of FCCB, whether amortisation of premium paid on foreign currency (USD) buy forward covers can be treated as borrowing cost, recognition of deferred tax asset on unabsorbed business loss and unabsorbed depreciation, accounting for Principal Only Currency Swaps, accounting treatment of borrowing cost for oil & gas assets acquired directly and through overseas subsidiary companies, etc.

I would like to invite the attention of the readers that although the Expert Advisory Committee has been constituted by the Council of the Institute, an opinion given or views expressed 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, 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, therefore, be read in the light of any amendments and/or developments subsequent to the issuance of opinions by the Committee.

I may also bring to the kind attention of 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 are published in all the volumes of the Compendium of Opinions.

This volume, like other recent volumes, also contains a Compact Disk (CD), which incorporates all the opinions published in all the volumes (viz., Volume I to Volume XXXIV) 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 place on record my sincere gratitude to the members of the Expert Advisory Committee during the Council Year 2014-15, namely, CA. Dhinal Ashvinbhai Shah (the then Chairman), CA. Sanjay Agarwal (the then Vice-Chairman), CA. K. Raghu (the then President), CA. Manoj Fadnis (the then Vice-President), CA. Rajkumar S. Adukia, CA. Pankaj Inderchand Jain, CA. Shriniwas Y. Joshi, CA. Nilesh Shivji Vikamsey, CA. G. Sekar, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. Vijay Garg, CA. Vijay Kumar Gupta, Shri P. Sesh Kumar (represented by Shri P.K. Mishra), Shri Bhaskar Chatterjee, Shri Sidharth Birla, Shri Salil Singhal, CA. Seethalakshmi M., CA. Chirag Mahendrabhai Shah, CA. Sanat Ulhas Chitale, CA. Sunil Kumar Birla, CA. Kalmanje Gururaj Acharya and CA. K. R. Sekar for their efforts in finalization 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 (2015-16).

I would also like to acknowledge the untiring efforts and support of Dr. Avinash Chander, Technical Director, CA. Parul Gupta, Secretary, Expert Advisory Committee and CA. Prafulla Raut, Executive Officer for formulating the drafts for the consideration of the Committee and thereafter in finalising them as per the decisions of the Committee.

I sincerely hope that like other volumes, this volume will also prove to be very useful to the members in discharge of their professional duties and to others concerned in the application and implementation of generally accepted accounting and auditing principles.

New Delhi
June 24, 2015

CA. Sanjiv Kumar Chaudhary
C*hairman*
Expert Advisory Committee

Contents

Query No. 1

Subject: Treatment of interest paid on compensation for lands acquired. [1]

A. Facts of the Case

1. Government of India has given mandate to a company (hereinafter referred to as 'the company') for construction of Mass Rapid Transit System ('MRTS') project in Delhi and NCR. For construction of MRTS project, being an infrastructure project, the company requires land for construction of stations, depots, viaduct and other structures for operation and maintenance of metro operations. The land for this purpose is being arranged by Land Acquisition Collector ('LAC'), an authority nominated by the Government under Land Acquisition Act, 1894. The method of land acquisition and the compensation paid for these acquisitions to LAC are given below:

(i) As per the project requirements, land pieces are identified and the proposal of land requirement is sent to Transport Department, Government of National Capital Territory of Delhi (GNCTD), which, in turn forwards it to Land & Building Department and LAC.

(ii) After joint survey of land by LAC and Revenue Authorities, the draft Notification for acquisition of land for MRTS project under section 4 of the Land Acquisition Act, 1894 is prepared by LAC based on the following parameters:

(a) Determination of market value of the land at the date of the publication of the Notification under section 4, sub-section (1), based on either the rates as per registered sale deed of that area or minimum rate notified by the Government for such land under Registration Act i.e., Circle Rates or any other relevant parameter.

(b) In addition to the market value of the land determined, interest at the rate of 12% p.a. for the period commencing on and from the date of publication of Notification to the date of Award or the date of taking possession of the land, whichever is earlier, is provided. This is provided for bringing the value of the land to its market value as on the date of

[1] Opinion finalised by the Committee on 11.4.2014.

possession of land or award of compensation, as the case may be.

(c) Further, a sum of 30% on such market value is provided as solatium, in consideration of the compulsory nature of the acquisition.

(iii) After approval of the Notification by competent authority, i.e., Lt. Governor of Delhi, the Notification is published in the Gazette and possession of land is taken over by LAC. Further, the amount of compensation of land acquired is disbursed by LAC directly to the land owners out of the advance given by the company to LAC.

(iv) Any interested person who has not accepted the award may, by application to the District Collector, require that the matter be referred for determination by the Court. In case of the company, the aggrieved parties have also gone to the District Court for enhanced compensation.

2. The querist has stated that on 14th July, 2011, the Hon'ble District Court of Delhi issued order to LAC for enhanced compensation to some land owners in respect of certain private properties acquired by LAC for the company at two areas for construction of Phase I of MRTS project. The relief given by the Hon'ble Court in favour of land owners is given below:

> "In view of the findings qua the issues herein above, the market value of the land of the petitioners in respect of the property bearing ... Delhi which was acquired through the notification No. F.7(26)/2000/L&B/LA/13537 dated 15.12.2000 U/s. 4 of the LA Act, is fixed at Rs. 28,351/- per sq. meter, which the petitioners shall be entitled to claim compensation as per their respective shares holding as mentioned in the Statement under Section 19 of LA Act on which 30% Solatium shall be admissible to the petitioners in terms of Section 23 of Land Acquisition Act. The petitioner shall also be entitled to have compensation in lieu of the 41 big and 9 small trees on the land belonging to the present claimant as per the claim given by LAC at the rate of Rs. 500/- per small tree and Rs. 1,000/- per big tree. As the acquisition was more or less is compulsory in nature, therefore, the petitioners are entitled to the interest at the rate of 9% for the first year from the date of dispossession and at the rate of 15% on the difference

between the enhanced compensation awarded by this Court and the compensation awarded by the LAC for the subsequent period till the payment is made to the petitioners. The petitioners are further entitled to the interest on the Solatium/additional amount in terms of the judgment of Hon'ble Supreme Court of India in Sunder Versus UOI DLT (2001) SC 569. Reference is answered accordingly."

3. In view of the order given by the Hon'ble District Court, the LAC advised the company to deposit a sum of Rs. 17,518.10 lakh during the financial year 2011-12 to pay enhanced land compensation as per the details given below:

Details of enhanced land compensation

The payments made by the company during the financial year 2011-12 to LAC as per the order of Hon'ble District Court were as under:

(Rs. in lakh)

Sr. No.	**Particulars**	**Land Pieces owned by the company**		**Land Pieces sold by the company**	**Total Amount**
		Land at place 'X'	**Land at place 'Y'**		
1.	Enhanced compensation by Court	1,609.73	390.35	3,062.65	5,062.73
2.	12% p.a. additional amount from the date of publication of notification to the date of taking possession	104.71	68.02	199.22	371.95
3.	30% Solatium on (1) above	482.92	117.10	918.79	1,518.81
4.	9% interest on (1) above	197.76	51.80	376.26	625.82
5.	15% interest on (1) above	3,113.03	902.95	5,922.81	9,938.79
	Total Amount	**5,508.15**	**1,530.22**	**10,479.73**	**17,518.10**

The company has deposited Rs. 17,518.10 lakh during the financial year 2011-12 with LAC.

4. The accounting policies, accounting treatment and disclosures given by the company are given below:

Accounting policies regarding land

Accounting policies of ……(name of the company) regarding land cover two facets of its operation – land utilised for creation of its own assets viz. construction of stations etc. and land utilised for revenue activity of property department for selling to a developer. Both the accounting policies consistently being followed in the company are reproduced below:

Accounting policies for capitalisation of land

The accounting policies of the company for capitalisation of land pieces are given below:

"3.1 Amount received directly by the Land and Building Department, Government of National Capital Territory of Delhi (GNCTD), from Government of India (GOI) and GNCTD for buying land for the company as part of interest-free Subordinate Loan for Land sanctioned to the company, is treated as interest-free subordinate loan for land. The disbursement therefrom through the Land Acquisition Collector directly to the land owners for the said purpose is adjusted as land cost and the balance shown as advance with Land and Building Department.

3.2 Amounts received directly by the company from GOI and GNCTD for the above stated purpose are also treated as interest free subordinate loan for land and included in the land cost to the extent of the amount spent for the purpose.

3.3 Payments made/adjusted provisionally towards cost or compensation related to the land including lease-hold land in possession, are treated as cost of the land or lease-hold land.

3.4 Payment made towards land acquired on temporary basis is amortised over the possession period of the land.

3.5 Compensation, replacement etc., relating to the cost of rehabilitation of Project Affected Persons (PAPs) are booked to Capital Work in Progress (CWIP) and on completion is added to the cost of related assets.

3.6 Land is valued on pro-rata basis with reference to the award given by Land Acquisition Collector wherever transfer value of land is not indicated."

Accounting Treatment

In terms of Accounting Policy 3.3, the company has capitalised Rs.7,038.37 lakh (Rs. 5,508.15 lakh + Rs. 1,530.22 lakh) as cost of land during the financial year 2011-12.

Accounting policies for revenue recognition in case of property development

The accounting policies of the company for revenue recognition in case of sale of land pieces are given below:

"10.4 Income from property development/ rental income in respect of land is recognised in accordance with terms and conditions of the contract with licensee/ lessee/ concessionaire etc.

10.5 Income from lease of land for property development pursuant to lease agreement for 60 years and above is recognised as sale on handing over of land to developer since it transfers substantially risks and rewards incidental to ownership of land."

Accounting Treatment

During the financial year 2011-12, the company has charged Rs.10,479.73 lakh as revenue expenses towards enhanced compensation in respect of land parcels sold to a developer in 2008-09 and the sale proceeds were considered as income of that year.

Accounting Disclosure

The company has also disclosed the facts vide Note No. 30, Sr. No. 14, in the Notes on financial statements for the financial year 2011-12, which is reproduced below:

"14. Hon'ble District Court vide order dated 14.7.2011 has directed ……(name of the company) to pay enhanced compensation of Rs.17,518.10 lakh to some Land Owners. The company has deposited the aforesaid amount with LAC (North)/Secretary Land & Building with a request to file an appeal against the order of

Hon'ble District Court. As per established accounting practices and prudent accounting measures, the company has capitalised a sum of Rs.7,038.37 lakh in respect of land portion owned by the company and balance Rs.10,479.73 lakh has been charged to revenue for the land piece which has been sold during the year 2008-09 and sale proceeds considered as income of that year."

5. On the above accounting treatment, Resident Audit Party of C&AG has issued Half Margin which is reproduced below:

"As per Query No. 28 in the Compendium of Opinions – Volume XXV, the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), interest on enhanced compensation of land as decided by the Competent Land Authority is not directly attributable to bringing the assets to its working condition for its intended use. Accordingly, these interest payments should not be capitalised but recognised in the profit and loss account for the year in which these are incurred. However, the company has paid Rs. 175.18 crore as enhanced land compensation; out of this Rs.55.08 crore including interest proportionately amounting to Rs.33.12 crore (55.08 x total interest/ total compensation i.e., 55.08 x 104.90/175.18) has been capitalised in the books of account during the year inconsistent with this opinion.

This has resulted into understatement of revenue expenditure relating to land and overstatement of capital expenditure on land to the extent of Rs.33.12 crore."

6. Against the Half Margin, the reply given by the company is reproduced below:

"Hon'ble District Court vide letter dated 14th July, 2011 directed ……(name of the company) to pay enhanced compensation to some land owners. Accordingly, company has deposited Rs.175.18 crore with the Secretary, Land and Building Department. As per accounting practice and prudent accounting measures, the company has capitalised a sum of Rs.70.38 crore in respect of land portion owned by the company and balance of Rs.104.80 crore has been charged to revenue for the land piece which has been sold during the year 2008-09 in which sale proceeds were considered as income.

The accounting treatment for the above enhanced land compensation is also in line with the opinion of the Expert Advisory Committee of the ICAI dated 10.10.2011[2]. As per paragraph 13 of the said opinion, the Committee mentioned that interest paid for acquisition of land is only a reference point for determination of final sale consideration of land and does not automatically lead to an inference that the amount so computed is of the nature of interest.

... (name of the company) has paid total enhanced compensation in line with the order of the District Court and recognised the payment of interest as part of cost of land in its books of account.

Hence, the accounting treatment towards interest payment given in the books of account is in line with the opinion of the Expert Advisory Committee of the ICAI dated 10.10.2011.

In view of the above, Audit is requested to drop the Half Margin."

7. During discussion in the office of Member, Audit Board, the company has given assurance to the Principal Director (Commercial Audit), Member Audit Board-I, Delhi that the whole issue will be referred to the Institute of Chartered Accountants of India for its expert opinion referring to the opinions mentioned in paragraphs 5 and 6 above.

8. The querist has given the following arguments for the company's accounting treatment of enhanced land compensation:

(i) The accounting treatment is based on the principle of 'Substance over Form' as per paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', which is reproduced below:

"*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."

(ii) Paragraph 35 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, reads as below:

[2] Published in 'The Chartered Accountant' Journal, April 2012 issue at pp 1584-1587 and included in 'Compendium of Opinions', Volume XXXI as query no.15.

"*Substance over Form*

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. ..."

(iii) The issue is also given cognizance in paragraph 11 of the opinion of the Expert Advisory Committee of the ICAI dated 10.10.2011, in which the Expert Advisory Committee mentioned that the transactions and events should be recorded in accordance with their substance and economic reality rather than legal form.

(iv) Further, paragraph 13 of the opinion mentioned in (iii) above, inter alia, reads as, "...The Committee is of the view that the payments determined on the basis of SBI PLR cannot be treated as 'borrowing costs' as neither the company has borrowed any funds from SPT on which the borrowing costs may be said to have incurred nor it is payment for any delays on the part of the company. In fact, such delay has occurred on the part of the Government for reaching the final decision for transfer of land. The Committee notes that it is based on the order of the Government that assets are being transferred from one entity to another at the amounts specified in the Order. Considering the principle of 'Substance over Form', as discussed in paragraph 11 above, the Committee is of the view that in the extant case, the reference by the Government to a rate of interest is only as a reference point for determination of final sale consideration of the land and does not automatically lead to an inference that the amount so computed is of the nature of interest. In substance, the company is paying the total amount as a consideration to obtain the title to land..."

(v) The rationale of opinion mentioned in (iii) above is relevant in the instant case as well. In the case of the company, initially the award has been given by LAC which is enhanced by Hon'ble District Court. In such cases, the rate of interest is only a reference point for determination of final sale consideration of the land and does not automatically lead to an inference that the amount so computed is of the nature of interest. In the case of the company, the total amount payable has been decided by another constitutional judicial authority, i.e., District Court instead of the Government. In the case mentioned in (iii) above as well as in this case, no borrowing cost is involved. Also, opinion given on 10.10.2011 is the latest opinion of the Expert Advisory Committee in this respect and, thus, has the merit of overriding any earlier opinion. Therefore, the company has capitalised the amount of interest paid on enhanced compensation for land in respect of land capitalised in the accounts.

9. The querist has separately given the following points in support of the accounting treatment adopted by the company:

(i) Ministry of Urban Development (MoUD) vide letter N0.K-14011/4/2009-MRTS dated 26th September, 2011 gave investment approval of the Union Cabinet for MRTS Project. In this letter, vide Item No. 111 at page 2, it is categorically mentioned about the financing of land which is reproduced below :-

"The land belonging to various Ministries/ Departments as well as autonomous/statutory bodies/agencies of the Govt. of India (GOI)/GNCTD, which is required for the project, will be taken over by GOI/GNCTD at inter-departmental transfer rates notified by the MoUD, while the Railway land required will be made available on lease rates based on the commercial market prices applicable for that area, as fixed by Land and Development Office of MoUD, in case the railway land so given is commercially exploited /proposed to be exploited by ….(name of the company). This will be applicable for only that part of Railway land commercially exploited /proposed to be exploited by ….(name of the company). In case the Railway Land given to ….(name of the company) is not used/proposed to be used for commercial exploitation, the land rate applicable for the surrounding land based on the existing use will be considered for working out the lease charges. *The total cost of the land to be transferred to ….(name of the company) will be funded by the GO1 and GNCTD in equal proportions in the form of interest-free "subordinate debt" to ….(name of the company). The land so taken over/acquired* *for the project would be made over to the ….(name of the company)* on 99 years' lease at a nominal rent of Rs.11 per annum, treating the actual cost of acquisition as "premium" to be recovered as interest-free "subordinate debt" during the years 21 -25 (i.e., after the senior debt has been fully repaid by ….(name of the company))." (Emphasis supplied by the querist.)

(ii) As per the above mandate, land required for the project will be acquired by various Government agencies as mentioned above and handed over to the company and total cost of the land so taken over/acquired for the project will be funded by the GOI and GNCTD in equal proportions.

(iii) Further, it is submitted that initially, to start the project within stipulated target time, LAC acquires land and hands over the same to the company as per the procedure explained in paragraph 1 above. All the elements mentioned in that paragraph are considered initially to compute suitable compensation to the land owners at least at initial stage. However, the aggrieved land owners always have a right to approach the Hon'ble District Court for enhanced compensation. The basic idea of all such elements is to bring the value of land equivalent to its market value as on the date of possession of the land which also includes compensation for late settlement of the enhanced compensation.

(iv) For the company, compensation paid at initial stage together with any additional payment made subsequently is treated as cost of land in the books. Moreover, Hon'ble District Court issued orders on Union of India through LAC and LAC, in turn, raised demand from the company for payment of enhanced compensation. The company, in turn, raised demand from the respective Government for financial assistance in line with the mandate that the total cost of land transferred to the company will be funded by the Government of India and GNCTD in equal proportion. Hence, the total compensation paid including interest is treated as total cost of land.

10. The querist has separately clarified the following:

(i) Phase I of the MRTS project was completed on 11th November, 2006.

(ii) Land was acquired by LAC for the MRTS project. LAC has been raising demand from the company as and when the land is acquired. On the basis of payment to LAC and after getting details of land, the company is capitalising the amount in the books as 'Land'. There is no system of providing liability towards probability of enhancement in land compensation and interest thereon in the books.

B. Query

11. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the company's accounting treatment to capitalise interest as mentioned in Sl. No. (4) and (5) of the table given in paragraph 3 above towards enhanced compensation in respect of land pieces owned by the company as per the order of Court is correct in terms of provisions of Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and as per the Expert Advisory Committee's opinion issued on 10.10.2011.

(ii) If not, what is the alternative treatment of interest paid on enhanced land compensation.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to accounting treatment of interest on enhanced land compensation. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting treatment of enhanced compensation and additional payments as mentioned in Sl. No. (1), (2) and (3) of the table given in paragraph 3 above, accounting policies for capitalisation of land and revenue recognition in case of property development or lease of land, accounting for cost of rehabilitation, propriety of valuing land on pro-rata basis, propriety of not providing for any liability for the probability of enhancement in land compensation and interest thereon, etc. The Committee has further not examined the issue from the angle of 'borrowing costs' as per AS 16 as the querist himself has contended in paragraph 8 (v) above that no borrowing cost is involved in the extant case. The Committee's opinion expressed hereinafter is purely from accounting point of view and not from the angle of

interpretation of various legal enactments, such as, the Land Acquisition Act, 1894 (hereinafter referred to as 'the Act'). The Committee also wishes to point out that though the expression 'enhanced compensation' normally means original compensation plus increase in compensation, for the sake of convenience, the Committee uses the expression 'enhanced compensation' as the difference between final compensation awarded by the Court (excluding 9% interest/15% interest) and the original compensation awarded by the Land Acquisition Collector.

13. At the outset, the Committee notes the querist's arguments with regard to earlier opinions of EAC, referred to in paragraphs 5 and 6 above. The Committee is of the view that the two opinions mentioned by the querist in paragraphs 5 and 6 above deal with two different situations which is explained as below:

(i) In the case mentioned in paragraph 5 above, initially the award for acquisition of land was given by the LAC which was enhanced by the Court. Further, the Court also directed to pay interest @ 9%/15% on enhanced compensation for the period from the date of award/dispossession till the date of payment, though determined at a later date. Thus, the facts of the case mentioned in paragraph 5 above were similar to the facts given in the present case.

(ii) In the case mentioned in paragraph 6 above, although the company in question had been handed over the possession of land by the transferor entity who had originally incurred certain costs for acquisition of land but at that time it was not clear that which party will own that land, viz., the transferor entity or the company to whom the possession of the land was handed over (viz., the company in question). After few years, the Government decided that the land would be owned by the company in question and also determined the sale consideration by adding an amount equivalent to the interest at the rate of SBI PLR to the cost incurred by the transferor entity. Thus, the Committee had opined that SBI PLR was used as a benchmark to arrive at consideration *for the transfer of land*.

Since the facts are different in the two cases as discussed above, the opinion expressed on the case mentioned in paragraph 5 above differs from the opinion on the case mentioned in paragraph 6 above. As such, the

Committee does not agree with the querist's view in paragraph 8(v) above that the opinion expressed on the case mentioned in paragraph 6 above overrides the opinion expressed on the case mentioned in paragraph 5 above. However, though the facts of the case referred to in paragraph 5 above are similar to facts of the extant case, the Committee notes that the earlier opinion referred in paragraph 5 above had apparently focused on the delay in the payment of compensation by the company rather than on delay in the process of arriving at the final decision.

14. The Committee notes that section 18 of the 'Act' provides for reference to the Court by the Collector, at the instance of any interested person who has not accepted the award, for the determination by the Court of certain matters, which include the amount of the compensation. Sections 23 and 24 of the 'Act' specify the matters to be considered and maters to be neglected respectively by the Court in determining the amount of compensation to be awarded. As per section 25 of the 'Act', the amount of compensation awarded by the Court shall not be less than the amount awarded by the Collector under section 11. Section 28 of the 'Act' reads as below:

> **"28. Collector may be directed to pay interest on excess compensation:** If the sum which, in the opinion of the Court, the Collector ought to have awarded as compensation is in excess of the sum which the Collector did award as compensation, the award of the Court may direct that the Collector shall pay interest on such excess at the rate of nine per centum per annum from the date on which he took possession of the land to the date of payment of such excess into Court:
>
> **Provided** that the award of the Court may also direct that where such excess or any part thereof is paid into Court after the date of expiry of a period of one year from the date on which possession is taken, interest at the rate of fifteen per centum per annum shall be payable from the date of expiry of the said period of one year on the amount of such excess or part thereof which has not been paid into Court before the date of such expiry."

15. From the above, the Committee notes that since the award notified by the Land Acquisition Collector (LAC) *may* be enhanced by the Court in case reference is made to the Court, the compensation towards the acquisition of the land becomes final only on the date of the final award by the Court. The Committee further notes that the Land Acquisition Act itself recognises that

the amount awarded by the LAC may not be final or acceptable to the land owners and accordingly, considering the long process of determination of final value of land, it envisages for the payment of various elements apart from the enhanced compensation such as interest @ 9% and 15% from the date of possession till the payment into the Court. The Committee also notes that till the final award of the Court, the quantum of interest to be paid cannot be determined as even the principal amount on which such interest payments are to be made is not determined and therefore, such interest is the result of the process of acquisition of land as per the Act. Accordingly, the Committee is of the view that 'interest' in the extant case is a part of the process for determination of purchase price of land and, in substance, should be considered as a component of purchase/ acquisition price only, to the extent the interest payments relate to the period of final determination of the price by the Court. Any interest beyond such period, viz., after the date of final award till the date of payment should not be capitalised and charged to the statement of profit and loss, since, interest after the date of Court's award is to compensate for delay in the payment of the enhanced compensation as finally awarded by the Court.

D. Opinion

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

(i) The interest payments referred to at Sl. No. 4 and 5 of the table in paragraph 3 above should be included as cost of the land to the extent they relate to the period upto the date of the Court's award. Any interest beyond that period should be treated as revenue expenditure and charged to the statement of profit and loss for the year of incurrence.

(ii) See (i) above.

Query No. 2

Subject: Determination of discount rate for calculating value in use for impairment of assets as per AS 28.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company'), a public sector enterprise, is the largest shipping company in India owning and operating about 80 ships in India as well as in international waters. The company owns fleet of ships consisting of various types and of different sizes to cater to diverse business requirements. For the company, every ship is a cash generating unit (CGU). The operating life of a ship owned by the company is normally 25 years.

2. The querist has stated that as required by Accounting Standard (AS) 28, 'Impairment of Assets', valuation of each ship is carried out through an international firm to determine its selling price as on 31st March every year. In case the selling price is less than the written down value (WDV) of a particular ship, net cash inflows for the remaining life of that ship are estimated keeping in mind cyclical nature of the industry. The net cash inflows for the first five years are based on the charter hire rates projected by the internationally acknowledged organisation. For the subsequent years of balance life of the vessel, such projections are not available and charter hire rates are estimated by the management keeping in view the cyclical nature of shipping industry. These net cash inflows are then discounted @ Weighted Average Cost of Capital (WACC) of the company for that particular year using Capital Asset Pricing Model (CAPM) to arrive at Net Present Value (NPV) of future cash inflows. In case the NPV of future inflows is less than the WDV of a ship, provision is made for impairment of that ship. The company has been following this practice of ascertaining impairment loss, if any, consistently for the last few years after AS 28 was made mandatory for the companies. The statutory auditors every year carry out the audit of the company's impairment exercise as mentioned above to confirm that same is as per the provisions of AS 28.

3. The company followed the same procedure for determining impairment loss in the financial year 2012-13 also. The issue of how the company carried out impairment exercise was discussed in detail with the statutory

[1] Opinion finalised by the Committee on 11.4.2014.

auditors. During discussions, the statutory auditors accepted the company's estimates of future cash flows and working of WACC using Capital Asset Pricing Model. However, they pointed out that the company has not complied with paragraphs 50 and 51 of AS 28 pertaining to the discounting rate applied to the future cash flows. The observation of the statutory auditor was as follows:

> *"On the review of the Report on the implementation of AS 28 received today evening we state as under:*
>
> > *On our understanding of AS 28 and as per the statement given by the management expert on discount rate (on page 6 of the report) which states that "For impairment of an individual asset or portfolio of assets, the discount rate is the rate the company would pay in a current market transaction to borrow money to buy that specific asset or portfolio."*
>
> *Also vide paragraph 49, AS 28 states "The purpose is to estimate, as far as possible, a market assessment of:*
>
> > *(a) the time value of money for the periods until the end of the asset's useful life; and*
> >
> > *(b) the risks that the future cash flows will differ in amount or timing from estimates.*
>
> *The Management expert has stated that "As informed, the rate was 6%. Hence a rate of 6% was considered ..." which is WACC of the Corporation.*
>
> *Further, paragraphs 50 and 51 of AS 28 state as follows:*
>
> *"50. As a starting point, the enterprise may take into account the following rates:*
>
> > *(a) the enterprise's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;*
> >
> > *(b) the enterprise's incremental borrowing rate; and*
> >
> > *(c) other market borrowing rates.*

51. These rates are adjusted:

(a) to reflect the way that the market would assess the specific risks associated with the projected cash flows; and

(b) to exclude risks that are not relevant to the projected cash flows.

…"

In view of the above requirement of AS 28, kindly reconsider the discount rate which would be justifiable and acceptable to all the interested parties." (Emphasis supplied by the querist.)

4. On the auditors' observation, the management conveyed to them that it has an option of taking WACC as discounting rate as per paragraph 50 of AS 28 and also explained the reasons why the discounting rate, viz., WACC does not need further adjustment for various risks as stated in paragraph 51 of AS 28. The management also submitted to them a note dated 25.05.2013 on how the company has complied with AS 28. Despite this, the statutory auditors qualified their report stating that *"The company has not complied with the requirements of AS 28 - Impairment of Assets, issued by the Institute of Chartered Accountants of India (ICAI) the effect of which is unascertainable".* The statutory auditors have not provided clear description and specific details as to which paragraphs of AS 28 have not been complied with. It may appear to a reader that the company has not carried out impairment exercise at all. (Emphasis supplied by the querist.)

5. In this connection, the querist has drawn the attention of the Committee to paragraphs 50 and 51 of AS 28. As per paragraph 50 of AS 28, the enterprise can take into account enterprise's WACC determined using techniques, such as, CAPM. The company has consistently done the same during the previous years. Further, as per paragraph 51 of AS 28, the above rate is to be adjusted:

(a) to reflect the way that market would assess the specific risks associated with the projected cash flows; and

(b) to exclude risks that are not relevant to the projected cash flows.

Consideration is also given to risks such as country risk, currency risk, price risk and cash flow risk.

6. The querist has also stated that the company has already taken into account aforesaid risks while projecting future cash flows and finds no reason to make adjustments to WACC as stated below:

(A) *Country risk:* Country risk refers to the risk of investing in a country, dependent on changes in the business environment that may adversely affect operating profits or the value of assets in a specific country. For example, financial factors such as currency controls, devaluation or regulatory changes, or stability factors such as mass riots, civil war and other potential events contribute to companies' operational risks. Ships are moving assets. Freight/ charter hire rates are determined by international supply and demand. India is a democratic country and has liberal economic policies. India's rating by international credit rating agencies has been certified as 'stable'. The company does not foresee any development which affects stability of India, e.g. mass riots, civil war, etc. Since there is no country risk involved, no adjustment is felt necessary in WACC.

(*B)* *Currency Risk:* A form of risk that arises from the change in price of one currency against another. The greater part of the company's revenue is booked and earned in USD as per standard shipping practice. The foreign currency earned is deposited in various bank accounts in foreign countries. This takes care of the company's expenditure in foreign currencies and creates a natural hedge against possible currency fluctuations. In view of this, no currency risk is envisaged in future cash flows and therefore, no adjustment is required in WACC.

(*C)* *Price Risk:* There is a risk that freight/ charter hire rates may go down in future. Shipping is a cyclical industry and freight/ charter hire rates depend upon demand for and supply of ships available in the market. The rates go up and down as and when tonnage available in the market goes down or up. Keeping this factor in mind, projected cash flows were adjusted, i.e., increased in some years and reduced in some years. The operating life of a ship is long, i.e., 25 years. Moreover, the company owns diversified fleet of bulk carriers, tankers, offshore supply vessels, chemical carriers, etc. which operate in different segments of markets (Indian as well as International) and this spreads the price risk as all segments may not experience price fluctuation at the same time or of the same level. Thus, it is not felt that further adjustment is necessary in discounting rate as the price risk is already covered in projected cash flows.

(*D)* *Cash flow risk:* It is the risk that a company's available cash will not be sufficient to meet its financial obligations. The company's operations in the past two decades have always made substantial cash profits and never faced any cash flow problem. Despite operational losses in the years 2011-12 and 2012-13, the company generated enough cash to meet its financial obligations. The Internal Rate of Return (IRR) of ships scrapped during last 3 years has been between 9 to 14 percent substantiating the fact that historically, the actual net cash inflows during ships' lifetime are much more than the cost of the vessel. With the shipping industry, which is dependent on international economy, expected to turn around in coming 1-2 years, the company expects that the cash flows will improve significantly in future. Since no cash flow risk is foreseen, no adjustment is felt necessary in discounting rate.

7. The querist has further referred to paragraph 47 of AS 28 which, inter alia, states that ***"The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted."*** As explained above, the company has ensured to adjust future cash flow estimates to reflect possible risks, viz., currency and price. It is for this reason that discounting rate adopted by the company, viz., WACC for the year 2012-13 does not need any adjustment to reflect these risks again. With the above clarification, the company feels that it has complied with the provisions of AS 28 in its letter and spirit. Since the statutory auditors have given a serious qualification on the accounts of the company on non-compliance of an important Accounting Standard like AS 28 without providing specific reason, the management considers it a very serious issue particularly when the same auditors audited the earlier two years' accounts and did not qualify even though the same methodology was adopted for calculation.

B. Query

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

(i) Whether the company has complied with paragraphs 50 and 51 of AS 28 by adopting WACC as discount rate.

(ii) Whether statutory auditors' qualification, "the company has not complied with the requirements of AS 28 - Impairment of Assets, issued by the ICAI the effect of which is unascertainable" without providing clear description and specific details as to which clauses of AS 28 have not been complied with is appropriate.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to determination of discount rate to be used for determining value in use as per AS 28. The Committee has, therefore, considered only this issue raised by the querist in paragraph 8 above and has not examined any other issues that may be contained in the Facts of the Case such as, identification of CGU, determination of cash flows, correctness in determination of WACC, whether there existed indicators for impairment as per AS 28, etc. The Committee also presumes from the Facts of the Case that the asset's value in use materially exceeds its net selling price.

10. The Committee notes that in the extant case, WACC has been calculated by the company using CAPM. The Committee also notes that ordinarily WACC is calculated by assigning weights to the rate of return on debt capital and rate of return on equity capital. Under CAPM, return on equity is an estimate of an equity investor's required rate of return for a given risk level associated with an investment and the same is arrived at by considering the risk free rate of return and market risk premium adjusted by systematic risk. As regards determination of discount rate to be applied to future cash flows for calculating value in use, the Committee notes the following paragraphs of Accounting Standard (AS) 28 'Impairment of Assets', notified under the Companies (Accounting Standards) Rules, 2006:

"47. The discount rate(s) should be a pre tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

48. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate

cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset. This rate is estimated from the rate implicit transactions for similar assets or from the weighted average cost of capital of a listed enterprise that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review.

49. When an asset-specific rate is not directly available from the market, an enterprise uses other bases to estimate the discount rate. The purpose is to estimate, as far as possible, a market assessment of:

(a) the time value of money for the periods until the end of the asset's useful life; and

(b) the risks that the future cash flows will differ in amount or timing from estimates.

50. As a starting point, the enterprise may take into account the following rates:

(a) the enterprise's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;

(b) the enterprise's incremental borrowing rate; and

(c) other market borrowing rates.

51. These rates are adjusted:

(a) to reflect the way that the market would assess the specific risks associated with the projected cash flows; and

(b) to exclude risks that are not relevant to the projected cash flows.

Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk.

52. To avoid double counting, the discount rate does not reflect risks for which future cash flow estimates have been adjusted.

53. The discount rate is independent of the enterprise's capital structure and the way the enterprise financed the purchase of the

> asset because the future cash flows expected to arise from an asset do not depend on the way in which the enterprise financed the purchase of the asset."

From the above, the Committee notes that the discount rate to be applied should be an estimate of the rate of return that the market would expect on an equally risky investment. This rate is estimated from the rate implicit in current market transactions for similar assets or from WACC of a listed enterprise that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review as per paragraph 48 of AS 28. Thus, the Committee is of the view that determination of discount rate is a matter of estimation and judgement considering various factors related to the assessment of the time value of money and risks specific to the asset under review. In the absence of the aforesaid rate, the company may use its WACC as the discount rate, as adjusted to reflect the way that the market would assess the specific risks associated with the projected cash flows and to exclude risks that are not relevant to the projected cash flows, as per the requirements of paragraph 51 of AS 28. The Committee is further of the view that while using the company's own WACC as the discount rate, there are certain considerations including the following that should also be kept in mind:

(i) WACC is a post-tax rate and AS 28 requires to use a pre-tax rate for determining value in use. Accordingly, it should be adjusted to a pre-tax basis.

(ii) Company's own WACC is based on its capital structure which may be different from the typical capital structure of market participants.

(iii) Discount rate as per AS 28 should reflect the risks specific to the asset and not the risks relating to the entity as a whole.

As regards adjustment of discount rate for various risks such as, currency risk, price risk, country risk, cash flow risks, etc., the Committee notes that as per the provisions of AS 28, the effect of the variability of cash flows can be reflected in either of the two ways: (i) the expected value of cash flows can be adjusted for risk and the adjusted figure (the certainty equivalent) discounted at a risk-free rate, or (ii) the expected value of cash flows can be discounted at a risk-adjusted rate. Thus, the discount rate should not reflect risks for which future cash flow estimates have been adjusted.

11. The Committee notes from the Facts of the Case that the querist has also analysed various risk factors that have been considered while determining projected cash flows (refer paragraph 6 above). At the outset, the Committee wishes to point out that since country risk, currency risk, price risk and cash flow risks have not been explicitly explained in AS 28, there may be various other factors related to these risks apart from what has been explained by the querist in paragraph 6 above. Further, for evaluation of various risks while determining future cash flows, various factors need to be considered in the view of the Committee. For example, the querist has stated that the greater part of the company's revenue is booked and earned in USD, whereas the expenditure is incurred in various foreign currencies in which the company is operating and accordingly, it is stated that this creates a natural hedge against possible currency fluctuations and in view of this, no currency risk is envisaged. The Committee is of the view that just due to earning a greater part of the company's revenue in USD does not necessarily create a natural hedge against foreign currency fluctuations for the company which is operating in various countries and also earning and incurring expenditure in the currencies of those countries. Accordingly, the risk from such possible currency fluctuations also needs adjustment in the future cash flows or the discount rate, if material. Similarly, while evaluating country risk, it is not only the risk of the country in which the company is domiciled but also the risks prevailing in the countries in which the company operates should be considered.

12. With regard to the auditors' qualification without providing clear description and specific details, the Committee notes paragraphs 16 and 17 of Standard on Auditing (SA) 705, 'Modifications to the Opinion in the Independent Auditior's Report', which is stated below:

> "16. When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by the SA 700 (Revised), include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "*Basis for Qualified Opinion", "Basis for Adverse Opinion",* or "*Basis for Disclaimer of Opinion",* as appropriate. ...
>
> 17. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including

quantitative disclosures), the auditor shall include in the basis for modification paragraph a description and quantification of thefinancial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in the basis for modification paragraph. ..."

From the above, the Committee is of the view that the auditor should include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification (qualification).

D. Opinion

13. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 8 above:

(i) Determination of discount rate is a matter of estimation and judgement considering various factors related to the assessment of the time value of money and risks specific to the asset under review. Therefore, the Committee is of the opinion that if the company has taken into account all the factors related to determination of discount rate as discussed in paragraphs 10 and 11 above, the company would be correct.

(ii) With regard to the auditor's qualification without providing clear description and specific details, the Committee is of the view that the auditor should include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification (qualification), in accordance with paragraphs 16 and 17 of SA 705.

Query No. 3

Subject: Accounting treatment of interest on enhanced land compensation. [1]

A. Facts of the Case

1. A Government of India company (hereinafter referred to as the 'company') is engaged in the construction and operation of thermal power plants in the country. The company has also diversified into hydro power generation, solar power generation, coal mining and oil & gas exploration, etc. The company is registered under the Companies Act, 1956. The company is also governed by the provisions of the Electricity Act, 2003 in respect of generation of electricity business. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956. The company is also listed with the Bombay Stock Exchange and National Stock Exchange.

2. The company is functioning in a regulated environment. The tariff for sale of energy from its stations is determined by the Central Electricity Regulatory Commission (CERC). Tariff for sale of energy comprises of two components, namely, annual capacity (fixed) charges and energy (variable) charges. The capacity charges mainly consist of interest on loan capital, depreciation, return on equity, operation and maintenance expenses, interest on working capital etc. and to a large extent depend on the admitted capital cost of a generating station. The energy charges consist of primary fuel cost as stipulated in the tariff regulations.

3. The querist has provided the background of the issue raised as below:

   (a) Land Acquisition Act, 1894 (hereinafter referred to as 'the Act') is applicable for acquisition of private land through the State Government for the projects of the company. As per the said Act, the compensation payable to the person whose land has been acquired (land loser) is determined by the Land Acquisition Officer (LAO) in the first instance. The compensation for the land acquired under the Act shall comprise in addition to the market value of land, an amount calculated at the rate of 12% per annum on the market value for the period commencing on and from the date of notification to the date of award or date of taking possession, whichever is earlier and further amount of 30% of the market

[1] Opinion finalised by the Committee on 11.4.2014.

value as solatium. The amount determined by the LAO is paid by the company to the land losers through the State Government. In case the land loser is aggrieved as regards the amount of the compensation or other matters, the Collector may, on an application by the land loser, refer the matter to the Court for determination of the compensation.

(b) Where the Court enhances the compensation, interest on the enhanced amount of compensation at the rate of 9% from the date of possession to the date of payment into Court for the first year and at the rate of 15% for the period beyond one year is payable as per section 28 of the Act.

(c) On an earlier reference to the Expert Advisory Committee (EAC) by an oil company for which opinion was finalised on February 25, 2006 (hereinafter referred to as 'oil company case') regarding accounting for interest paid on enhanced land compensation awarded by the courts under the Act, the EAC opined that interest payments (9% and 15%) referred in paragraph (b) above are "in the nature of cost for delay in the payment of enhanced compensation and are not directly attributable to bringing the asset to its working condition for its intended use. These costs also do not generate any future economic benefit. Accordingly, in the view of the Committee, these interest payments should not be capitalised but recognised in the profit and loss account for the year in which these are incurred".

4. *Present accounting practice followed by the company:*

(a) The basic price (market value), 12% p.a. on market value from the date of publication of notification under section 4 of the Act upto the date of award or possession whichever is earlier and solatium, as determined by the LAO in terms of section 23 of the Act are treated as land cost.

(b) Where the land losers approach the Court demanding compensation higher than that awarded by the LAO and if the Court awards higher compensation, keeping in view the principles of conservatism and prudence, liability is provided for the enhanced compensation awarded by the court, including interest if any thereon, irrespective of fact whether the decisions are contested by the company or by the land losers before higher courts.

(c) Interest on the compensation awarded by the Court is recognised in the statement of profit and loss. Interest upto the date of commercial declaration of the first unit of the stage for which land has been acquired is capitalised as 'Expenditure during Construction (EDC)', since during that period the entire project was under construction. Though this interest is not in the nature of borrowing costs, the accounting treatment followed by the company similar to the provisions of paragraph 16 of Accounting Standard (AS) 16, 'Borrowing Costs', which states that *"… borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. …"* (Emphasis supplied by the querist.)

(d) In respect of cases pending before the District Court (appeals against the amounts awarded by the LAO), the financial effect is disclosed as contingent liability after considering the following:

  (i) In case the claims of some of the land losers are disposed off by a Court, the contingent liability in respect of the pending claims is disclosed considering the rate awarded by the Court in respect of cases in the same/adjacent locality.

  (ii) If none of the cases have been decided by the Courts, opinion of the legal counsel dealing with the case is obtained with regard to tenability of the claims made and the amounts likely to be admitted by the Court taking into consideration the rate awarded by the land acquisition officer, decisions of the courts for land acquisition cases in the project vicinity and other relevant factors.

(e) Where interim payments are made as per directions of the Court, interest liability ceases on such payments from the date of payment into the Court, unless otherwise provided in the orders of the Court.

(f) In case a superior Court modifies the award of the lower Court, suitable updation of liability is carried out in the accounts in line with the decision of the superior Court, even though any appeals filed against such decision are pending.

5. The accounting treatment of land followed by the company is explained by way of an example as under:

Land acquired by the company (10 land losers 10 acres each)	= 100 acres
Market value of land awarded by the LAO	= Rs. 100 per acre
Date of publication of Notice u/s 4 of the Act	= 1st January, 2010
Date of possession of land by the company	= 31st March, 2010
Date of award by the LAO	= 31st March, 2010
Date of commercial declaration of first unit of the station	= 31st January, 2012
Amount deposited with LAO for land (calculated as under):	= Rs. 13,300/-
Market value of land	= Rs. 10,000/-
12% on market value upto the date of possession (10,000 X 0.12 X 3/12)	= Rs. 300/-
30% Solatium	= Rs. 3,000/-
	= Rs. 13,300/-

The amount of Rs. 13,300/- is capitalised as cost of land in the books of account.

After accepting the compensation awarded by the LAO, 5 land losers approach the District Court for enhancing the market value of land from Rs. 100 per acre to Rs. 200 per acre on 30th September, 2010 with consequential benefits. Further, the balance 5 land losers also approach Court for enhancing the market value of land from Rs. 100 per acre to Rs. 200 per acre on 31st

December, 2010 with consequential benefits. The District Court after hearing the prayer of first 5 land losers enhances the market value of land from Rs. 100 per acre to Rs. 150 per acre on 30th November, 2012 along-with other entitlements as per the Act. The Court directs the collector to recalculate balance amount payable to the land losers. Such orders along-with the calculations for payments are received by the company from the office of the collector on 31st December, 2012. On 1st January, 2013, the company deposits the balance amount of Rs. 4,497/- with the LAO for payments to the land losers. The calculation of Rs. 4,497 is as under:

Differential market value of land	= Rs. 2,500/-
12% on market value upto the date of possession (2,500 X 0.12 X 3/12)	= Rs. 75/-
30% solatium	= Rs. 750/-
	= Rs. 3,325/-
Interest @ 9 % from 1st April, 2010 to 31st March, 2011 (3,325 X 0.09)	= Rs. 299/-
Interest @15% from 1st April, 2011 to 1st January, 2013) (3,325 X 0.15 X 21/12)	= Rs. 873/-
Total amount deposited with the LAO for 5 land losers	= Rs. 4,497/-

The enhanced compensation of Rs. 3,325/- is capitalised as cost of land. Interest of Rs. 299/- and Rs. 873/- is debited to the statement of profit and loss. Out of this, interest of Rs. 299/- (9% for one year) and Rs. 374/- (15% from 1st April, 2011 to 1st January, 2012 i.e., the date of commercial declaration of the station) is capitalised as EDC since the entire project during this period was under construction.

6. The querist has stated that considering the guidelines given in paragraph 4 (d) above, claims of the land losers have been disclosed as under:

Financial Year 2010-11

Contingent liability of Rs. 14,497/- (differential market value of land with 12% on market value, 30% solatium and 9% interest from 1st April, 2010 to 31st March, 2011, i.e., Rs. 10,000/- (+) Rs. 300/- (+) Rs. 3,000/- (+) Rs. 1,197/-) is disclosed.

Financial Year 2011-12

Contingent liability of Rs. 14,497/- appearing in the accounts as at 31st March, 2011 is updated with 15% interest for the year 2011-12 and the amount of Rs. 16,492/- (i.e., differential market value of land with 12% on market value, 30% solatium, 9% interest for one year and 15% interest from 1st April, 2011 to 31st March, 2012, i.e., Rs. 10,000/- (+) Rs. 300/- (+) Rs. 3,000/- (+) Rs. 1,197/- (+) Rs. 1,995/-) is disclosed.

Financial Year 2012-13

On receipt of the judgment of the District Court on 31st December, 2012, an amount of Rs. 4,497/- is paid to the LAO based on the order of District Court. Contingent liability towards the claims of balance 5 land losers is updated based on the judgment of the Court in similar cases and disclosed at Rs. 4,622, (i.e., differential market value of land awarded by the district court along-with 12% on market value, 30% solatium, 9% interest for one year and 15% interest from 1st April, 2011 to 31st March, 2013, i.e., Rs. 2,500/- (+) Rs. 75/- (+) Rs. 750/- (+) Rs. 299/- (+) Rs. 998/-).

7. *New developments:*

In April 2012, the EAC of the Institute of Chartered Accountants of India (ICAI) pronounced another opinion which was finalised on 10th October, 2011 (hereinafter referred to as 'port trust case') relating to accounting for payments made in respect of land pending execution of conveyance deeds and borrowing costs incurred in respect thereof. The opinion related to the State Port Trust (SPT), entrusted with the construction of a new port by the Government of India (GOI) and subsequently handover it to a company as per the directions of the GOI. In the opinion, the Committee referred to paragraphs 49 (a), 58 and 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI and opined that the company should capitalise the total amount (including the interest) as cost of land as the interest in substance is part of the consideration of land.

8. *Points for Consideration*

The company is of the view that keeping in view the opinion of the EAC in the port trust case, there is a need to review the existing practice of accounting for interest on enhanced land compensation and the entire amount of enhanced compensation together with interest awarded by the Court should be treated as cost of land for the following reasons:

(a) As per paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', "*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.

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". (Emphasis supplied by the querist.)

In the context of the land acquired under the Act, the price is initially determined by the LAO. The Act also has provisions for the land losers to make an application to the collector to refer the matter to the Court for determination of the compensation if they are not satisfied with the award of the LAO. The collector is obligated to make such reference and the Court thereupon determines the compensation taking into account various factors as provided in the Act. The decision of the Court can be challenged before the High Court and thereafter, in the Supreme Court as per the Code of Civil Procedure. Further, the Act also provides that if even in a single case the Court determines enhanced compensation compared to that awarded by the LAO, the other land losers can make an application for re-determination even though they have not previously made an application to the collector for reference to the Court. It is observed that invariably the award of the LAO is challenged and the land losers approach for enhanced compensation on various grounds. While there is a prescribed time for the collector to make an award, there is no such time limit for the Court to determine the compensation. Due to these reasons, the cost of the land acquired does not get finality for a considerable period of time.

It is observed that in many instances, with a view to expedite the project development, possession of the land is handed over to the company pending issuance of award by the LAO on deposit of 80% of the estimated compensation decided by the LAO. The awards are issued by the LAO subsequently following the procedure under the Act. Under the circumstances, the company provisionally capitalises the land in its books as per the best estimate of the cost incurred which is updated from time to time depending upon the developments in each case. Where the awards are challenged before courts, the cost of land is adjusted in the books as and when decisions of the courts are received. The above accounting treatment is similar to adjustment in the cost of assets provisionally capitalised pending final receipt of bills from the suppliers/contractors where upon receipt of final bills, adjustments are made in the asset cost as per the admitted bill amounts. This is also disclosed through accounting policy of the company which states that *"In the case of assets put to use, where final settlement of bills with contractors is yet to be effected, capitalisation is done on provisional basis subject to necessary adjustment in the year of final settlement" (emphasis supplied by the querist).* AS 10 also recognises that 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. The enhanced compensation awarded by the courts in the case of land acquisition together with interest thereon are in the nature of price adjustments subsequent to initial recognition as provided in AS 10 and should be recognised as cost of land.

(b) The compensation for land is determined by the collector or the Court considering various aspects including market value, standing crop, buildings, trees, wells, etc. on the land and any damages to the other property of the land loser. The market value of land is to be increased by 12% per annum for the period commencing on and from the date of publication of the notification under section 4 of the Act to the date of award of the collector or the date of taking possession of the land whichever is earlier. Solatium @ 30% of the market value is also to be paid due to the compulsory acquisition of the land. In cases where the Court enhances the compensation, it may order payment of interest on such excess @ 9% p.a. for the first year and 15% p.a. for the subsequent period till the payment of such excess into Court. It is submitted that all the above elements differ from one another only in the method by which they are computed and are in reality consideration paid for the acquisition of land. Accordingly, they should be treated as cost of land in terms of AS 10 since these payments are directly attributable to the acquisition of land. While AS 10 does not define 'directly attributable', drawing reference to the 'avoidability test' given in AS 16, it can be said that since all the above elements of cost, including interest, could have been avoided only if the company had not made the land acquisition, these are directly attributable costs. It may be appreciated that the competent authority to determine the compensation for the land acquired is the LAO or the Court (including the High Court or Supreme Court, where appeals are made) and until such determination is made by them, the cost is not finally known to the company. The company cannot avoid any such amount as finally determined by the courts and therefore, the same is a directly attributable cost for the land.

(c) As to the element of interest included in the compensation awarded by the Court, it may not be correct to term the same to be 'in the nature of cost for delay in the payment of enhanced compensation' since such interest arises due to the very process of determining the compensation specified in the Act which is inherently a time consuming affair. The amount of interest awarded by the courts does not constitute a penalty. Even assuming these are arising due to delays, such delays cannot be attributed to the company as primarily interest arises due to the time taken by various authorities for determination of the compensation and not due to any delay in payment of the compensation amount by the company. Even in those instances where the company appeals against the enhanced compensation awarded by a Court, the time taken by the higher Court for disposal of the appeal cannot be said to be a delay on the part of the company since the company, as a commercial organisation, is required to take all necessary actions to protect its interests. The company has also a moral obligation to ensure that the electricity tariffs for its customers do not go up on account of enhanced compensation awarded by the courts considered as unreasonable or excessive by it. In many instances the company has also seen that the enhanced compensation awarded by a lower Court has been rejected or significantly reduced by the higher courts.

(d) The views expressed by the EAC in the oil company opinion that the interest costs do not generate any future economic benefit are not substantiated. Land acquired under the Act is freehold land which is a non-depreciable asset with indefinite life. One of the reasons for not depreciating land is that usually land prices appreciate and therefore, there is no diminution in its value to be recognised in the financial statements. Drawing from the principles of Accounting Standard (AS) 28, 'Impairment of Assets', the economic benefit could be in the form of 'value in use' or 'net realisable value'. In any case, the cost of land would form part of the related cash generating unit and would be subjected to impairment testing as per AS 28. Therefore, it may not be fair to automatically conclude that the amounts paid as interest do not yield any future economic benefit.

The argument that there is no future economic benefit is particularly not relevant in the case of the company since tariffs for sale of energy are regulated by the Central Electricity Regulatory Commission (CERC). As per the Tariff Regulations issued by the CERC, the company is allowed to recover the capital cost incurred for generation of power by way of depreciation, interest on borrowed funds and a specified return on equity over the useful life of the asset. Where courts order payment of enhanced compensation for the land acquired, the company is entitled to approach the CERC for revision of the project cost for tariff purposes and the same would be considered by the CERC as per the Tariff Regulations providing 'future economic benefits'.

(e) For the sake of argument, let us assume that the LAO or Court determines the compensation as a lump sum amount without providing break-up for various elements considered. In such case, the entire amount would be treated as cost of land without the need to charge any portion thereof as 'interest' to the statement of profit and loss. The methodology followed by the LAO or Court in determining the amounts payable for the land acquired should not guide the accounting in the books of the company. Applying the principle of substance over form, from the company's perspective the entire amount is a cost for the land acquired.

(f) In the port trust case also, the EAC has been guided by the substance over form principle and has stated that the entire amount paid should be treated as cost of land even though in arriving at the amount payable, an interest element was identified by the Government. While the facts of the port trust case are different from that of the oil company case (which squarely deals with land acquisition under the Act), certain important similarities are relevant. Firstly, the port company, from the beginning, obtained possession of the land though the price thereof was not fixed. Secondly, the SPT and the port company, undertook to be bound by the decision of the GOI on the cost of the land. In the case of land acquired by the company under the Land Acquisition Act, also (i) the possession of land is available pending final determination of compensation amount and (ii) the compensation amount is determined by an independent agency which is the LAO or the Court. The EAC in its opinion in the port trust case has been guided by the 'substance over form' principle and observed that "for accounting purposes, the transactions and events should be recorded in accordance with their substance and economic reality rather than legal form". Referring to paragraph 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI which states that "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"* , the EAC noted that "until and unless the Government issued a final order that the title to the land can be obtained by the company alongwith determining the final payments that the company would make to SPT, *the cost of land cannot be measured reliably".* Accordingly, in accordance with paragraph 88 of the Framework, as reproduced above, the Committee was of the view that "*although in the extant case, the land may meet the criteria of an asset for the company, but before the financial year 2007-08 when the said order was issued by the Government of India, it cannot be recognised in the books of the company"*. The EAC also opined that even though the compensation required to be paid by the port company included interest element, the same is not a borrowing cost nor it is payment for any delays on the part of the company. The EAC was of the view that "… *rate of interest is only as a reference point for determination of final sale consideration of the land and does not automatically lead to an inference that the amount so computed is of the nature of interest. In substance, the company is paying the total amount as a consideration to obtain the title to land*". It may be seen that the EAC opinion stresses on the fact that pending the Government order the cost of land could not be measured reliably. Drawing the same analogy, in the case of land acquired by the company, the acquisition is done as per the provisions of the Act where the LAO or the courts are the competent authorities to determine the compensation. The modus operandi for such determination is not relevant as in substance, all amounts paid by the company are consideration to obtain the title to land. As opposed to the port trust case, where perhaps the compensation amount was not disputed, in the case of land acquired by the company, the awards of the LAO are more often than not disputed before courts. Pending final determination of the compensation amount by the appropriate Court, the company provisionally recognises the payments made in respect of land in possession as land cost which is subsequently adjusted for increases/decreases ordered by the courts.

(Emphasis supplied by the querist.)

According to the querist, considering the above, it is submitted that the company is paying the total amount including interest to the land losers as consideration to obtain the title to land. Accordingly, the total amount should be recognised as cost of land in the books of account.

B. Query

9. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Whether interest on enhanced land compensation awarded by the courts should be included in the capital cost of land.

(b) If answer to question (a) is negative, whether the current accounting practice of the company is in order.

(c) If answer to question (b) is also negative, what shall be the correct accounting treatment of such interest?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to accounting treatment of interest on enhanced land compensation. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting treatment of enhanced compensation and additional payments as mentioned in paragraph 3(a) above, accounting policy of the company for providing liability or disclosing contingent liability for the probable/possible enhancement in land compensation and interest thereon, propriety of capitalisation of land on provisional basis and updation of the same from time to time depending on the developments, etc. Further, the Committee's opinion expressed hereinafter is purely from accounting point of view and not from the angle of interpretation of various legal enactments, such as, Land Acquisition Act, etc. The Committee has also not examined the issue from the angle of tariff regulations issued by the CERC as the considerations for tariff determination may be different from accounting considerations. The Committee also wishes to point out that though the expression 'enhanced compensation' normally means original compensation plus increase in compensation, for sake of convenience, the Committee uses the expression 'enhanced compensation' as the difference between final compensation awarded by the Court (excluding 9% interest/15% interest) and the original compensation awarded by the Land Acquisition Officer (LAO).

11. At the outset, the Committee notes the earlier opinions of the Committee

referred to by the querist in paragraph 3(c) above (viz., oil company case) and paragraph 7 above (viz., port trust case). The Committee also notes the arguments of the querist with respect to the earlier opinions of the Committee and is of the view that these deal with two different situations (as also admitted by the querist) as explained below:

(i) In the oil company case, initially the award for acquisition of land was given by the Land Acquisition Officer which was enhanced by the Court. Further, the Court also directed to pay interest @ 9%/15% on enhanced compensation for the period from the date of award/dispossession till the date of payment, though determined at a later date. Thus, the facts of that case were similar to the facts given in the present case.

(ii) In the port trust case, although the company in question had been handed over the possession of land by the transferor entity who had originally incurred certain costs for acquisition of land but at that time it was not clear that which party will own that land, viz., the transferor entity or the company to whom the possession of the land was handed over (viz., the company in question). After few years, the Government decided that the land would be owned by the company in question and also determined the sale consideration by adding an amount equivalent to the interest at the rate of SBI PLR to the cost incurred by the transferor entity. Thus, the Committee had opined that SBI PLR was used as a benchmark to arrive at consideration *for the transfer of land*.

Since the facts are different in the two cases as discussed above, the opinion expressed on the oil company case differs from the opinion on the port trust case. However, though the facts of the case in oil company case are similar to facts of the extant case, the Committee notes that the earlier opinion in oil company case had apparently focused on the delay in payment of compensation by the company rather than on delay in the process of arriving at the final decision.

12. The Committee notes that section 18 of the 'Act' provides for reference to the Court by the Collector, at the instance of any interested person who has not accepted the award, for the determination by the Court of certain matters, which include the amount of the compensation. Sections 23 and 24 of the 'Act' specify the matters to be considered and maters to be neglected respectively by the Court in determining the amount of compensation to be

awarded. As per section 25 of the 'Act', the amount of compensation awarded by the Court shall not be less than the amount awarded by the Collector under section 11. Section 28 of the 'Act' reads as below:

> **"28. Collector may be directed to pay interest on excess compensation:** If the sum which, in the opinion of the Court, the Collector ought to have awarded as compensation is in excess of the sum which the Collector did award as compensation, the award of the Court may direct that the Collector shall pay interest on such excess at the rate of nine per centum per annum from the date on which he took possession of the land to the date of payment of such excess into Court:
>
> **Provided** that the award of the Court may also direct that where such excess or any part thereof is paid into Court after the date of expiry of a period of one year from the date on which possession is taken, interest at the rate of fifteen per centum per annum shall be payable from the date of expiry of the said period of one year on the amount of such excess or part thereof which has not been paid into Court before the date of such expiry."

13. From the above, the Committee notes that since the award notified by the Land Acquisition Officer (LAO) *may* be enhanced by the Court in case reference is made to the Court, the compensation towards the acquisition of the land becomes final only on the date of the final award by the Court. The Committee further notes that the Land Acquisition Act itself recognises that the amount awarded by the LAO may not be final or acceptable to the land owners and accordingly, considering the long process of determination of final value of land, it envisages for the payment of various elements apart from the enhanced compensation such as interest @ 9% and 15% from the date of possession till the payment into the Court. The Committee also notes that till the final award of the Court, the quantum of interest to be paid cannot be determined as even the principal amount on which such interest payments are to be made is not determined and therefore, such interest is the result of the process of acquisition of land as per the Act. Accordingly, the Committee is of the view that 'interest' in the extant case is a part of the process for determination of purchase price of land and, therefore, in substance, should be considered as a component of purchase/ acquisition price only, to the extent the interest payments relate to the period of final determination of the price by the Court. Any interest beyond such period,

viz., after the date of final award till the date of payment should not be capitalised and charged to the statement of profit and loss, since, interest after the date of Court's award is to compensate for delay in the payment of the enhanced compensation as finally awarded by the Court.

14. As regards the policy of the company to capitalise the interest on enhanced compensation incurred for the period before commercial declaration of the first unit of the stage for which land is acquired on the basis of the principles enunciated in AS 16, the Committee is of the view that any expenditure incurred during construction cannot be capitalised or expensed on the basis of the principles of AS 16. AS 16 prescribes principles for accounting treatment of borrowing costs. In the extant case, the interest payments cannot be considered as a 'borrowing cost' as there is no borrowing of funds by the company.

D. Opinion

15. 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 interest payments on enhanced land compensation awarded by the Court should be included as cost of the land to the extent they relate to the period upto the date of Court's award. Any interest beyond that period should be treated as revenue expenditure and charged to the statement of profit and loss for the year of incurrence, as discussed in paragraph 13 above.

(b) No, the current accounting practice of the company is not in order, as discussed in paragraphs 13 and 14 above.

(c) See (a) above.

Query No. 4

Subject: Disclosure requirements as per AS 15 in respect of employees seconded to subsidiary company by the holding company. [1]

A. Facts of the Case

1. A Government of India company (hereinafter referred to as 'the holding company') is engaged in the construction and operation of thermal power plants in the country. The holding company has also diversified into hydro power generation, coal mining and oil & gas exploration, etc. The holding company is registered under the Companies Act, 1956 and, being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. The holding company prepares its annual financial statements as per the provisions of the Companies Act, 1956. The holding company is also listed with the Bombay Stock Exchange and the National Stock Exchange.

2. The holding company is having five subsidiary companies. There are no employees on the rolls of the subsidiary companies. All the personnel of the subsidiary companies are employees on the rolls of the holding company and are under deputation to the subsidiary companies on secondment basis. The employees on deputation to the subsidiary companies can be repatriated to the holding company at any time.

3. (i) The benefits provided by the holding company to its employees include:

(a) Provident fund

(b) Gratuity

(c) Leave (Earned leave and half pay leave)

(d) Post retirement medical facility (PRMF)

(e) Contributory pension scheme

(f) Terminal benefits towards settlement at home town for employees & dependents and farewell gift at the time of superannuation

[1] Opinion finalised by the Committee on 11.4.2014.

(g) Other benefits, viz., long service award and economic rehabilitation scheme.

(ii) The employees' benefits indicated at serial number (a) and (b) above (viz., provident fund and gratuity) are funded by the holding company and are managed by separate trusts. The plan assets in respect of the funded schemes are not bifurcated between employees of holding company and those seconded to the subsidiaries. In respect of employees' benefits indicated at serial number (c), (d), (f) and (g) above, provisions are created based on the actuarial valuation and are maintained in the books of the holding company. There are no earmarked investments against these provisions.

(iii) The pension scheme at (e) above is under implementation which will be a defined contribution scheme as per the Guidelines issued by the Department of Public Enterprises (DPE), Government of India (GOI). DPE is the nodal agency for determination of the pay-scales and other benefits payable to employees of Central Public Sector Enterprises (CPSEs). As per the DPE Guidelines, the total of PF, gratuity, PRMF and pension contribution shall be limited to 30% of basic pay plus dearness allowance (DA).

(iv) All the employee benefit schemes are functioning for the total employees and not separately for the holding company and its subsidiaries.

(v) In respect of employees on secondment from the holding company, liability of the subsidiaries is limited only to the extent of periodical/yearly charge debited to them by the holding company. Responsibility for the payment of such benefits due to the employees viz., leave, long service award, gratuity (through the trust), post retirement medical facility, farewell gift, settlement allowance, etc. continues to be of the holding company.

(vi) The holding company makes disclosures as per Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005) in its financial statements for the various defined benefit schemes.

4. The querist has stated that till the financial year 2011-12, the actuarial valuation of employee benefits was carried out for the company as a whole

and year-end liability was determined by the actuary for each of the subsidiary, considering the current service cost plus increase/decrease in total defined benefit obligation arising on account of other reasons e.g., actuarial gains and losses. Based on above, the proportionate share of expense was recovered from the subsidiaries.

5. The issue of disclosures to be made in the financial statements of the subsidiary company for defined benefit plans was previously referred to the Expert Advisory Committee (EAC) for its opinion. The EAC in its opinion stated that *"It is assumed that amount allocated is derived considering current service cost plus increase or decrease in total defined benefit obligation arising on account of other reasons like the actuarial gains and losses on entire obligation (irrespective of whether the obligation relates to period during which employee was with service with subsidiary or not). This indicates that there is a contractual agreement or stated policy based on which the proportionate share of expenses is being allocated to the subsidiary company. Further, since there is a common scheme for the employees of the holding company and the subsidiary company, keeping in view the Facts of the Case, it appears to the Committee that in substance, the holding company is running a group administration plan. The Committee is further of the view that the existence of such contractual agreement or stated policy through which the current service costs and obligations of defined benefit plans for employees of subsidiary company are being allocated to it clearly provides a basis for allocating the assets and obligation of the plan too"* and accordingly, the EAC opined that the subsidiaries are required to make disclosures as per paragraphs 119 and 120 of AS 15. (Emphasis supplied by the querist.)

6. During the year 2012-13, the holding company reviewed the basis of allocation of employee's benefits to the subsidiaries considering the provisions of DPE Guidelines applicable to CPSEs w. e. f. 1st January, 2007. These Guidelines provide that the CPSEs are allowed to pay 30% of basic pay and dearness allowance (DA) as superannuation benefits which may include PF, gratuity, pension and post retirement medical facility. Accordingly, it was decided to debit the subsidiaries by an amount equal to 30% of basic pay and DA of the employees seconded to the subsidiaries towards the superannuation benefits and at a fixed percentage of basic pay and DA in respect of other employee benefits such as leave and other retirement benefits. These changes were made retrospectively from 1st January, 2007, i.e., from the date of applicability of the DPE Guidelines.

7. The querist has also stated that under the revised methodology implemented during the year 2012-13, the cost of employee benefits debited to the subsidiaries was not based on actuarial valuation as was being considered till the year 2011-12. Accordingly, no actuarial assumptions were used while determining the amount of contribution to be made by the subsidiaries to the holding company for the employees' benefits.

8. Consequent to the above change, following disclosures were made by the subsidiary companies in their financial statements for the year 2012-13:

> **"Significant Accounting Policies:**
>
> The liabilities for employee benefits are accounted for on the basis of allocation of such expenses made by the parent company, in accordance with the corporate policy.
>
> **Disclosure in the Note for Employee Benefits Expense**
>
> (a) All the employees of the company are on secondment from the holding company.
>
> (b) Employee benefits expense include ' ____ (previous year ' ____) debited by holding company towards leave, superannuation and other benefits in respect of employees posted on secondment basis from the holding company."

9. The statutory auditor of one of the subsidiary companies has given a qualification in his report on the accounts for the year 2012-13 as under:

> "...*the superannuation and provident fund liabilities are allocated and charged to the company by its parent according to the corporate policy. Both these liabilities are defined benefit liabilities according to the schemes in force. The method of disclosure made in the financial statements is not in compliance of paragraph 33-35 of AS 15".*

10. The company does not agree with the observation of the statutory auditors on the accounts for the financial year 2012-13 considering the following:

(a) Reference is invited to following provisions of Accounting Standard (AS) 15, 'Employee Benefits', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

"7.5 *<u>Defined contribution plans</u> 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."*

"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."

"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.

44. Accounting for defined contribution plans is straightforward because the reporting enterprise's obligation for each period is determined by the amounts to be contributed for that period.

Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis, except where they do not fall due wholly within twelve months after the end of the period in which the employees render the related service."

"47. An enterprise should disclose the amount recognised as an expense for defined contribution plans."

As stated above, the subsidiary company pays a fixed percentage of salary as contribution towards various employee benefit plans to the holding company. Taking inference from the above-mentioned paragraphs of AS 15, the payment of fixed amount on a predetermined basis, agreed between the holding and subsidiary companies, in substance, is the settlement of the employee benefit obligation, rather than an investment to meet the obligation. Accordingly, the subsidiary no longer has an asset or a liability towards the employee benefits. Therefore, it is appropriate that the subsidiary treats such payments as contributions to a defined contribution plan.

(b) Since all the employees of the subsidiary company are on secondment basis from the holding company and the liability of the subsidiary company is limited to the agreed contribution at the pre-determined rate, going by the provisions of paragraph 35 of AS 15, the subsidiary companies are required to recognise, in their separate financial statements, a cost equal to their contribution payable for the period. Accordingly, disclosure requirements of paragraphs 119 and 120 of AS 15 are not applicable to them. The disclosures made by the subsidiary company as stated in paragraph 7 above are, in the opinion of the querist, in compliance with the requirements of paragraph 47 of AS 15.

(c) It is pertinent to note that the basis of charge to the subsidiary companies towards employee benefits due to the seconded employees has changed in the year 2012-13. The assumptions on which the opinion of the EAC referred in paragraph 5 above are no longer valid and therefore, the EAC opinion is not relevant in the changed circumstances.

(d) From the standpoint of the subsidiary company, the scheme is in effect a defined contribution scheme because:

   (i) The obligation of the subsidiary is limited to the agreed amount of contribution;

   (ii) No actuarial assumptions are required to measure the obligation or the expense, and hence, there is no actuarial gain or loss;

   (iii) The amount of contribution is not based on current service cost plus increase or decrease in total defined benefit obligation arising on account of other reasons like actuarial gains and losses on entire obligation;

   (iv) The subsidiary has 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;

   (v) The liabilities/provisions in respect of the above employees benefits are kept in the books of the holding company and the plan assets in respect of the funded schemes cannot be bifurcated for employees of holding company and those seconded to the subsidiaries as the schemes are functioning for the employees as a whole and not separately for the holding company or subsidiaries; and

   (vi) The holding company is the legal entity responsible to settle the plan obligations. Disclosures as per AS 15 are made in the financial statements of the holding company.

B. Query

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

(i) Whether existing disclosures made by the subsidiary as stated in paragraph 8 above are in order.

(ii) If answer to (i) above is in negative, what disclosures are required to be made by the subsidiary company in its financial statements in this regard?

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to disclosure requirements in the books of the subsidiary companies with regard to various employee benefit plans in respect of employees sent on deputation to it by the holding company for which, as per the querist, the holding company is making adequate disclosures as per the requirements of AS 15. 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, classification of various employee benefit plans as defined benefit or defined contribution plan, accounting in the books of the holding company, accounting for impact of change in the plan due to retrospective change in the methodology of charging the amount of employee benefits from the subsidiary companies, etc. Further, the opinion expressed hereinafter is only from accounting perspective and not from the legal perspective, such as, interpretation of various enactments, such, as DPE Guidelines, etc. since as per Rule 2 of its Advisory Service Rules, the Committee is prohibited from such legal interpretation.

13. With regard to the disclosure requirements in the books of subsidiary company in respect of employee benefit plans for employees sent on deputation to subsidiary companies, which are administered by the parent company, the Committee is of the view that the first and foremost issue to be examined is whether these plans which the employees deputed to subsidiary companies are entitled to are defined contribution plans or defined benefit plans for the subsidiary company. In this regard, the Committee notes the following paragraphs of AS 15, notified under the Rules, which provide as follows:

> **"7.5 *<u>Defined contribution plans</u> 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."***
>
> "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."

"33. Multi-employer plans are distinct from group administration plans. A group administration plan is merely an aggregation of single employer plans combined to allow participating employers to pool their assets for investment purposes and reduce investment management and administration costs, but the claims of different employers are segregated for the sole benefit of their own employees. Group administration plans pose no particular accounting problems because information is readily available to treat them in the same way as any other single employer plan and because such plans do not expose the participating enterprises to actuarial risks associated with the current and former employees of other enterprises. The definitions in this Standard require an enterprise to classify a group administration plan as a defined contribution plan or a defined benefit plan in accordance with the terms of the plan (including any obligation that goes beyond the formal terms).

34. Defined benefit plans that share risks between various enterprises under common control, for example, a parent and its subsidiaries, are not multi-employer plans.

35. In respect of such a plan, if there is a contractual agreement or stated policy for the net defined benefit cost for the plan as a whole to individual group enterprises, the enterprise recognises, in its separate financial statements, the net defined benefit cost so charged. If there is no such agreement or policy, the net defined benefit cost is recognised in the separate financial statements of the group enterprise that is legally the sponsoring employer for the plan. The other group enterprises recognise, in their separate financial statements, a cost equal to their contribution payable for the period."

> "44. Accounting for defined contribution plans is straightforward because the reporting enterprise's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis, except where they do not fall due wholly within twelve months after the end of the period in which the employees render the related service."
>
> ***"47. An enterprise should disclose the amount recognised as an expense for defined contribution plans."***

From the above, the Committee notes that in case of defined contribution plans, the obligation of an enterprise is to pay fixed contribution to another entity and has no obligation to pay further contribution if there are no sufficient assets to pay all employee benefits relating to employee service in the current and prior periods, which means that actuarial risk and investment risk are not borne by the enterprise paying fixed contribution. Further, the Committee notes that as per the requirements of paragraphs 34 and 35 of AS 15, if there is no contractual agreement or stated policy *for sharing risks between the individual group enterprises in respect of defined benefit plan,* the net defined benefit cost is recognised in the books of the sponsoring employer and the other group enterprises recognise only their contribution payable for the period.

14. The Committee notes from the Facts of the Case that all the employees of the subsidiary companies are on the rolls of the parent company and have been sent on deputation to the subsidiary companies on secondment basis. The parent company is providing various benefits to its employees as listed in paragraph 3 above and all the employee benefit schemes are functioning for the total employees and not separately for the holding company and its subsidiaries. Thus, there is a group administration plan where holding company is the sponsoring employer. Further, the Committee notes that as per the DPE Guidelines, the total of superannuation benefits which consist of provident fund, gratuity, pension and PRMF shall be limited to 30% of basic pay plus DA. The Committee also notes that in the financial year 2012-13, the parent company has revised its methodology of collecting the share of subsidiary companies on account of employee benefits in respect of deputed employees to a fixed contribution of 30% of basic pay plus DA, retrospectively from 1st January, 2007. Further, it has been stated that in

respect of employees on secondment, liability of the subsidiaries is limited only to the extent of periodical/yearly charge debited to them, which is not based on current service cost plus increase or decrease in total defined benefit obligation on account of other reasons like actuarial gains and losses on entire obligation (paragraphs 3 (v) and 10 (d)(iii) above). From this, the Committee is of the view that although the company is charging maximum amount as per the DPE Guidelines from the subsidiary company on account of afore-mentioned employee benefits, the risks of defined benefit plans are not being shared between the holding company and the subsidiary company, rather only a fixed contribution which is based on the percentage of aggregate of basic pay and DA is being charged from the subsidiary. Therefore, the subsidiary company should recognise only the contribution paid by it in its financial statements, as per the requirements of above-reproduced paragraphs of AS 15 as the same is a defined contribution plan. Accordingly, the question of disclosure as per paragraphs 119 and 120 of AS 15, which is applicable in respect of defined benefit schemes does not arise. Since nature of plan has changed from defined benefit plan to defined contribution plan for the subsidiary company, nature and the impact of such change in plan should also be given in the notes to accounts of the subsidiary company. With regard to the existing disclosures made by the subsidiary company in its financial statements, the Committee wishes to point out that the subsidiary company should provide a clear description of the charge being made by the holding company from it. Subsidiary company should not state that the liabilities for employee benefits are accounted for on the basis of 'allocation' by the holding company as being currently used for its fixed contribution (to the holding company) in its significant accounting policy.

D. Opinion

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

(i) As explained in paragraph 14 above, since this arrangement is a defined contribution plan for subsidiary company, it need not give disclosures as per paragraphs 119 and 120 of AS 15. However, since nature of plan has changed from defined benefit plan to defined contribution plan for the subsidiary company, nature and the impact of such change in plan should be given in the notes to accounts of the subsidiary company. With regard to the existing disclosures made by the subsidiary company in its financial statements, the subsidiary company should provide a clear description of the charge being made by the holding company from it. Subsidiary company should not state that the liabilities for employee benefits are accounted for on the basis of 'allocation' by the holding company as being currently used for its fixed contribution (to the holding company) in its significant accounting policy, as discussed in paragraph 14 above.

(ii) Refer to (i) above.

Query No. 5

Subject: Accounting treatment of borrowing costs, administrative and other general overhead expenses incurred during the period when the construction work of the project is interrupted.[1]

A. Facts of the Case

1. A public sector company (hereinafter referred to as the 'company') registered under the Companies Act, 1956 is engaged in construction and operation of hydro electric power projects. The company is in a regulated regime and tariff for the power supplied from power stations of the company is fixed by the Central Electricity Regulatory Commission (CERC).

2. Hydro electric projects (hereinafter referred to as the 'projects') by nature are not only capital intensive but also take considerable time for completion. The projects are mostly set up in far flung areas away from even smaller towns. The process of construction of projects may be divided into three stages namely pre-construction, construction and testing & commissioning. Pre-construction activities include survey and investigation, preparation of detailed project report (DPR), obtaining numerous approvals from various authorities, etc. Although all stages are important for the smooth completion of the projects, construction stage is very critical. Construction

[1] Opinion finalised by the Committee on 11.4.2014.

phase of the projects encompass numerous activities which must be properly aligned with each other so that project is completed in a timely manner. However, often, construction activities are interrupted by various stakeholders for a number of reasons. Local people who have not witnessed construction of projects of large magnitude and who are expected to be affected by construction of the project continuously raise issues of all sorts before every platform they find. *All such activities are considered normal in the hydro power sector* (emphasis supplied by the querist). As a result, the setting up of project may take 5 to 20 years depending upon various factors, viz., geographical, geological, status of infrastructure, etc.

3. During the construction of one of such projects, the local people raised the issues related to safety and downstream impact of the proposed dam. The activists ramped up their agitation and stopped the supplies to the project by blocking national highway and other access roads to the project resulting in interruption of construction works of the major packages on 16.12.2011. The major works are under temporary delay since then and needful to resolve the issues are being vigorously acted upon both administratively as well as technically. The company had been in constant touch with the Central Government and State Government (SG) for immediate resumption of the construction activities of the project. Matter was actively pursued with the State Government and various pressure groups to sort out the issues and to eliminate fear psychosis from the people living downstream to the dam.

4. *Status of works in respect of major packages:*

- Civil Works: Dam Concreting: 43% completed. Power House Concreting: 41% completed. Head Race Tunnel Heading, Benching & Overt Lining: 99%, 60% and 45% completed, respectively. Surge Tunnel Heading Excavation: 88% completed.

- Hydro-Mechanical (HM) Works: Erection of Diversion Tunnel Gates: 23% completed. Erection of Intake-5: 2% completed. Erection of Intake-7 and 8: 20% completed each. Pressure Shaft Steel Liner: 13% completed.

- E&M Works: Unit-1: Turbine Stay Ring and Spiral Case erection completed. Unit-2: Turbine Stay Ring and Spiral Case erection completed. Unit-3: Earth- mat is to be laid. Unit-4 to 8: No work.

5. Keeping in mind the concerns of the people living downstream of the project and at the instance of the State Government, the company had constituted an Expert Group (EG) in May 2008 to evaluate the downstream impacts of the project.

(i) The recommendations of EG were discussed in State Assembly. The EG report was also discussed by the Expert Appraisal Committee of the Ministry of Environment and Forests (MoEF) in the presence of representative from EG and the company.

(ii) As desired by the State Government, the company constituted a Joint Steering Committee (JSC) in April 2011 to examine part II (downstream impact) of EG report and identify feasible remedial measures to take care of possible downstream impacts, flood, erosion etc. and report on their physical/ financial aspects.

(iii) The State Government constituted a Group of Ministers (GoM) to appropriately advise the Government on the issues of hydro power projects in totality with an inter-disciplinary approach. Recommendations of the GoM have been accepted by the State Government.

(iv) Further, at the instance of Prime Minister's Office (PMO), the Planning Commission constituted a Technical Experts Committee (TEC) to review the status of the Project and to recommend/ report on how the company could move forward. The TEC has submitted its report.

(v) Pursuant to recommendations of TEC, Dam Design Review Panel (DDRP) under the chairmanship of Chairman, Central Water Commission (CWC) was constituted by the Ministry of Power (MOP), wherein all the aspects including foundation competency, earthquake parameters, energy dissipation arrangement (EDA) were deliberated upon. DDRP has submitted its report which has been accepted by the Government of India.

(vi) During last more than one year, at no point of time it was felt that the interrupted works will not resume within reasonable period of time. Preparedness of the major works contractors was ensured and care of works was undertaken throughout the period since 16.12.2011 for resumption of the works at the earliest. Continuous efforts were undertaken by the company for resumption of the works of major packages of the project and breakthrough is now expected shortly as most of the concerns of the people have been addressed through the country's reputed institutions and appropriate authorities. During the period of interruption, technical & administrative works and numerous activities related to ancillary works, infrastructure works, work related to corporate social responsibilities and running & maintenance works at the project were continued.

6. During the audit of accounts of the project, the office of the Comptroller & Auditor General of India (C&AG) raised an observation on the capitalisation of the borrowing cost incurred during the period of interruption. The said observation was dropped by the C&AG on the basis of reply of the management that substantial technical and administrative works were continued to be carried on during the period of interruption. However, the joint statutory auditors of the company proposed to qualify their audit report for the financial year 2012-13 with the following qualification:

> *"Capital work-in-progress carried in the balance sheet amounting to Rs. 19,709.04 crore. Management has included borrowing cost of Rs. 386.88 crore and administrative & other cost of Rs. 139.69 crore incurred on the ... Project, wherein active development of project is interrupted. Accounting Standards require these expenditure incurred during interruption period be charged to the statement of profit and loss. This constitutes departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.*
>
> *Accordingly, 'Finance Cost' would have increased by Rs. 386.88 crore and 'Generation, Administration and Other Expenses' would have increased by Rs. 139.69 crore and 'Net Profit before Tax', 'Capital work-in-progress' would have reduced by Rs. 526.57 crore and Shareholders' Fund (net of taxes) would have reduced by Rs. 421.22 crore."*(Emphasis supplied by the querist.)

7. The company did not agree with the qualification of the auditors due to following reasons:

(i) Auditors have placed reliance on paragraph 17 of Accounting Standard (AS) 16, 'Borrowing Costs' alone and have completely ignored paragraph 18 of AS 16, by virtue of which capitalisation of borrowing costs is permitted during the period when substantial technical and administrative work is being carried out. Paragraph 17 and 18 of AS 16 are reproduced below:

"17. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

18. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. *However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out.* Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. *For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved."* (Emphasis supplied by the querist.)

(ii) Hydro-electric projects are very much susceptible to time and cost overrun on account of various reasons, like natural calamities, geological surprises as well as law and order situation in the concerned area. *Interruption of work in hydro projects due to such type of problems is common, which matches with example of high water levels in case of construction of bridge as given in example in paragraph 18 of AS 16. Hence, borrowing cost and other general overheads during interruption of work due to these problems are allowed as per paragraph 18 of AS 16.* (Emphasis supplied by the querist.)

(iii) Technical and administrative works were continued to be carried out at the project even during the period of interruption (Refer Annexure A).

(iv) Tariff fixation for power generating companies is based on completion cost of the project duly approved by appropriate authority i.e., Press Information Bureau (PIB)/Cabinet Committee on Economic Affairs (CCEA), which takes into account the expenditure incurred as per audited balance sheet of the company for verifying the expenditure. As such, the said qualification will result into reduction of capital cost of the project and in turn, future earning capacity of the company, as the same will not be considered by CERC.

(v) The process of tariff fixation involves inviting comments from beneficiaries and once the expenditure is not allowed to be capitalised, the same may not be accepted by the beneficiaries at a later stage.

(vi) Accounting Standard (AS) 10, 'Accounting for Fixed Assets' does not prohibit capitalisation of administrative and general overhead expenditure during the period of interruption.

(vii) Period of interruption is not substantial considering the overall construction period of a hydro-project of such magnitude.

(viii) The following disclosure has been given by the company in the notes to the accounts:

"*Construction activities at site of ... Project have been interrupted w.e.f. 16.12.2011 due to protest of anti-dam activists, however substantial technical and administrative work is continuing. As such administration and other general overheads including borrowing cost directly attributable to Project has continued to be capitalised. The construction activities at site are expected to be resumed shortly since the matter is being pursued at the level of the Government of India.*"

(ix) The company is a listed entity having domestic as well as foreign stake holders. Such qualification by auditors will have adverse impact on its corporate image. Further, Securities and Exchange Board of India (SEBI) may also take adverse view due to the said qualification of the auditors.

(x) There is going to be huge consequential impact on the financial health of the company due to such narrow interpretation of Accounting Standards.

(xi) The company is in a regulated regime and is governed by Electricity Act, 2003. All expenditure incurred by the company for construction of project is allowed by CERC for fixation of tariff and as such, the provisions of Accounting Standards should be construed accordingly.

8. Auditors however persisted with their qualification and included the proposed qualification in their final report. After issuance of the audit report by auditors, the office of Principal Director of Commercial Audit, MAB-III, New Delhi issued *nil* comments on the accounts for the company of the financial year 2012-13. Principal Director, MAB-III, New Delhi has also advised the company to refer the matter to the Expert Advisory Committee of the Institute of Chartered Accountants of India for its opinion in the matter of qualification in the audit report of auditors.

B. Query

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

(i) Whether the capitalisation of borrowing cost during the period when construction work of the project is interrupted, as above, is in line with provisions contained in paragraph 18 of AS 16 on 'Borrowing Costs', considering the technical and administrative works being carried on at the project as mentioned in Annexure A.

(ii) Whether capitalisation of directly attributable administrative and other general overhead expenses during the period of interruption is in line with provisions contained in AS 10.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised in the query relate to whether capitalisation of borrowing cost as well as administrative and other general overhead expenses (which as per the querist, are directly attributable to project), incurred during the period when construction work of the project is interrupted is in line with the principles of AS 16 and AS 10, respectively. The Committee wishes to point out that henceforth 'the period when the construction work of the project is interrupted' has been referred to as 'interruption period'. The Committee has, therefore, considered only aforesaid issues and has not examined any other issue that may arise from the Facts

of the Case, such as, commencement of capitalisation of borrowing costs, accounting treatment of expenditures during interruption period other than administrative and other general overhead expenses (which as per the querist, are directly attributable to project), etc.

11. With regard to capitalisation of borrowing cost during the period of interruption, the Committee notes the following paragraphs from Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> "16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.
>
> ***17. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.***
>
> 18. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved."

From the above, the Committee notes that borrowing costs which are incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted do not qualify for capitalisation. The Committee also notes that 'interrupted period' refers to a period when no *active development that changes the asset's condition* is taking place. The Committee further notes that capitalisation of borrowing costs is not normally suspended in case of 'temporary delay' which is a *necessary part of the process of getting an asset ready for its intended use or sale or when substantial technical and administrative work is being carried out*.

12. In the extant case, the Committee notes from the Facts of the Case that construction activities of the project are interrupted as the local people alongwith the activists have raised issues relating to their safety and downstream impact of the proposed dam. Their agitation leading to stoppage of the supplies to the project resulted into interruption of construction works. The company is making continuous efforts for resumption of the works of major packages of the project by actively pursuing with the State Government and various pressure groups, viz., TEC, Group of Ministers, Joint Steering Committee (JSC) to sort out the issues. The Committee notes that the querist has argued that the company has undertaken certain technical and administrative works which are listed in Annexure A and as per AS 16, borrowing cost incurred during the period when substantial technical and administrative work is being carried out should be considered for its capitalisation. The Committee also notes Annexure A provided by the querist containing details of the technical and administrative works being carried out by the company and is of the view that most of these works do not apparently lead to the development/construction of the project rather are aimed at taking remedial measures so that matter may be resolved. Such remedial measures includes undertaking geological studies, dam studies, landslide and earthquake studies, hydraulic model studies, works related to CSR and SD, etc. and preparing report thereon for various Government Departments and Ministries, viz., report to planning commission, report of JSC, DDRP report to MoP, etc. for obtaining necessary approvals for resumption of the interrupted work. In other words, the technical and administrative works which are being carried out cannot be considered to be leading to active development of the project, rather these are the activities necessary for resumption of construction work of the project. Further, agitation of local people and interruption of work in the extant case cannot be considered as a *temporary delay* which is a *necessary part of the process*

for getting the project ready for its intended use. In fact, borrowing costs incurred during such period are costs incurred for holding partially completed assets rather than cost of undertaking activities for developing the project. Hence, capitalisation of borrowing costs incurred during such period should be suspended.

13. As regards capitalisation of administrative and other general overhead expenses during the period of interruption, the Committee notes that the accounting principles for determination of the cost of a self-constructed fixed asset, have been laid down, inter alia, in paragraph 10.1 of AS 10, notified under the 'Rules', 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 9.5. 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 Committee further notes paragraphs 9.1 and 9.2 of AS 10, notified under the 'Rules', 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. Examples of directly attributable costs are:
>
> ..."
>
> "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 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. 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. The Committee also notes that as no specific accounting treatment for the expenses incurred during the interruption period of project has been prescribed, the same principle of capitalisation as prescribed under AS 10 will be applicable. The Committee notes that in the extant case, the querist has argued that the administration and overhead expenses incurred are directly attributable to the project. However, the Committee is of the view that only if the expenses, so incurred, add to the value or utility of the already constructed project or is leading to development/construction of the project then only to that extent these costs can be considered to be directly attributable to the project and can be capitalised with the cost of the concerned fixed asset(s)/ project(s). However, the administrative and overhead expenses incurred to resolve the issue like undertaking technical and administrative activities at the instance of various groups involved in resolving the issues, etc., do not add value to already existing project in progress. In fact, these remedial measures are being undertaken to resume the construction rather than developing the project. Hence, such expenses do not qualify for capitalisation.

14. As far as the impact of accounting treatment of the borrowing costs and other expenditure incurred by the company during interruption of the project, on tariff as per the tariff regulations is concerned, the Committee is of the view that the accounting treatment of an expenditure is to be determined on the basis of the nature of the expenditure as per the generally accepted accounting principles. It is on this basis that the treatment to be accorded by the company in the present case has been arrived at in the above paragraphs. Whether or not this expenditure should be made a part of fixed charges for tariff fixation as per the tariff regulations is a matter to be considered by the relevant authority/company.

D. Opinion

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

(i) No, the capitalisation of borrowing cost during the period of interruption, is not in line with provisions contained in paragraph

18 of AS 16, considering the technical and administrative works being carried on at the project as mentioned in Annexure A, as discussed in paragraph 12 above.

(ii) The capitalisation of administrative and other general overhead expenses during the period of interruption would be correct provided such expenses facilitate the development/construction of the project, rather than facilitating resumption of the construction, as discussed in paragraph 13 above.

Annexure-A

The major technical and administrative works undertaken during the financial year 2012-13 are detailed below:

A: Technical works

(i) During the year, the Engineering and Environment Group at Corporate Office and officers of the Project were associated for the discussions and deliberations with the Technical Expert Committee (TEC) constituted by the Planning Commission, Government of India. The TEC submitted its report by the end of July 2012 to Planning Commission, Government of India.

(ii) During the year, the Engineering & Environment Group at Corporate Office and officers of the Project, officers were associated with the Joint Steering Committee (JSC) for discussions and deliberations to find out the applicability of suggested measures by the Expert Group. The JSC was constituted by the company in consultation with Ministry of Power (MoP), Government of India and State Government. The JSC submitted its report in August 2012.

(iii) As per TEC recommendation, the Dam Design Review Panel (DDRP) has been constituted by the Ministry of Power, Government Of India under the chairmanship of Chairman CWC and other experts from Central Electricity Authority (CEA), Central Water Commission) CWC, Geological Survey of India (GSI), IIT Roorkee, CWPRS and the company to review some design features of Project. The sub-committee of DDRP has visited site on 7/8-03-2013 and members of DDRP visited Project site on 5-5-2013. DDRP has submitted its report to MoP, Government of

India by the end of May 2013 which stands accepted by the Govt. of India.

(iv) At the instance of (TEC), landslide studies of the area where River got blocked during 1950 earthquake have been carried out by M/s ABC, New Delhi. Report submitted in May-2012.

(v) Assessment of engineering properties of rock mass was carried out by an expert in Rock Mechanics at the instance of TEC. Report on Foundation of Dam was submitted in May-2012.

(vi) Additional hydraulic model studies in Stilling Basin was carried out by CWPRS, Pune at the instance of TEC. CWPRS submitted the report during June'12.

(vii) During the year, around 1660 MT of total consignments of steel plates and steel gates have been received at site for HM works of the Project under LOT SSL-3.

(viii) The shifting of 2 no's of turbine runners, 1 set of MIV and 1 no. of annul ring has been completed from Kolkata to Jogigopa in Assam in Dec. 2012.

(ix) Total 120 consignments comprising of turbine and generator spares and other BOP items of E&M components under LOT SSL-4 contract has been received at site during the financial year 2012-13.

(x) The water pressure testing of Unit-1 spiral casing along with other ancillary works has been completed during Nov. 2012.

(xi) The erection of spiral casing along with associated works of Unit-2 has been completed upto Dec. 2012. Further, the erection of rail line at Transformer Floor in Unit-1 & 2 areas has been completed by Nov. 2012.

(xii) During the year, preservation works for the E&M equipments/ components have been undertaken by the contractor for E&M works.

(xiii) As per recommendation of TEC, 24th meeting of National Committee on Seismic Design Parameter (NCSDP) was held on 15-03-2013 at New Delhi to review the Seismicity aspects, for the Project. *The Committee decided that further revisions in the approved seismic design parameters of Project (as approved by NCSDP in its 14th meeting held on 29-04-2004) may not be required*. (Emphasis supplied by the querist.)

(xiv) Apart from above, various infrastructure works and CSR-SD have been undertaken by the Project during the financial year 2012-13.

(xv) During the year 2012-13, various design and re-engineering works as per the requirements/suggestions of TEC, JSC, NCSDP and DDRP have been undertaken by the Design & Engineering Group at Corporate Office.

(xvi) Project has awarded the supply of 36500MT OPC/PPC cement on 22nd March 13 for meeting the day to day requirements for infrastructural and CSR works and the future requirement of the project in case the project starts and gains momentum.

(xvii) Dewatering was continued throughout the year 2012-13 at all the required sites of underground and surface works as per the requirement for safety of structures by the major civil contractors of the Project. The quantity has been measured, recorded and paid to the contractors from time to time as per the contract.

(xviii) The instrumentation readings of all the instruments installed in underground structures and at surface works as per the construction drawings have been recorded regularly throughout the year 2012-13 by the major civil contractors of the Project and submitted to the company from time to time for interpretation of the data and continuous monitoring of the behavior of underground and surface structures. This is required for continuous monitoring of the safety and stability of the major components of the Project.

B: Administrative works

(i) The company Management held meeting on 27-08-2012 with agitating groups to resolve the issues for re-start of project work.

(ii) The company Management held meeting on 20-09-12 with 25 ethnic groups of the State to resolve the issues for re-start of project work.

(iii) Meeting of officials of Government of India, State Government and the company was held on 26-11-2012 at Delhi to negotiate the issues raised by protestors.

(iv) Further, the meeting on 14-12-2012 was held with State Government for resolving the issues raised by the activists.

(v) 1st meeting of DDRP has been held on 06-02-13 in CWC office, New Delhi.

(vi) A Committee of Group of Ministers(GoM) constituted by the Government of Assam vide notification dated 17-12-2011 to appropriately advise the Government on the issues of hydropower project in totality with an interdisciplinary approach, submitted its report to state cabinet and the report was accepted on 20-02-2013.

(vii) A presentation on status of works vis-a-vis issues of this project in view of the ongoing protest and view of the company on the entire issues was made to the Advisor to the Prime Minister, Dy. Secretary, Planning Commission and Chief Secretary, adjoining State Govt. on 01-03-2013.

(viii) Based on recommendations of TEC and the GoM of State Government, a meeting was held on 04-03-2013 with the State Government which was attended by the CMD, Director (Tech), Director (projects), Executive Director of the Project and other officials from Company.

(ix) During the year 2012-13, Project is has made continuous efforts to make people aware of the benefits of the Project by intensive public meetings, media campaign, meeting with state officials and local ethnic groups. CSR activists as per policy are being carried out.

(x) During the year 2012-13, the running and maintenance and service contract works for the establishments and the project sites have been undertaken by the Project.

Query No. 6

Subject: Accounting treatment of accumulated unencashable half-pay leave.[1]

A. Facts of the Case

1. A public sector undertaking under the Ministry of Railways is engaged in catering business (on board and off board). The company is making provision/liabilities towards gratuity and leave encashment on the basis of actuarial valuation at the year end and charging to the statement of profit and loss. The company's rules also provide for grant of compensated absence on account of half pay leave which can be carried over in case not utilised by the employees. Further, the company's rules categorically provide that accumulated half pay leaves can in no case be encashed either on retirement or on separation.

2. The querist has stated that as per the Department of Public Enterprises (DPE) guidelines, half pay leaves cannot be encashed under any circumstances. The company is making provision for encashment of earned leaves upto the maximum level of encashment permitted by the company's rules. According to the querist, as per paragraph 14 of the Accounting Standard (AS) 15 (revised), 'Employee Benefits', the liability for the expected cost of accumulated compensated absence is to be recognised only when there is expectation to pay any additional amount on account of accumulation. However, while conducting the supplementary audit, the Comptroller & Auditor General (CAG) had raised the issue of non-provision of accumulated half pay leaves stating that the company is accounting the expenditure on cash basis rather than on accrual basis.

B. Query

3. The querist has sought the opinion of the Expert Advisory Committee as to whether under the circumstances narrated above, the company is required to create provision for accumulated half pay leaves which are not encashable. If so, how the provision is to be operated on each balance sheet date, since the half pay leaves are not to be encashed?

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[1] Opinion finalised by the Committee on 11.4.2014.

C. Points considered by the Committee

4. The Committee, while answering the query, has considered only the issues raised in paragraph 3 above and has not touched upon any other issue that may arise from the Facts of the Case, such as, accounting treatment for earned leave benefits and gratuity, classification of accumulating half pay leaves as 'short-term' or 'other long-term' employee benefits and their measurement, etc. Further, the Committee presumes from the Facts of the Case that the half pay leaves in the extant case can be carried forward and availed upto the retirement/superannuation of the employees.

5. At the outset, the Committee wishes to point out that from an accounting angle, the nature of unencashable leave is similar to that of the encashable leave insofar as the former provides a right to an employee to receive salaries and wages for the period for which he avails leave as during that period he does not render any services to the employer. The Committee is of the view that accumulating half pay leave creates an obligation on the enterprise because any unused entitlement increases the employee's entitlement to avail leave in future periods. Thus, a provision should be recognised for all these benefits and recorded as part of the cost of service rendered during the period in which the service was rendered which resulted the entitlement. In this regard, without examining the classification of accumulating half-pay leaves into 'short-term' and 'other long-term' employee benefits, the Committee further notes the following paragraphs of Accounting Standard (AS) 15, 'Employee Benefits', notified under the Companies (Accounting Standards) Rules, 2006 as below:

> "8. Short-term employee benefits include items such as:
>
> …
>
> (b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;
>
> …"
>
> **"Short-term Compensated Absences**
>
> ***11. An enterprise should recognise the expected cost of short-***

term employee benefits in the form of compensated absences under paragraph 10 as follows:

> ***(a)*** ***in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences; and***
>
> ***(b)*** ***in the case of non-accumulating compensated absences, when the absences occur."***

"13. Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. Accumulating compensated absences may be either vesting (in other words, employees are entitled to a cash payment for unused entitlement on leaving the enterprise) or non-vesting (when employees are not entitled to a cash payment for unused entitlement on leaving). An obligation arises as employees render service that increases their entitlement to future compensated absences. The obligation exists, and is recognised, even if the compensated absences are non-vesting, although the possibility that employees may leave before they use an accumulated non-vesting entitlement affects the measurement of that obligation."

"Other Long-term Employee Benefits

127. Other long-term employee benefits include, for example:

> (a) long-term compensated absences such as long-service or sabbatical leave;
>
> ..."

From the above, the Committee notes that as per the above-reproduced paragraph 13 of AS 15, obligation exists in respect of short-term accumulating compensated absences irrespective of whether these are vesting or non-vesting and is required to be recognised. Similarly, paragraph 129 of AS 15 requires to provide for a liability in respect of other long-term compensated absences. Accordingly, the Committee is of the view that irrespective of whether accumulating half-pay leaves in the extant case can be classified as 'short-term employee benefits' or as 'other long-term employee benefits', a liability on account of compensated absences should be recognised as per the requirements of AS 15, which should be reviewed at each reporting date to recognise the effects of changes in estimates in this regard.

D. Opinion

6. On the basis of the above, the Committee is of the opinion that irrespective of whether accumulating half-pay leaves in the extant case can be classified as 'short-term employee benefits' or as 'other long-term employee benefits', a liability on account of compensated absences should be recognised as per the requirements of AS 15, which should be reviewed at each reporting date to recognise the effects of changes in estimates in this regard, as discussed in paragraph 5 above.

Query No. 7

Subject: Applicability of paragraph 46A of AS 11 to buyer's credit/ suppliers' credit repaid through a long-term liability. [1]

A. Facts of the Case

1. A closely held public limited company is engaged in the business of developing a 1200 MW (600 MW*2) coal based thermal power project at Madhya Pradesh. The company is a fully owned subsidiary of a company which is the thermal holding company, developing coal based thermal power projects. The group is currently operating in solar, hydro, thermal power and EPC business through various companies. The company is registered under the Companies Act, 1956. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956 and revised Schedule VI to the Companies Act, 1956. The company follows financial year as its accounting year. The holding company through various subsidiaries is planning to expand its operations to different states of India in the near future.

[1] Opinion finalised by the Committee on 11.4.2014.

2. The company has awarded an Engineering, Procurement and Construction (EPC) contract to a third party for two units of 600 MW each and other major non-EPC contracts and the project is under construction stage. EPC related project work got started post-December 2010 and the project is expected to start commercial operations by July 2014.

3. One of the major costs of the project includes offshore supply contract with the EPC contractor for Boiler Turbine and Generator (BTG) denominated in US Dollars. The contract involves a total time period of 35-39 months from supply to commissioning as mentioned therein.

4. As a part of the contract between the company and the EPC contractor, the main plant and equipment is being supplied by the contractor by importing it from vendors in China, through their Singapore subsidiary. The equipment is being sold on high sea sale basis to the company and risks and rewards get transferred on the date of such agreement. Therefore, the date of high sea sale agreement is considered as the date of transaction for recording the foreign currency monetary items. The company accounts for such supplies/ equipment as capital assets.

5. The company is funding the project by way of long-term rupee term loans for a period of upto 15 years from the Indian Project Lead Lenders. For import of capital assets for the project, Foreign Letter of Credits (FLCs) have been issued in favour of offshore vendors by the lead lenders. Against issuance of FLCs denominated in USDs, equivalent Indian rupee balance to be disbursed by the Project Lead Lenders gets blocked from the total sanctioned rupee loan limit. Further, the company has opted for part funding of the project cost through buyers'/ suppliers' credit to finance offshore liabilities in case of capital assets. These buyers'/suppliers' credits from foreign lenders are short-term in nature, i.e., generally for a term of six months to 360 days (i.e., less than one year) and are availed against the Letter of Undertaking (LOUs) given by the Indian Project Lead Lenders who undertake to pay liabilities to the foreign lenders. Generally, LOUs contain following terms of repayment to the buyer's/ supplier's credit lenders:

> ***"We Lead Lenders hereby unconditionally agree to pay the principal, interest at applicable interest rate and other under this loan. We undertake to credit your designated account on the due date as per your instructions. We hereby undertake to pay you on demand the loan amount and interest thereon and/or the amount***

> ***of any losses, cost or damages you may suffer in our failure to credit your designated account on due date".***

In accordance with the terms of LOUs issued by the Indian Project Lead Lenders to the buyers'/suppliers' credit issuing foreign lender, the amount so availed by the company eventually gets converted into long-term loan upon maturity of these buyers'/suppliers' credit. Since these buyers'/suppliers' credits (even though contracted for a period of less than 12 months) are converted into long-term rupee loans upon maturity, *in substance*, this results in conversion of one liability into another. In the said conversion, no real cash outflows happen which are known to the querist on the date of transaction.

6. Currently, foreign exchange differences arising on actual repayments of above foreign currency liabilities and buyers'/suppliers' credit for offshore supplies and restatement of such liabilities as at the balance sheet date are treated as below:

(i) When the company avails buyers'/supplier' credit, the offshore vendor is paid by the foreign lenders giving such facility. Such buyers'/suppliers' credit is then accounted as a short term foreign currency liability in the company's books, as it is repayable in less than 12 months period.

(ii) On maturity, the Project Lead Lenders pay foreign lenders for such buyers'/ suppliers' credit availed and then the basic amount of FLCs get converted into long-term rupee term loan in the books of the company. Any foreign exchange difference between payment by project lead lenders to the foreign lenders and basic amount of FLC availed is recorded as foreign exchange gain/ loss in the statement of profit and loss of the company.

(iii) Further, buyers'/suppliers' credits outstanding to foreign lenders on the balance sheet date are restated and foreign exchange gain/ loss on account of such restatement, if any, is also recorded in the statement of profit and loss of the company. Thus, the current view being taken is that the buyers'/suppliers' credits outstanding to foreign lenders are short-term monetary items which are taken from different foreign lenders (other than the long term project lenders) and thus, are not covered under paragraph 46A and accordingly, disclosed as 'short-term borrowings' repayable within one year in the financial statements.

7. (i) The querist has reproduced paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' issued by the Institute of Chartered Accountants of India, which states that "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*." Further, paragraph 10 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets' defines liability as ***"a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits".*** (Emphasis supplied by the querist.)

(ii) Considering the *principle of substance over legal form as mentioned above*, it can be construed that such short-term buyers'/suppliers' credits from foreign lenders are a part of long-term rupee term loan as there are no real pay outs at maturity for the company as the liability is undertaken to be paid by the long-term project lead lenders (as per the terms of LOUs as mentioned in paragraph 5 above). In substance, the company has to pay to the Project Lead Lenders against the amount paid by them to these foreign lenders as a part of long-term rupee term loan as per the repayment schedule of rupee term loan agreement which extends up to 15 years and therefore, it is a long-term monetary item in nature.

(iii) Accordingly, the querist is of the view, based on practices of some sections of the industry, that such buyers'/suppliers' credit taken against FLCs are an integral part of the long-term loans and thus, should be treated as long-term monetary items. Also, in accordance with paragraph 10 of AS 29 as mentioned above, actual settlement of liability against such buyers'/suppliers' credit is not taking place at the time of payment by the Project Lead Lenders to buyers'/suppliers' credit foreign lender, rather actual event of settlement of liability is occurring at the time of payment by the company to the Project Lead Lenders as per the pre-decided repayment schedule for the long-term rupee loans.

(iv) For long-term monetary items, *the querist has also reproduced new paragraph 46A inserted in Accounting Standard (AS) 11,* 'The Effects of Changes in Foreign Exchange Rates', by Companies (Accounting Standards) (Second Amendment) Rules 2011 which, inter alia, states, "the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset". To exercise the option as referred above, as per clause (2) of paragraph 46A of AS 11, "an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a *term of twelve months* or more at the *date of origination* of the asset or liability".

(Emphasis supplied by the querist.)

8. As per the querist, in substance, term of the buyers'/suppliers' credit to the company on the date of transaction is more than twelve months as per the terms of LOUs mentioned in paragraph 5 above and the view taken in paragraph 7(ii) and (iii) above. Hence, such liabilities should be treated as long-term and accordingly, the impact should be recorded in the books of account as per paragraph 46A of AS 11.

B. Query

9. The querist has sought the opinion of the Expert Advisory Committee that, since the short-term buyers'/suppliers' credit taken from foreign lenders is settled by the long-term Project Lead Lenders and the company is required to settle such liability as a part of long-term rupee term loan availed from the Project Lead Lenders, foreign exchange differences on settlement of foreign lenders' liabilities during the year as well as restatement of such buyers'/suppliers' credit at balance sheet date should be treated as against long-term foreign currency monetary items and hence, should be allowed to be adjusted to the cost of capital assets instead of charging them to the statement of profit and loss in the books of the company.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to whether repayment of short term foreign currency liability by availing Indian currency long-term liability can be treated in substance as a long term foreign currency monetary liability for the purpose of application of paragraph 46A of AS 11. 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 EPC contract including the contract for supply of BTG/capital asset, accounting for long-term Rupee term loan from the Project Lead Lenders, accounting for foreign letter of credits issued by the Project Lead Lenders in favour of offshore vendors for import of capital assets, etc.

11. The Committee notes from the Facts of the Case that the company has availed buyers' credit/suppliers' credit in foreign currency from foreign lenders to partly finance the offshore liabilities in respect of capital assets, which is short-term in nature, i.e., less than twelve months. Accordingly, on availing of such facilities, the company records a short-term foreign currency liability in its financial statements. On maturity of such short-term liabilities, these are repaid through an existing Rupee long-term fund arrangement entered into with another lender, viz., Project Lead Lenders. Further, at the time of maturity of such short-term liability, the repayment is made at the foreign exchange rate prevailing on the date, which may result into foreign exchange gains or losses. Thus, one short-term foreign currency liability is being extinguished and settled by availing another long-term Indian currency liability.

12. From the above, in the context of application of paragraph 46A, the Committee is of the view that since buyers' credit/ suppliers' credit is settled within a period of twelve months from the date of its origination and thereafter, there would be no foreign exchange fluctuation exposure, the question of recording it as a long-term foreign currency liability as per paragraph 46A of AS 11 does not arise. Accordingly, foreign exchange differences on short-term buyers'/suppliers' credit arising on either restatement at balance sheet date or on settlement should be recognised as income or as expense in the period in which they arise and should not be allowed to be adjusted to the cost of the capital assets in the books of the company. The reason being that a short-term liability cannot be considered to be converted into a long-term liability just because it is being settled by a long-term liability.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that foreign exchange differences on short-term buyers'/suppliers' credit arising on either restatement at balance sheet date or on settlement should be recognised as income or as expense in the period in which they arise and should not be allowed to be adjusted to the cost of capital assets in the books of the company. The reason being that a short-term liability cannot be considered to be converted into a long-term liability just because it is being settled by a long-term liability.

Query No. 8

Subject: Accounting for unspent expenditure towards Corporate Social Responsibility and Sustainability activities as per Revised DPE Guidelines. [1]

A. Facts of the Case

1. A public sector company is engaged in the field of power equipment manufacture. The company has manufacturing units, power sector regions, service centers and regional offices besides project sites spread all over India and abroad. Shares of the company are listed at National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). The turnover of the company was Rs. 50,156 crore in the year 2012-13. The company had an employee strength of 48,399 Nos. as on 31.03.2013.

2. The querist has raised the extant query in the context of Department of Public Enterprise (DPE) Guidelines (Revised) on Corporate Social Responsibility (CSR) and Sustainability for Central Public Sector Enterprises (CPSEs), which are effective from April 01, 2013 (hereinafter referred to as 'revised DPE Guidelines'):

Paragraph 1.5.1 of the revised DPE Guidelines states, "Every year, each

[1] Opinion finalised by the Committee on 11.4.2014.

CPSE shall with the approval of its Board of Directors make a budgetary allocation for CSR and Sustainability activities/ projects for the year. The budgetary allocation will be based on the profitability of the company. More specifically, it will *be determined by the Profit After Tax (PAT) of the company in the previous year* as shown hereunder:

PAT of CPSE in the previous year	Range of budgetary allocation for CSR and Sustainability activities (as % of PAT in previous year)
(i) Less than Rs. 100 Crore	3%-5%
(ii) Rs. 100 Crore to Rs. 500 Crore	2%-3%
(iii) Rs. 500 Crore and above	1%-2%

Further, paragraph 1.5.3 of the revised DPE Guidelines states, "The budget allocated for CSR and Sustainability activities/ projects planned for each financial year is expected to be spent within that year*. If due to some reason, the budget of a year remains unutilised, the same would not lapse.* Instead, it would be carried forward to the next year for expenditure on CSR and Sustainability activities, which were planned for implementation in the previous year, but could not be completed due to some reason. However, the public sector enterprise shall have to disclose reasons for not being able to spend the entire budget on CSR and Sustainability activities as planned for that year, and shall make every endeavour to spend the unutilized budget of any year within the next two financial years. In case the CPSEs are unable to spend the unutilized budget within the next two financial years, the unspent amount would be transferred to a 'Sustainability Fund' to be used for CSR and Sustainability activities. This 'Sustainability Fund' would be created separately. Implementation mechanism in this context is also being formulated separately."

(Emphasis supplied by the querist.)

3. Policy of the company relating to the unspent expenditure towards Corporate Social Responsibility and Sustainability Development (SD) is as below:

> DPE guidelines on CSR were adopted by the Board in its 427th meeting held on 23.07.2010 wherein it was decided that CSR budget for financial year 2010-11 would be 0.5% of profit after tax (PAT).

The querist has stated that any unspent amount at the end of the year is provided for and shown as 'short-term provision' in the accounts of the company.

4. *Point raised by Government Audit:*

During the audit of annual accounts for the year 2012-13, the Government audit has raised a query stating that unspent amount related to CSR & SD should be shown as CSR & SD reserve under 'Reserves & Surplus' instead of provision for CSR activities.

5. *The company's views:*

As evident from revised DPE guidelines referred to in paragraph 2 above, there is a clear mandate for spending on CSR activities of the specified amount and time limit for incurring this expenditure is also clearly specified. Though penalty, in financial terms, is not prescribed for not incurring the specified expenditure during the year, companies have to disclose reasons for not being able to spend the entire budget on CSR and Sustainability activities as planned for that year. (Emphasis supplied by the querist.)

This obligatory nature is further evident in section 135(5) of the Companies Act, 2013 (implementation date yet to be notified)[2] which states:

> "The Board of every company shall ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy…
>
> … Provided further that if the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of section 134, specify the reasons for not spending the amount."

Moreover, the provision for carry forward of the unspent balance also exists in the proposed draft Corporate Social Responsibility Rules[3]. It clearly means

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[2] Subsequent to the submission of query by the querist, implementation date of section 135(5) was notified by the Ministry of Corporate Affairs vide Notification dated 27th February, 2014, as per which, it came into force from 1st April, 2014.

[3] Subsequent to the submission of query by the querist, the Companies (Corporate Social Responsibility Policy) Rules, 2014, was notified by the Ministry of Corporate Affairs vide Notification dated 27th February, 2014, which came into force from 1st April, 2014.

that the unspent balance of amount specified for CSR cannot lapse or be used for any other purpose.

In the opinion of the querist, based on these facts, treatment of unspent amount of CSR as provision is in line with Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', as it is fulfilling all the following three pre-requisites of recognition as provision:

(i) There is a *present obligation to spend on CSR activities as a result of past event of earning of profits* as is clear from the intention of DPE in its revised Guidelines and also New Companies Act, 2013:

The amount to be spent in the year is based on the past event of earning of profit, i.e., PAT for the last year and it is a present obligation as on the balance sheet date and it is independent of the future action of the company (i.e., future conduct of its business;

(ii) *Outflow of resources will be certainly required* to settle the obligation:

The outflow for the amount specified for CSR is certainly required to take place in the specified period to settle this statutory obligation and there is no realistic alternative available to the company to settle this. Compromising on a lower level of performance can not be a realistic alternative to avoid the obligation in this context; and

(iii) *A reliable estimate can be made* of the amount of obligation:

Amount of CSR obligation as specified by DPE can be estimated accurately as it is based on a known figure i.e. PAT of the last year.

(Emphasis supplied by the querist.)

B. Query

6. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee (EAC) as to whether in line with the Revised DPE Guidelines, the company can continue its practice to provide unspent

amount of CSR/SD in accounts and carry forward the same in the next year as 'short term provision' till final cash outflow takes place.

C. Points considered by the Committee

7. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to accounting for unspent amount of expenditure required to be made for CSR and SD activities as per the above-mentioned revised DPE Guidelines that are effective from April 1, 2013. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as, determination of the amount to be earmarked for CSR and SD activities, legal interpretation of DPE Guidelines, disclosure of CSR and SD fund, etc. The Committee has also not considered the issue in the context of the Companies Act, 2013.

8. The Committee notes the definitions of the terms, 'provision', 'liability', 'obligating event', 'present obligation' and paragraphs 11, 14 and 16 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, as follows:

> ***"10.1 A <u>provision</u> is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***10.2 A <u>liability</u> is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***
>
> ***10.3 An <u>obligating event</u> is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation."***
>
> ***"10.6 <u>Present obligation</u> - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."***
>
> "11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

"14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised."

"16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event."

9. The Committee further notes paragraph 1.5.3 of the revised DPE Guidelines:

"1.5.3 The budget allocated for CSR and Sustainability activities/ projects planned for each financial year *is expected to be spent within that year*. If due to some reason, the budget of a year remains unutilised, the same *would not lapse*. Instead, it would be carried forward to the next year for expenditure on CSR and Sustainability activities, which were planned for implementation in the previous year, but could not be completed due to some reason. However, the public sector enterprise shall have to *disclose reasons for not being able to spend* the entire budget on CSR and Sustainability activities as planned for that year, and *shall make every endeavour to spend the unutilised budget* of any year within the next two financial years. In case the CPSEs are unable to spend the unutilised budget within the next two financial years, the unspent amount would be transferred to a 'Sustainability Fund' to be used for CSR and Sustainability activities. This 'Sustainability Fund' would be created separately. Implementation mechanism in this context is also being formulated separately." (Emphasis supplied by the Committee.)

From the above, the Committee notes that as per the DPE Guidelines, the enterprises are required not only to make budget allocation for CSR and

Sustainability activities but are also expected to spend it within that year. If due to some reason, the budget of a year remains unutilised, the same would not lapse and would be carried forward to the next two years and finally, the unspent amount would be transferred to a 'Sustainability Fund' to be used for CSR and Sustainability activities. Further, the Committee notes that the enterprise shall have to disclose reasons for not being able to spend the entire budget on CSR and Sustainability activities as planned for a year and shall make every endeavour to spend the unutilised budget. Thus, the Committee is of the view that as per the revised DPE Guidelines, there is a mandate not only on budget allocation but also to spend on CSR and Sustainability activities within a specified period.

10. The Committee also notes that as per the provisions of AS 29, a provision should be recognised when there is a present obligation i.e., more likely than not involving incurrence of expenditure, arising from a past event that leaves no realistic alternative apart from settling that obligation and that the obligation exists independently of an enterprise's future actions. Since as per the revised DPE Guidelines, the company is required to spend certain amount on CSR and Sustainability activities within a specified period and since, the unspent amount would not lapse and would be transferred to a 'Sustainability Fund' which can be used only for CSR and Sustainability activities as per the implementation mechanism specified by DPE, the Committee is of the view that in order to act in an equitable manner, the company has no realistic alternative apart from spending that amount on the CSR and Sustainability activities. Thus, it is more likely than not that the company would be required to spend the specified amount on CSR and Sustainability activities, which creates a present obligation on the company. Accordingly, the company should make a provision for such an obligation as per the requirements of AS 29. On the basis of the above, the Committee is of the view that in the extant case, in the financial year 2013-14, the company would be correct in recognising a provision in respect of unspent expenditure on CSR and Sustainability activities.

11. With regard to disclosure of unspent amount of CSR & SD as short-term provision, the Committee is of the view that the company may classify the same as short-term provision under the head 'current liabilities' provided it meets the definition of 'current liabilities' as per the requirements of the revised Schedule VI to the Companies Act, 1956. In this regard, the Committee notes clause 3 of 'General Instructions for preparation of Balance Sheet' to Revised Schedule VI to the Companies Act, 1956 as follows:

"3. A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current."

From the above, the Committee is of the view that to the extent the liability for CSR and SD is due to be settled within twelve months, the same should be disclosed as 'short-term provision' under the head 'current liability', otherwise, the same should be classified as 'non-current liability'.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that in the financial year 2013-14, the company should provide for the unspent amount of CSR & SD as provision in its accounts. With regard to disclosure, the Committee is of opinion that to the extent, the liability for CSR and SD is due to be settled within twelve months, the same should be disclosed as 'short-term provision' under the head 'current liability' otherwise it should be classified as 'non-current liability', as discussed in paragraph 11 above.

Query No. 9

Subject: ***Accounting treatment of lease deposits received for lease of land by the company engaged in development of software technology parks.[1]***

A. Facts of the Case

1. A company is a wholly owned Government of Tamil Nadu Undertaking incorporated on 21st March, 1977 under the Companies Act, 1956 and is having its registered office at Chennai. The authorised share capital of the company is Rs. 30.00 crore consisting of 3,00,000 equity shares of Rs. 1000/- each and the paid-up share capital is Rs. 25,93,05,000/-. The entire share capital has been subscribed by the Government of Tamil Nadu.

2. The company was formed with the main objective of promoting electronics industry in the State and nurture them. The business activities of the company include promotion of software technological parks in tune with the policy of the Government of Tamil Nadu to promote software industry in the State. With this aim, the company is setting up Information Technology (IT) parks at Chennai and other tier II cities as per the guidelines under the Special Economic Zones Act, 2005 (SEZ Act) read with the Special Economic Zone Rules, 2006 (SEZ Rules).

Category I

3. The querist has stated that the company has, inter alia, been leasing out land to IT companies and was collecting lease deposits upfront for the lease of land from the lessee IT companies. Initially, the lease deposit was 100% repayable when the lessee surrenders the land as per the lease agreement entered into between the company and the lessee IT companies. The lease deposits so collected in the previous years have been disclosed as ‘Land Lease Deposit’ under the head ‘Loan Funds’ which had not been objected by the Comptroller and Auditor General of India (C&AG) /Accountant General until financial year 2009-10. A sample copy of such a lease agreement has been supplied by the querist for the perusal of the Committee.

Category II

4. The querist has also stated that since 22.12.2010, the company is

[1] Opinion finalised by the Committee on 1.5.2014.

collecting lease deposits with the condition that 15% of the amount will be forfeited if the lessee surrenders the land within a period of 3 years and for subsequent periods, 5% of the lease deposit will be forfeited from the 4^{th} year onwards. Only 15% of the lease deposit collected is repayable after the expiry of 17 years or subsequently. This has been stated at 3.01 (n) of the 'Statement of Significant Accounting Policies' in the accounts of the company for the year ending 31.03.2011 and subsequent years also. A copy of this category of agreements entered into with the lessee has also been supplied by the querist for the perusal of the Committee. Relevant extracts of C&AG's comments on the annual accounts for 2010-11and 2011-12 have been provided by the querist as given below:

"2010-11

A. Source of Funds

Current Liabilities and Provisions – Rs. 679.60 crore

This includes a sum of Rs. 226.68 crore being the sale value of plots allotted in various SEZs. This should have been treated as income as the transfer of ownership to the lessees amounted to sale and accounted for accordingly. This has resulted in overstatement of current liabilities and provisions and understatement of income to that extent.

B. Application of Funds

Fixed Assets – Sch.1.05 – Land – Rs. 337.47 crore

The above includes a sum of Rs. 229.50 crore being the cost of 783.71 acres of land which is saleable in nature. The same should be classified as 'stock-in-trade' under 'Current Assets'. Inclusion of the same under above head has resulted in overstatement of fixed assets and understatement of current assets to the extent of Rs. 229.50 crore. These comments of C&AG are based on the opinion given for query no. 22 of Volume XX of the Compendium of Opinions, issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI).

2011-12

Non-current Liabilities and Provisions - Long Term borrowings - Rs. 273.94 crore.

> This includes a sum of Rs. 273.82 crore being the amount received as lease deposits which should have been accounted as income treating the long term lease as sale. Non-accounting has resulted in overstatement of liabilities and understatement of income and profit to that extent.
>
> **Non-current Assets – Fixed Assets – Tangible Assets – Land Rs. 337.47 crore**
>
> The above includes a sum of Rs. 113.24 crore being the cost of 783.69 acres of land which is saleable in nature. The same should have been classified as 'stock-in-trade' under 'Current Assets'. Inclusion of the same under above head has resulted in overstatement of fixed assets and understatement of current assets to the extent of Rs. 113.24 crore."

5. According to the querist, the above comments given by the C&AG were based on the opinion given by the Expert Advisory Committee of the ICAI in the case of a company, which was presumably based on commercial leases. The company in this case is coming under the SEZ Act and SEZ Rules, 2006 which came into force from 10th February, 2006, which provides that these lands cannot be sold. The Board of Directors of the company examined the matter in detail besides considering the professional advice from three opinions which included lawyers and chartered accountants and decided that the company may write to the Institute of Chartered Accountants of India for expert opinion in the matter.

6. The querist has also stated that as observed by C&AG, Rs. 226.68 crore represents the lease deposits received from prospective IT companies, which have taken lands in various special economic zones on lease from the company for periods ranging upto 99 years. The Government of India (GOI) granted the company, through various Gazette notifications, approval for development and operation of sector specific special economic zones for information technology enabled services at various places in Chennai, Trichy, Madurai, Coimbatore, Salem and Thirunelveli. The company as sector specific developer of SEZ leased the land to the prospective entrepreneurs for 90/99 years lease. These leases of land are governed by the SEZ Act, 2005 and SEZ Rules, 2006. Section 11(9) of the SEZ Rules prohibits sale of land by the developer in any SEZ and section 51 of the SEZ Act overrides all other Acts. As per the querist, in view of the specific provisions in the SEZ Act and SEZ Rules, the non-compliance with these provisions may lead to cancellation of the status of 'Developer of SEZ'. Thus, as a Developer of

SEZ, the company has to comply with the Acts and Rules under SEZ and hence, the lease cannot be considered as sale and the lands in question in SEZ remain with the company. Hence, it had to account the lease deposit at the beginning of the lease period under 'Loans & Advances' head only.

B. Query

7. In the above circumstances, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment of the land lease deposits and lease hold land already given by the company in the accounts upto 2010-11/ 2011-12 is in order.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to accounting treatment of land lease deposits received by the company and land given on lease by the company in the two categories of lease agreements, a sample copy of each of which has been supplied by the querist for the perusal of the Committee. 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, accounting for acquisition of land by the company from the Government, accounting for development expenditure incurred by the company, accounting for lease rent, service charges, annual maintenance charges and the sum received by the company in respect of development expenses, timing of recognition of lease income over the period of lease, interpretation of SEZ Act and SEZ Rules, etc. In the facts and circumstances of the company, the Committee has presumed that the company is not acting as an agent of the Government. The Committee has also presumed from the Facts of the Case that land lease deposit is payable by the lessee only in respect of lease of land and is not towards development expenditure.

9. The Committee notes the following paragraphs of the Technical Guide on Accounting for Special Economic Zones (SEZs) Development Activities, issued by the Research Committee of the ICAI in the year 2010:

> "16. Although, Accounting Standard (AS) 19, *Leases*, excludes from its scope the leases of land, yet, for the purpose of this Technical Guide, for accounting by Developer as the lessor, the principles of AS 19 should be used even in case of accounting for leases of land. Accordingly, leases of land should be classified as operating or finance

leases in the same way as leases of other assets. In determining whether land is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, there is a strong indication that lessee does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be considered as an operating lease. Accordingly, in such cases, the Developer shall present land in his balance sheet as its asset."

"30. Where a Developer leases land on operating lease as discussed in paragraph 16, lease income should be recognised on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit, in accordance with AS 19.

31. The lease deposits received before the inception of the lease (which is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease) should be considered as 'income received in advance' to the extent the deposits are not refundable. The income from lease should be recognised in the statement of profit and loss only after the inception of the lease as discussed in the above paragraph."

From the above, the Committee notes that the principles enunciated in AS 19 can be applied in the case of lease of land also. Further, the Committee is of the view that in the case of lease of land, considering its indefinite economic life and if title to the land is not expected to be transferred, ordinarily, lease of land would be classified as an operating lease unless there are other facts that demonstrate that lease is of the nature of 'finance lease', such as, at the inception of lease, the present value of various payments related to use of land during or at the beginning of the lease amounts to substantially the fair value of land, etc. In this context, the Committee notes the following provisions of AS 19:

"3.2 A <u>finance lease</u> is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

3.3 An <u>operating lease</u> is a lease other than a finance lease.

3.4 A <u>non-cancellable lease</u> is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain."

"3.6 The <u>lease term</u> is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise."

"8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent."

From the above, the Committee notes that whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form and requires exercise of judgement considering various factors peculiar to the lease agreement, as prescribed in paragraphs 8 and 9 of AS 19, such as, transfer of ownership of the asset at the end of lease term, option to purchase the asset at the end of the lease term, present value of lease payments, conditions for cancellation, etc. The Committee notes that in the extant case, SEZ Act prohibits sale of land in any SEZ and thus, the legal title of land is not expected to be transferred during or at the end of lease term. Further, the Committee notes from the lease agreement (a copy of which has been supplied by the querist for the perusal of the Committee) that in case of Category I type of leases, there is 100% refundable deposit and a nominal lease rent of Re. 1 per year over the period of lease which does not appear to be the fair value of leased asset (land). Further, the lease agreement states that in case of surrender of lease of the land by the lessee to the lessor prior to the end of the period of lease of 90 years, the refund of the land deposit shall be made by the lessor to the lessee which indicates that the lessee has the option to cancel the lease before the initial lease period. Also, the lessee cannot directly/indirectly transfer/sell/assign/sublet, etc. the leased property in any manner whatsoever and can utilise the leased property only for the purpose for which it has been granted indicating that the lessee does not have discretion on the use of the leased property. The Committee is of the view that all these factors do not indicate that the lease is of the nature of finance lease and accordingly, it should be considered as an operating lease.

10. In case of Category II type of leases, the Committee notes from the copy of the lease agreement supplied by the querist for the perusal of the Committee that there is a lock-in-period of only 3 years during which the lessee cannot exit/surrender the property and after that, the lessee shall be entitled to surrender the property and will be entitled to receive the lease deposit after deduction of minimum 15% and maximum 85% depending upon the lease term. Also, there are restrictions on the utilization of the leased property and direct/indirect transfer/sale/assignment, etc. of the lease without the prior consent of the lessor except to its wholly owned subsidiary company or the company in which the lessee holds 51% or more of the total share capital with controlling stake, which indicate that the lease is not of the nature of finance lease. However, if there are other facts which demonstrate otherwise, such as, at the inception of lease, the present value of various payments related to use of land including non-refundable lease deposit during or at the beginning of the lease amounts to substantially the fair value of land, the lease is classified as finance lease. Similarly, other terms such as, renewability clause with an option to lessee to renew the lease for a further such term on such terms and conditions as may be mutually agreed between the lessor and the lessee, etc., may indicate that the lease is a finance lease. Thus, whether the lease in this category is an operating lease or finance lease would depend upon the facts and circumstances and accordingly, the company should consider various factors, as discussed above, and decide whether to classify the lease as operating or finance lease.

11. Accordingly, the Committee is of the view that in case of Category I type of leases and in case of Category II if the lease is classified as an operating lease, the company should recognise the land in its financial statements as its own fixed asset. Further, the land lease deposits to the extent these are non-refundable should be considered as ‘income received in advance’ and the income from lease should be recognised in the statement of profit and loss only after the inception of the lease on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit, in accordance with AS 19. In this regard, the Committee wishes to point out that the lease term should be determined as the initial non-cancellable period and any further period for which the lessee has the option to continue the lease and it is reasonably

certain that the lessee will exercise such option at the inception of lease. In case of Category II type of leases, if the lease is classified as finance lease, the company should recognise the transaction in accordance with the requirements of AS 19. With regard to the disclosure requirements, the Committee notes that as per revised Schedule VI to the Companies Act, 1956, "a liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current."

12. On the basis of the above, the Committee is of the view that land lease deposits to the extent expected to be recognised as income within next twelve months after the reporting period, should be classified as 'other current liabilities' under 'Current Liabilities' and remaining land lease deposits should be classified as 'Other long term liabilities' under 'Non-current liabilities' as per point (c) stated above. Further, refundable land lease deposits to the extent these are due to be settled within twelve months after the reporting date should be classified as 'Current liabilities' and the balance should be classified as 'Non-current liabilities'. The Committee is also of the view that upto the year 2010-11, to the extent, the land lease deposits are refundable, these should be treated and disclosed under 'Current Liabilities' as per the requirements of pre-revised Schedule VI to the Companies Act, 1956.

13. The Committee also notes certain distinguishing features in the extant case which were not existing in the facts of earlier opinion of EAC issued on 8.8.2000, referred by the querist, are applicability of SEZ Act, 2005 and SEZ Rules, 2006 which prohibits sale of land in the SEZ, which was not

applicable in the earlier opinion of EAC, issuance of Technical Guide by the Research Committee of the ICAI in the year 2010 etc. Similarly, other terms relating to lease premium, transferability of lease by the lessee, etc. are different from the facts of the extant case and accordingly, the earlier opinion cannot be applied in the extant case.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that the land in Category I type of leases and in Category II, if lease is classified as an operating lease considering various factors as discussed in paragraph 10 above, should be treated as the fixed asset of the company in its financial statements. For Category II type of leases, which are classified as finance lease, the company should recognise the transaction in accordance with the requirements of AS 19. Where the lease is considered as operating lease, the land lease deposits to the extent these are non-refundable should be considered as 'income received in advance' and the income from lease should be recognised in the statement of profit and loss only after the inception of the lease on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit, in accordance with AS 19, as discussed in paragraph 11 above. Further, land lease deposits to the extent expected to be recognised as income within next twelve months after the reporting period, should be classified as 'other current liabilities' under 'Current Liabilities' and remaining land lease deposits should be classified as 'Other long term liabilities' under 'Non-current liabilities'. The refundable land lease deposits to the extent these are due to be settled within twelve months after the reporting date should be classified as 'Current liabilities' and the balance should be classified as 'Non-current liabilities'. Upto the year 2010-11, the land lease deposits to the extent these are refundable should also be treated and disclosed under 'Current Liabilities', as per the requirements of pre-revised Schedule VI to the Companies Act, 1956, as discussed in paragraph 12 above.

Query No. 10

Subject: Inclusion of various costs in the valuation of inventories.[1]

A. Facts of the Case

1. A navaratna public sector undertaking (PSU) (hereinafter referred to as the 'company') under the administrative control of the Ministry of Petroleum and Natural Gas is engaged in exploration, production and transportation of crude oil and natural gas, production and sale of liquid petroleum gas (LPG) and condensate and transportation of finished petroleum products of other PSU refineries to their marketing points. Presently, the company sells its entire crude oil to PSU refineries. The transfer of crude oil to the refineries takes place after testing and determination of quality (base sediment and water determination) and quantity of crude oil at the refinery gate through the process pipeline owned by the company and the requisite documentations are prepared and authenticated jointly by the representatives of the company and the respective refineries. Sales take place at the refinery gate with the passing of risks and rewards to the refineries. Revenue is only recognised at the refinery gate, i.e., at the custody transfer point. Extract of the relevant portion of the company's accounting policy has been stated below:

> "Revenue Recognition: Revenue from sale of products is recognised on custody transfer to customers."

2. It may be noted that in the process of delivery of crude oil through its pipeline, there has always been certain amount of finished crude oil remaining in the operational process namely at tank farm and pipeline before the transfer takes place at the custody transfer point. The broad operational process flow diagram for this is as under:

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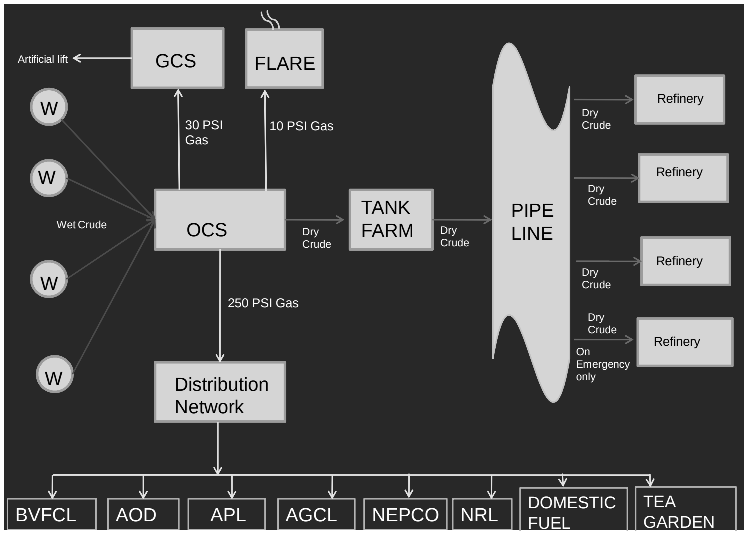
[1] Opinion finalised by the Committee on 1.5.2014.



The querist has separately explained with reference to flow diagram as follows:

W Indicates producing wells. Producing wells located in the fields are used for lifting the crude oil upto surface level (i.e., well head).

OCS OCS stands for Oil Collecting Stations. After lifting, crude oil is transported through flow lines from the well head to the connected Oil Collecting Stations for further processing.

In OCS, separation of formation water, associated natural gas, etc. are carried out. After separation, crude oil is stored in storage tanks for onward despatch to tank farm. Gas separated at the OCS is:

(i) transported through fields net work line to GCS (Gas Collecting Stations) which is used further for injection into the well bore for lifting of crude oil (which is called Artificial Lifting Technique).

(ii) transported through fields net work line to distribution network for onward distribution to various consumers of natural gas.

(iii) Low pressure gas which is otherwise not required is flared.

Dry crude (separated from water and associated natural gas) is transported from OCS through flow lines to the connected tank farm.

TANK FARM

From the storage tanks, the crude oil which contains formation water is despatched to tank farms, where it is processed for further separation of formation water by gravity separation process as in Central Tank Farm (CTF) or is routed through dehydration facilities like Electrostatic Emulsion Treater (EET) in Intermediate Tank Farm (ITF). In gravity separation process, the crude once received in the tanks is allowed to settle for a retention time of ideally 10-12 hours for free water and sludge to settle.

The processed crude oil at tank farm level is then handed over to pipeline department through custody transfer for onward despatch to refineries.

PIPELINE

Pipeline functions though its various pumping stations. Crude oil from tank farm is handed over to pipeline department which is pumped to pump stations nearer the central tank farm. On receiving, pump stations pump it further to the next forward pump stations on its way to the custody transfer point before the refinery gate.

3. Crude oil remaining in the operational process as stated above before its transfer of risks and rewards to the refineries at the custody transfer point is required to be valued at the end of a given financial period. Cost of finished goods is determined on absorption costing method. Relevant portion of the accounting policy of the company is as under:

> *"Finished goods of Crude Oil, Liquified Petroleum Gas and LPG Condensate are valued at cost or net realisable value, whichever is lower. Cost of finished goods is determined on absorption costing method."* (Emphasis supplied by the querist.)

Accordingly, quantities of finished crude oil stock lying in the process namely at tank farm and pipeline at the end of a given financial period are valued at lower of cost or net realisable value as per the above accounting policy as well as Accounting Standard (AS) 2, 'Valuation of Inventories'.

4. With regard to the absorption costing method followed by the company, the querist has also clarified that in the method, the fixed production costs for a period are shared across the output for that period. In an extractive

industry like oil and gas, where the company produces crude oil from the wells located in blocks owned by it, there is no variable cost of production except royalty which is payable on production (royalty varies with the quantity of crude oil produced). Fixed production cost normally comprises the actual cost incurred during a period towards:

(i) Salary and wages of manpower engaged in operation and maintenance of wells and production installations (OCS), well servicing and work over operations, wellhead setup, tank farm, etc.

(ii) Stores and consumables like chemical, flow improver, industrial gases, etc.

(iii) Cost of any hired services for maintenance, casual labour, vehicles, equipments, etc.

(iv) Insurance premium on assets like building, plant and machineries installed at OCS, crude oil flow lines.

(v) Fuel and lube oil used for plant and machineries.

(vi) Captive consumption of gas etc. for injection.

(vii) Depreciation of plant and machineries and depletion of producing fields.

(viii) Share of engineering and general services departments like water, electricity, transport, administration, finance and accounts, security, safety and environment, township etc. (all services relating to fields operational area). Total of actual cost of service departments are apportioned to production on a reasonable basis.

Sum of the actual cost incurred on (i) to (viii) above during a period is divided by the net production quantity (Gross production less unavoidable losses) during that period to calculate the per unit cost of production (excluding royalty) under absorption costing method.

Note: Costs do not include corporate/ general administrative expenditure.

In addition, the querist has stated that operation and maintenance cost of pipelines towards salary and wages, stores and consumables, cost of hired services, insurance and depreciation of pipelines and other plants and machineries etc., cost of apportioned services and overhead cost on actual basis of pipeline transportation activity are divided by the crude oil quantity delivered to the refineries at the custody transfer point to calculate the pipeline cost per unit.

5. The querist has stated that the cost elements considered for valuation of crude oil are cost of production, royalty charges at a rate applicable as on valuation date and other costs incurred for tank farm and pipeline, viz., depreciation/depletion, operation and maintenance cost, insurance charges. With regard to royalty charges, the querist has separately clarified as follows:

(i) Royalty is levied on crude oil, condensate and natural gas and governed by Oilfield (Regulation & Development) Act, 1948 (the 'Act') and Petroleum & Natural Gas Rules, 1959 (the 'Rules').

(ii) The liability of royalty arises to the lessee, i.e., company at the time of production and is payable to the Central/State Government who has granted the lease at the rate and time specified in the Act and the Rules.

(iii) Taxable event/base for payment of royalty is production of crude oil/natural gas/well head condensate. Royalty is not collected from or billed to the customer separately as per the pricing terms of crude oil sale agreement. It is a cost to the company and is shown as expenditure in the statement of profit and loss.

With regard to maintenance, the querist has separately clarified that it primarily comprises dewaxing the pipelines through pigging service at regular intervals depending on temperature, line pressure and crude quality. Maintenance activities of tank farm and pipelines are part of regular operational process. Further, insurance costs are incurred in respect of crude oil lying in pipelines and tanks farm as well as for pipelines and tank farms. The querist has also stated that the above other costs have been included in valuation of inventories in line with the principle enunciated in paragraph 11 of AS 2 which states as under:

> *"Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. ..."* (Emphasis supplied by the querist.)

6. Further, it is to be stated that crude oil lying in the tank farm is subjected to certain operations, viz., heating and agitating on a continuous basis to

retain its marketable characteristics and then the same is transmitted through the pipeline upto the custody transfer point which are the normal operational processes of the upstream oil and gas companies. As per the refinery practices, the selling point starts only at the refinery gate, i.e., the custody transfer point. These tank farm and pipelines are not used for any storage and also not technically built for continuous storage purpose. It is relevant to note that the downstream companies on receiving such crude oil keep the same in their tank farm and such crude oil is again subjected to heating and agitating process in the tank farm till it is sent for refinery process.

7. The querist has also stated that value of inventories determined as above does not also include the stipulations mentioned in paragraph 13 of AS 2, which inter alia, states as below:

"(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs."

(Emphasis supplied by the querist.)

Views of the Auditor:

8. During the audit for the financial year (F.Y.) 2012-13, the question of inclusion of royalty charges on crude oil at a rate applicable as on valuation date before the sales take place and other costs incurred on tank farm and pipeline, viz., depreciation/depletion, operation and maintenance cost and insurance in the valuation of closing finished stock of crude oil was raised. It was contended by the audit that these costs are in the nature of selling and distribution expenses. Therefore, these costs should not be included in the inventory cost.

Views of the company:

9. The company contended that the liability of royalty charges on crude oil like excise duty accrues on production of crude oil and it has been

treating the tank farm and pipeline cost being part of other costs for bringing the finished crude oil to its present location and condition in line with paragraph 11 of AS 2 as mentioned above. This practice of valuation of closing stock of finished crude oil is being followed by the company consistently. The company further contended that tank farm and pipeline are part and parcel of the operational process and there is no involvement of storage and distribution activities in the said process. Moreover, the quantum and value of finished crude oil stock including the value of cost of production lying in the tank farm and pipeline before its custody transfer point are not material (less than 0.5% of turnover).

B. Query

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

(i) Whether the royalty charges on crude oil at a rate applicable as on valuation date and other costs of tank farm and pipeline, viz., depreciation/depletion, operation and maintenance cost and insurance charges should be included in the valuation of finished crude oil stock.

(ii) If not, then what is the correct method of valuation of finished crude oil stock before its custody transfer?

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to inclusion of royalty charges on crude oil and other costs of tank farm and pipeline viz., depreciation/depletion, operation and maintenance cost and insurance charges in the cost of finished crude oil stock. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, other elements of cost in the cost of inventories, allocation of fixed production cost to determine cost of production, propriety of method or cost formula used for determining cost of finished goods, applicability of paragraph 1(d) of AS 2 for valuation of producer's inventories of mineral oils, ores and gases at net realisable value at certain stages of production, revenue recognition of crude oil, measurement of royalty charges to be included, if any, in the cost of inventories, inclusion of insurance charges of crude oil lying in the tank farm or pipeline in the cost of inventories, assessment of materiality with regard

to quantum and value of finished crude oil lying in the tank farm and pipeline, etc.

12. The Committee notes the following paragraphs of Accounting Standard (AS) 2, 'Valuation of Inventories', notified under the Companies (Accounting Standards) Rules, 2006:

> ***"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.***
>
> **Costs of Purchase**
>
> 7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.
>
> **Costs of Conversion**
>
> 8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. …"
>
> "11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."
>
> "13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:
>
> (a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs."

13. From the above, the Committee notes that as per AS 2, the cost of inventories would also include costs other than cost of purchase and cost of conversion as are incurred in bringing the inventories to their present location and condition. The Committee is of the view that the test for determining whether or not the cost of carrying out a particular activity should be included in the cost of inventories is whether the activity contributes to bringing the inventories to their present location and condition.

14. With regard to inclusion of royalty charges in the cost of inventories, the Committee notes that, as per the facts provided by the querist, the liability for royalty arises for the company at the time of production and is payable to the Central/State Government at the rate and time specified in the Act and the Rules. Keeping this in view, the Committee feels that the royalty charge is a necessary operational expense which must be incurred to bring the inventories to their present location and condition and, accordingly, actual royalty incurred and accounted in the books by the company should be included in the cost of finished crude oil stock.

15. With regard to inclusion of other costs of tank farm and pipeline, viz., depreciation/depletion, operation and maintenance cost and insurance charges of tank farm and pipeline in the cost of finished crude oil stock, the Committee notes that the querist has stated that tank farms and pipelines are not used and technically built for continuous storage. In this regard, the Committee notes from paragraph 13(b) of AS 2 reproduced above that generally storage costs are excluded from the element of cost for inventory valuation, unless those costs are necessary in the production process prior to a further production stage. In the extant case, the Committee notes that the crude oil which still contains formation water is despatched from the storage tanks to tank farms, where it is processed for further separation of formation water by gravity separation process or are routed through dehydration facilities like Electrostatic Emulsion Treater and that in gravity separation process, the crude once received in the tanks is allowed to settle for a retention time of ideally 10-12 hours for free water and sludge to

settle. From this, the Committee notes that the crude oil lying in the tank farm is subjected to certain operations and that some production process is carried out in tank farm. Accordingly, the Committee is of the view that the other costs of tank farm, viz., depreciation/depletion, operation and maintenance cost and insurance charges related to tank farm are the costs necessary in the production process and that these costs are necessary for changing the condition of the inventory from unprocessed to processed. Accordingly, these costs should be included in the valuation of crude oil lying in the tank farm and pipelines.

16. With regard to inclusion of other costs of pipeline, viz., depreciation/ depletion, operation and maintenance cost and insurance charges of pipelines in the cost of finished crude oil stock, the Committee notes paragraph 13(d) of AS 2 (reproduced above) and is of the view that 'distribution costs' referred to paragraph 13(d) should be construed as the costs which are incurred by the seller in making the goods available to the buyer from the point of sale. In this regard, the Committee notes from the Facts of the Case that pipelines are used to transmit the crude oil to the custody transfer point at the refinery gate and that the sale takes place at the refinery gate with the passing of risks and rewards to the refineries. Thus, considering the refinery gate as point of sale, the Committee is of the view that in the extant case, pipelines are used to transmit the oil to the point of sale and therefore, the above-mentioned expenditure is incurred in changing the location of the inventories, i.e., bringing the inventories to the intended point of sale. Accordingly, depreciation/depletion, operation and maintenance cost and insurance charges of pipelines should be considered in arriving at the costs of inventories lying in the pipelines.

D. Opinion

17. Based on the above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

(i) Royalty charges on crude oil, incurred and accounted in the books by the company should be included in the valuation of finished crude oil, as discussed in paragraph 14 above. With regard to depreciation/depletion, operation and maintenance cost and insurance charges of tank farm, the Committee is of the view that these are the costs necessary in the production process and that these costs are necessary for changing the condition of the inventory from unprocessed to processed. Accordingly, these costs should be included in the valuation of crude oil lying in the tank farms and pipelines, as discussed in paragraph 15 above. With regard to inclusion of depreciation/depletion, operation and maintenance cost and insurance charges of pipelines in the cost of finished crude oil stock, the Committee is of the view that in the extant case, pipelines are used to transmit the oil to the point of sale and therefore, this expenditure is incurred in changing the location of the inventories, i.e., bringing the inventories to the intended point of sale. Accordingly, these costs should be considered in arriving at the costs of inventories lying in the pipelines, as discussed in paragraph 16 above.

(ii) In view of (i) above, the question does not arise.

Query No. 11

Subject: Determination of long-term liability for application of paragraph 46A of AS 11. [1]

A. Facts of the Case

1. A closely held public limited company (hereinafter referred to as the ‘company’) is engaged in the business of developing a 1200 MW (600 MW*2) coal based thermal power project at Madhya Pradesh. The company is a fully owned subsidiary of a company, which is developing coal based thermal power projects. The group is currently operating in solar, hydro, thermal power and EPC business through various companies. The company is registered under the Companies Act, 1956. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956 and revised Schedule VI to the Companies Act, 1956. The company follows financial year as its accounting year. The holding company through various subsidiaries is planning to expand its operations to different states of India in the near future.

[1] Opinion finalised by the Committee on 1.5.2014.

2. The company has awarded an Engineering, Procurement and Construction (EPC) contract to a third party for two units of 600 MW each and other major Non-EPC contracts. The project is under construction stage. EPC related project work got started post December 2010 and the project is expected to start commercial operations by July 2014.

3. One of the major costs of the project includes offshore supply contract with the EPC contractor for Boiler, Turbine and Generator ('BTG') denominated in US Dollars. The contract involves a total time period of 35-39 months from supply to commissioning.

4. As a part of the contract between the company and the EPC contractor, the main plant and equipment is being supplied by the contractor by importing it from vendors in China, through their Singapore subsidiary. The equipment is being sold on high sea sale basis to the company and payments are made to the contractor as set out in the contract which are given below:

Payment terms for supply of BTG

a. 5.00% of BTG contract price as first advance within 5 days of submission of advance bank guarantee;

b. 3.50% of BTG contract price as second advance on execution of this contract and against submission of first corporate guarantee;

c. 5.00% of BTG price as third advance on or before the date of falling 3 months from the date of payment of first advance against submission of second corporate guarantee;

d. 61.50% of the BTG contract price by way of sight letter of credit on despatch of equipment on pro rata basis on issuance of material despatch clearance certificate and submission of satisfactory documentary evidence of shipment and relevant shipping documents (generally paid within two to three months of recording of high sea purchases);

e. 10.00% of BTG contract price on receipt of supplies at site on pro rata basis duly certified and verified by owner's representative (paid within 5-6 months of recording of high sea purchases);

f. 1.25% of BTG contract price on boiler light of unit 1;

g. 1.25% of BTG contract price on boiler light of unit 2;

h. 1.25% of BTG contract price on turbine and barring gear for unit 1;

i. 1.25% of BTG contract price on turbine and barring gear for unit 2;

j. 2.50% of BTG contract price on issuance of provisional acceptance certificate for unit 1;

k. 2.50% of BTG contract price on issuance of provisional acceptance certificate for unit 2 and submission of warranty period guarantee by the contractor for an amount equal to 8.5% of the contract price; and

l. 5.00% of BTG contract price on the earlier of (i) issuance of final acceptance certificate or (ii) if the owner refuses to carry out the performance guarantee test within 3 months of issuance of provisional acceptance certificate and contractor has fulfilled all other requirements of final acceptance under the contract, against an unconditional and irrevocable bank guarantee for a period of 6 months.

5. According to the querist, all such offshore supplies are sold by the contractor through high sea sale agreement and risks and rewards get transferred on the date of such high sea sale agreement. Therefore, the *date of high sea sale agreement is considered as the date of transaction* for recording the foreign currency monetary items. The company accounts for such supplies/ equipments as capital assets (emphasis supplied by the querist).

6. The querist has reproduced paragraph 9 of Accounting Standard (AS) 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', issued by the Institute of Chartered Accountants of India (ICAI), which states that ***"A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction".***

7. Further, the querist has also stated that the new paragraph 46A inserted in AS 11 by Companies (Accounting Standards) (Second Amendment) Rules 2011, *inter alia,* states that "the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at

which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of asset and shall be depreciated over the balance life of the asset, …"

8. To exercise the option as referred above, as per clause (2) of paragraph 46A of AS 11, "an asset or liability shall be designated as long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a *term of twelve months* or more at the *date of origination* of the asset or the liability. Accordingly, the date of transaction as per paragraph 9 of AS 11 and date of origination of liability as per paragraph 46A can be considered as the same. (Emphasis supplied by the querist.)

9. Presently, foreign exchange differences arising on actual repayments of such foreign currency liabilities for offshore supplies and restatement of such liabilities as at the balance sheet date are accounted in financial statements as below.

10. Exchange differences on payment made as per the terms of payments as mentioned in paragraph 4(a) to (c) above are considered as 'capital advances' and are not restated considering the same as non-monetary item as based on earlier opinions of Expert Advisory Committee in the said matter. Such payments are adjusted against the liability booked on account of purchase of capital asset on the respective date of transaction.

11. Exchange differences arising on payment of part liabilities as per terms mentioned in paragraph 4(d) to (e) are recorded in the statement of profit and loss by the company considering them as short-term monetary items as these are paid normally in less than 12 months from the date of transaction.

12. Payment of part liabilities as per terms mentioned in paragraph 4(f) to (k) are considered as 'retention money' and as these liabilities are payable normally in a time period of more than 12 months from the date of transaction, therefore, considered as long-term monetary items and same are accounted for as per paragraph 46A of AS 11. Accordingly, exchange differences arising thereon are added or deducted from the cost of asset.

13. As per the querist, in case of these capital imports (offshore supplies contract, as stated above), the liability against such imports of depreciable capital assets originates at the date of transaction (i.e., at the time of high sea sales to the company) as mentioned in paragraph 5 above and will

finally get discharged at the time of balance 5% payment of the contract on issuance of final acceptance certificate from the contractor to the company as mentioned in paragraph 4(l) above. Therefore, complete settlement of the liability will be after a period of 12 months from the date of transaction/ date of origination of liability.

14. Also, according to the querist, the terms of payment as mentioned in paragraph 4 above are *merely payment terms against a single liability and classification of long-term monetary nature of a liability for paragraph 46A of AS 11 should be determined in accordance with the complete tenure from the date of transaction till final payment and not in parts as per part payment terms.* Hence, such single liabilities should not be bifurcated into two different classification of long-term and short-term monetary items and should be treated as long-term and accordingly, the impact is to be recorded in the books of account. (Emphasis supplied by the querist.)

B. Query

15. The querist has sought the opinion of the Expert Advisory Committee that since the time between the date of origination of the liability as per clause 2 of paragraph 46A and final payment/settlement of liability is more than 12 months, as per the terms of contract, whether the entire liability recorded as at the date of origination/transaction should be considered as a long-term monetary item and hence, whether the foreign exchange differences arising on such transaction should be allowed to be adjusted to the cost of capital assets.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised by the querist is that since final payment/settlement of liability is after 12 months from the date of its origination whether the entire liability arising on the date of transaction should be considered as long-term foreign currency monetary item for the purpose of capitalisation of foreign exchange differences under paragraph 46A of AS 11 irrespective of the fact that a part of the liability is repaid/ settled within a period of 12 months. Therefore, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, timing of recognition of liability in case of high sea sale, timing of transfer of risks and rewards related to ownership of asset, accounting for EPC contract, whether liability is monetary liability as per AS 11, etc. Further, the Committee's opinion is not in respect of

determination of nature of individual payments, as mentioned in paragraph 4 above rather on the criteria for determination of nature of liability, i.e., long-term or short-term. The Committee also presumes from the Facts of the Case that the timing of recognition of liability in the extant case is in accordance with the Indian GAAPs.

17. The Committee notes paragraph 46A of AS 11, notified under the Companies (Accounting Standards) Rules, 2006 which, *inter alia,* provides as follows:

> "46A. …
>
> (2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:
>
> *…*"

18. The Committee further notes the following definition of 'Long-term Liability', as given in the Guidance Note on Terms used in Financial Statements, issued by the Research Committee of the ICAI:

> "9.04 **Long-term Liability**
>
> *Liability* which does not fall due for payment in relatively short period, i.e., normally a period not more than twelve months."

The Committee also notes FAQ No. 13 of 'Frequently Asked Questions on AS 11 notification', issued by Accounting Standards Board of the ICAI, which is reproduced as below:

> ***"(13) If the long term foreign currency monetary item is received in instalments whether the installment received within a period of 12 months should be treated as short term in nature?***
>
> **Response**
>
> Yes, each loan installment should be treated as a separate monetary item. The principle should be to amortise the exchange difference proportionately over the period of the monetary item and not to carry forward any unamortised amount beyond the

> settlement of the monetary item to which the exchange difference relates. Treating the entire loan as a single monetary item would result in the exchange difference relating to the loan instalment which is settled being amortised in accounting periods even after such settlement."

19. From the above, the Committee is of the view that the nature of a liability, i.e., short-term or long-term would depend upon its term from the date of origination (i.e., the date of the initial recognition) till the date it falls due for payment, whether partly or fully, as per the terms of payment. In the extant case, although the entire liability may originate on the date of transaction which is the date of its initial recognition, but its nature, i.e., long-term or short-term would depend on the terms of its payment, i.e., when it falls due for payment. Thus, the portion of the liability which falls due within twelve months from the date of its origination would be short-term and the portion of the liability which falls due after twelve months from the date of its origination would be long-term. Moreover, in the context of application of paragraph 46A also, the Committee is of the view that to the extent a liability is discharged within a period of twelve months from the date of its origination, there is no long-term foreign exchange fluctuation exposure on that part of the liability and, accordingly, the foreign exchange gains and losses on that part of liability, i.e., short-term liability should be recognised in the statement of profit and loss. The part of liability which is discharged after twelve months has long-term exposure towards foreign exchange fluctuations, and accordingly, the foreign exchange gains and losses arising on that part of the liability, i.e., long-term liability can be treated in accordance with paragraph 46A of AS 11.

D. Opinion

20. On the basis of the above, the Committee is of the opinion that for the purpose of paragraph 46A of AS 11, the term of a monetary liability as long-term or short-term should be assessed on the basis of terms of the payment. Therefore, the portion of the liability which falls due within twelve months from the date of its origination is short-term and the portion of the liability which falls due after twelve months from the date of its origination is long-term liability. The exchange differences related to the liability which qualifies to be long-term monetary liability can be treated in accordance with requirements of paragraph 46A of AS 11.

Query No.12

Subject: Presentation of write-back of provisions no longer required in the statement of profit and loss. [1]

A. Facts of the Case

1. A public sector company under the Ministry of Steel, Government of India, is primarily engaged in rendering design & engineering, technical consultancy, and project management services etc. for various clients in India and abroad. The company is also executing Engineering, Procurement and Construction (EPC)/turnkey projects involving supply of equipment, erection, commissioning etc. for various clients/projects. As a part of financial and business restructuring, the core business activities of the company have been divided into four Strategic Business Units (SBUs), namely metal, power, oil & gas and infrastructure. These four segments have been disclosed as primary business segments as per the requirements of Accounting Standard (AS) 17, 'Segment Reporting'. The primary objectives of these SBUs are to focus on procurement and execution of jobs in the above fields. The nature of activities of the company is diverse and flexible depending upon various factors like global business scenario, economic policy of the Government, investment decision, and corporate strategy.

2. The querist has stated that as per revised Schedule VI to the Companies Act, 1956, in the statement of profit and loss, total revenue is divided under two heads, i.e., 'Revenue from Operations' and 'Other Income'. In respect of a company other than a finance company, revenue from operations is sub-divided into three heads namely sale of products, sale of services and other operating revenue. Other income is sub-divided into interest income, dividend income, net gain/loss on sale of investment and other non-operating income. It is important to understand the meaning of the term 'other operating revenue' and which items should be classified under this head vis-a-vis under the head 'other income'. The Guidance Note on the Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI), inter alia, states that the term 'other operating revenue' is not defined. However, these include revenues arising from the company's operating activities. *Whether a particular income constitutes 'other operating revenue' or 'other income' is to be decided based on the facts of*

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[1] Opinion finalised by the Committee on 1.5.2014.

each case and detailed understanding of the company's activities (emphasis supplied by the querist).

3. The querist has also reproduced the relevant extracts of accounting policy of the company as follows (refer Note 32 of the financial statements of the company for the year 2012-13):

> *"Use of Estimates*
>
> In preparing the financial statements in conformity with accounting principles generally accepted in India, the company makes best estimates and assumptions that may affect the reported amount of assets and liabilities and the disclosure of contingent liabilities as at the reporting date and the amount of revenue and expenses during the reporting period. Actual result in some cases may differ from those estimates. Any revision of such estimates is recognised during the period in which the same is determined."
>
> *"Provision for Contractual Obligations/LD, etc.*
>
> (i) Provisions for estimated liabilities on account of guarantees & warranties etc. in respect of Engineering & Consultancy Services and Turnkey Contracts are made by the company after assessment of risk and consequential probable liabilities on case to case basis.
>
> (ii) Provisions for liquidated damages are made as and when these are deducted and/or considered deductible by the client as per contract.
>
> (iii) Suppliers'/contractors' claims for price escalation, additional or extra claims, etc. are accounted for to the extent such claims are accepted by the company."

4. Accounting treatment/ practice followed by the company has been stated by the querist as follows:

- Each and every job being distinct and different in nature is allotted a specific work item number (chargeable) from the date of commencement of job. Each and every job being executed for client is part and parcel of the company's operating activities and source of revenue. The company has divided revenue from operations into three items namely revenue from consultancy services, revenue from construction contracts and other operating revenues (refer Note 23). Revenue from consultancy services and revenue from construction contracts are recognised as per the accounting policy of the company. In the course of execution of jobs/operating activities of the company, the company is making various provisions for expenditures out of contractual obligations as per the requirement of contracts with various sub-contractors/ vendors/clients etc. Further, the company is also making provisions as per the requirement of applicable Accounting Standards /accounting practices as the case may be.

- Broadly, the company has classified the expenditure as 'operating expenditure' and 'non-operating expenditure'. Accordingly, expenses incurred in relation to work items (chargeable) are treated as operating expenses and expenses incurred not in relation to any work item (chargeable) are treated as non-operating expenses keeping in mind the nature of activities of the company. However, the revised Schedule VI has not categorically classified any expenditure as either 'operating expenditure' or 'non-operating expenditure'.

- Provisions for contractual obligations/expenses and other provisions, which are related to work items (chargeable) and which are related to operating activities, are part of operating expenses (Refer Note 25 and Note 30 of the financial statements of the company for the financial year (F.Y.) 2012-13). Provisions for contractual obligations/expenses, provisions for bad & doubtful debts, provisions for liquidated damages recovered by clients, provisions for claims recoverable from clients, provisions for advances recoverable from clients etc., which are related to work items (chargeable) and which are related to operating activities, are reviewed periodically and reversed in the accounts on case to case basis as and when these provisions are no longer required to be carried in the balance sheet. Therefore, such provisions no longer required and written back which are related to work items and related to operating activities are treated as part of 'other operating revenues' considering the nature of activities of the company and also in the ordinary course of business of the company. For instance, trade receivable is essentially recognised as amount to be realised from goods sold or services provided to the particular client in the normal course of operation. Hence, writing back of provision against trade receivable with specific work item number is also shown as 'other operating revenues'. Considering the nature of activities/business profile of the company, same logic is applied for similar items of provisions written back which are related to work items and related to operating activities and, therefore, are shown under 'other operating revenues' as a matter of prudent accounting practice consistently followed by the company.

- Provisions for salary and wages, provision for employee related expenses, provision for various administrative and office expenses of general nature which are not related to any work item (chargeable) are treated as non-operating expenses (Refer Note 27 and Note 30). Such provisions which are not related to work items (chargeable) are reviewed periodically and reversed in the accounts on case to case basis as and when these provisions are no longer required to be carried in the balance sheet. Therefore, such provisions no longer required and written back which are not related to work items are shown as 'other non-operating income' under the head 'other income' (refer Note 24) as a matter of prudent accounting practice consistently followed by the company.

- As per the annual accounts of the company, Note 25 'Purchase of Equipments and Direct Expenses' represent operating expenses only, Note 27 'Employee Benefit Expenses' represent non-operating expenses only and Note 30 'Other Expenses' represent operating expenses and non-operating expenses both. As per Note 30, provision for bad & doubtful debts, provision for liquidated damages recovered by clients, provision for claims recoverable from clients, provision for advances recoverable from clients, provision for doubtful deposits etc. which are related to work items (chargeable) and related to operating activities of the company are items of operating expenses. On the other hand, rent, rates & taxes, repairs & maintenance, audit fees, advertisement & publicity, legal & professional fees, postage & telephone, power & fuel etc. which are not related to any work item (chargeable) are items of non-operating expenses.

- To sum up, in compliance with the requirements of revised Schedule VI, provisions written back related to work items (chargeable) are shown as 'other operating revenues' under the head 'revenue from operations' and provisions written back not related to work items (chargeable) are shown as 'other non-operating income' under the head 'other income' in the statement of profit and loss as a matter of prudent accounting practice consistently followed by the company.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee of the ICAI on the following issues:

(i) Considering the nature of activities of the company, whether the company is correct to present and disclose provisions no longer required and written back which are related to work item numbers (chargeable) and related to operating activities as 'other operating revenues' under the head 'revenue from operations'.

(ii) Considering the nature of activities of the company whether the company is correct to present and disclose provisions no longer required and written back which are not related to work item numbers as 'other non-operating income' under the head 'other income'.

(iii) Whether the company can continue to follow the above accounting treatment and the above presentation and disclosure as required under revised Schedule VI to the Companies Act, 1956 or Schedule III to the Companies Act, 2013 as applicable.

(iv) If not, what alternative accounting entry should be passed in the accounts and what presentation and disclosure should be made by the company as required under the Companies Act and Accounting Standards as applicable.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to the presentation and disclosure of write back of provisions no longer required in the financial statements. 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, propriety of classification of expenses including provisions into operating and non-operating, whether accounting policies of the company with regard to use of estimates and recognition of provisions are in conformity with Accounting Standards, etc. The Committee while expressing its opinion has dealt only with the broad principles regarding presentation of write back of provisions and has not gone into the presentation of each provision being recognised by the company.

7. The Committee notes the following paragraphs of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets' and Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies':

AS 29

"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation."

"Measurement

Best Estimate

35. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. ..."

"Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed."

AS 5

"Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required,

for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item."

"25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item."

8. From the above, the Committee notes that the provisions are measured at the best estimate of the expenditure which may be required to settle the present obligation at the balance sheet date and the same should be reviewed at each balance sheet date and adjusted to reflect the current best estimates. Accordingly, any change in the amount of the provision including write-back of earlier provision no longer required is a change in estimate, which should be treated in accordance with the requirements of AS 5. With regard to classification of the effect of change in accounting estimates, AS 5 prescribes that the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. Accordingly, in the extant case, the Committee is of the view that where, in an accounting period, there is any write-back of the earlier recognised provision for a liability and a provision for the same item is also being recognised in that accounting period, the write-back should be adjusted in arriving at the amount of that provision, i.e., only the net amount after adjustment of the write-back should be charged/credited to the statement of profit and loss. However, where, in an accounting period, there is only write-back of the earlier recognised provision and no provision is being recognised, the write-back should be recognised as income in the

statement of profit and loss using the same classification as was used previously. For example, reversal on account of provision for warranties created during the earlier years is Rs. 20 and Rs. 100 is required for providing for warranties in respect of sales effected in the current year on account of provision for warranties. In such a case, write-back of Rs. 20 should be adjusted to Rs. 100 and Rs. 80 (Rs. 100 - Rs. 20) should be recognised as provision for warranties in the statement of profit and loss for the current year. Where no provision is required to be recognised for the current year on account of provision for warranties, write-back of Rs. 20 should be recognised as income. The Committee notes from 'Note No. 36.9 - Particulars of Provision' to the financial statements of the company for the F.Y. 2012-13 that in respect of provisions, for example, in respect of 'provision for claims recoverable', the company is not adjusting the write-back of provisions in the amount of provisions recognised in the statement of profit and loss for the current period. Accordingly, the Committee is of the view that the company's presentation policy to that extent is not correct.

9. The Committee further notes that although revised Schedule VI to the Companies Act, 1956, requires incomes to be classified into operating and non-operating, such an explicit classification is not specified for expenses. Accordingly, the Committee is of the view that if the provision was earlier classified as 'other expense', the reversal should be classified as other operating income or non-operating income keeping in view the fact that whether the provision pertains to an item which is operating in nature or non-operating in nature considering the business and nature of the activities of the company.

10. With regard to the disclosure of write-back of the excess provisions no longer required, the Committee notes the following paragraph of AS 29:

> **"Disclosure**
>
> ***66. For each class of provision, an enterprise should disclose:***
>
> > ***(a) the carrying amount at the beginning and end of the period;***
> >
> > ***(b) additional provisions made in the period, including increases to existing provisions;***
> >
> > ***(c) amounts used (i.e. incurred and charged against the***

provision) during the period; and

(d) unused amounts reversed during the period.

..."

The Committee further notes Clause (b) of Note 5(v) of the 'General Instructions for Preparation of Statement of Profit and Loss', of revised Schedule VI to the Companies Act, 1956, as well as, Schedule III to the Companies Act, 2013, which is reproduced as below:

"5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

...

(v) (a) ...

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required."

On the basis of the above, the Committee notes that in addition to the presentation requirements discussed in paragraphs 8 and 9 above, the company should give disclosures as per paragraph 66 of AS 29 and above reproduced requirements of revised Schedule VI to the Companies Act, 1956, or Schedule III to the Companies Act, 2013, as applicable.

D. Opinion

11. The Committee is of the following opinion on the issues raised by the querist:

(i) & (ii) The Committee is of the view that where, in an accounting period, there is any write-back of the earlier recognised provision for a liability and a provision for the same item is also being recognised in that accounting period, the write-back should be adjusted in arriving at the amount of that provision, i.e., only the net amount after adjustment of the write-back should be charged/credited to the statement of profit and loss. However, where, in an accounting period, there is only write-back of the earlier recognised provision and no provision is being recognised, the write-back should be recognised as income in the statement of profit and loss using the same classification as was used previously. Since the company is not adjusting the write-back of provisions in the amounts of provisions recognised in the statement of profit and loss for the F.Y. 2012-13, the company's presentation policy to that extent is not correct. The Committee is further of the view that if the provision was earlier classified as 'other expense', the reversal should be classified as other operating income or non-operating income keeping in view the fact that whether the provision pertains to an item which is operating in nature or non-operating in nature considering the business and nature of the activities of the company.

(iii) & (iv) With regard to presentation of write-back of provisions no longer required, refer (i) & (ii) above. With regard to disclosure requirements in this regard, the company should give disclosures prescribed in AS 29 and revised Schedule VI to the Companies Act, 1956, or Schedule III to the Companies Act, 2013, as applicable, as mentioned in paragraph 10 above.

Query No. 13

Subject: Determination of stage of completion in foreign currency contracts executed by foreign branches.[1]

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 like Malaysia, Nepal, Bangladesh, Mozambique, Algeria and Sri Lanka. The query is for recognition of revenue in its foreign projects and accordingly the facts below pertain to foreign projects.

2. The company secures contracts through bidding or negotiations and pricing of contracts is decided at the level of the Chairman and Managing

[1] Opinion finalised by the Committee on 1.5.2014.

Director (CMD) of the company at corporate office. The projects are executed on item rate, cost plus or lump sum turnkey basis.

3. The company on behalf of projects, because of its financial strength, arranges various types of bank guarantees (bid bond, advance payment guarantee, performance guarantee, guarantee for release of retention money, etc.) at a very competitive cost to the clients as per the contract conditions. The company has also provided a corporate guarantee towards its design obligations in a foreign contract.

4. At times, the company avails the services of consultants who provide various services in connection with securing the contracts as well as for smooth operation during execution stage. The appointment of these consultants is done at corporate level only.

5. The expenditure incurred upto the stage of securing the contract in all cases and on services of consultants referred above is generally borne by the corporate office and is not passed on to projects even if the project is secured. The project may earn profit or incur losses. The project duration is normally 2-3 years but may be longer for high value projects.

6. The project operates as a foreign branch of the company and is treated as Permanent Establishment (PE) in the country of operations. The manpower for executing the contract is deputed by the company to the projects on temporary posting basis. The salary of employees, in US$, is processed at corporate office and credited to their accounts but the actual expenditure is charged to the project. The project is executed by deploying machinery/ plant which is procured specifically for the project or diverted from other projects and/or by sub-contracting of certain portion of the work. On completion of the project, the plant & machinery is transferred to other projects in other countries or brought to India or disposed-off in the foreign country and all activities are wound up. Similarly, employees are posted back to India. Pending and unsettled issues like disputes, taxation issues of the country etc. are dealt with from the corporate office which takes a long time.

7. The company also posts project heads who, besides a power of attorney, are delegated certain financial and administrative powers by the CMD. The projects can float tenders; appoint sub-contractors within the limits laid down as per the delegated powers as aforesaid beyond which they have to approach the corporate office. In such cases, either the

proposals are finalised at corporate office or approval from higher management at corporate office is obtained. Progress of the projects is monitored from the corporate office on regular basis and the officers/ concerned director incharge of the project from the corporate office also visit the projects for supervision from time to time. The projects are also subject to internal audit conducted by officers deputed by corporate office and proprietary & supplementary audit by the office of Comptroller and Auditor General (C&AG). In nutshell, the projects are given functional freedom so that project execution is carried out efficiently but they have to operate under the control and supervision of the corporate office and are required to follow the rules and regulations laid down by the company in all matters.

8. The contract payments are received in various currencies like Euro, US$ and the local currency of the project country. The percentage of payments in different currencies varies from contract to contract. Expenditure on executing the contracts is also in different currencies and varies from contract to contract. Efforts are made to enter into contracts such that the company pays in the currency in which it receives the payment. However, in case of projects where funds are provided by the Government of India (Indian lines of credit) to the foreign Government, large portion of expenditure is/may be in INR although the contract with the foreign Government provides for payment in foreign currency. Payment in such cases is released to the company by Export-Import Bank of India (EXIM bank) in foreign currency or equivalent INR.

9. Temporary surplus funds with the projects are generally invested at corporate level in short-term bank deposits to be made available to projects when required. Surplus funds which are considered no longer required are repatriated to India keeping in view the Foreign Exchange Management Act (FEMA) provisions. Similarly, if the projects require funds, the same are provided by the company's corporate office. The transfer of funds from/to the projects is not based on profit earned/loss incurred but on the needs of the projects. The projects are not permitted to borrow.

10. Separate books of account are maintained for each contract. The statutory audit of these projects is carried out either by the local auditors appointed by the board of the company with the approval of C&AG or the central statutory auditors are deputed for the audit after taking approval of C&AG. For meeting local tax requirements and payment of local taxes, accounts are also prepared in local currency.

11. Consolidated accounts incorporating the figures of foreign projects are prepared at corporate level and incremental tax as per the Indian Income-tax Act is paid by the company. The querist has stated that based on the above facts, the company is treating all foreign projects as integral foreign operations under the Indian Generally Accepted Accounting Practices (GAAPs).

12. Upto 31.03.2011, the books of account of the projects were prepared in different currencies and INR figures were worked out by converting different currencies figures into INR using yearly/ monthly average exchange rates. Since 01.04.2011, the books of account are prepared in single currency in Indian Rupees by converting foreign currency transactions into INR at the exchange rate prevailing on the date of transaction. Monetary items are restated at the prevailing closing exchange rate at each balance sheet date. Net exchange gains on restatement of monetary items are accounted for in the statement of profit and loss for the year. During January 2011, the company had obtained an opinion from a renowned firm regarding determination of functional currency as per which the functional currency of foreign jointly controlled operations would be INR.

13. Since more realistic estimate can be prepared in the currency in which substantial payments are to be received (say MYR), project cost estimate/ revised cost estimates are prepared in that currency. For this purpose, back up records in MYR are maintained and transactions in currencies other than in MYR are also converted into MYR. Percentage of completion of the project and profitability is calculated based on actual audited figures in INR for the expenditure incurred to date and the estimated remaining costs (in different currencies) which is arrived at in INR by applying the exchange rates for different currencies on the balance sheet date (sample calculations have been provided by the querist as Annexure ‘A’ for the perusal of the Committee).

14. The querist has stated that major projects in hand are either complete or in advanced stage of completion. In the past few years, the turnover from foreign projects has been varying between 30% to 50% of the total turnover.

15. The relevant provisions of the Accounting Standards referred to by the company for the above treatment have been reproduced by the querist as follows:

Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'

"7.6 <u>Foreign currency</u> is a currency other than the reporting currency of an enterprise."

"Foreign Currency transactions

Initial Recognition

...

9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction."

"Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transactions; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign

currency should be reported using the exchange rates that existed when the values were determined."

"Recognition of Exchange Differences

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 exception of exchange differences dealt with in accordance with paragraph 15."

"Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31."

"Financial Statements of Foreign Operations

Classification of Foreign Operations

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations"."

"20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those or the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification."

"Non-integral Foreign Operations

24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

(b) ***income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and***

(c) ***all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment."***

"Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised."

Accounting Standard (AS) 7, 'Construction Contracts'

"Recognition of Contract Revenue and Expenses

21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."

"24. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

25. Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is

performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35."

"29. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contracts, the methods may include:

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract."

"Changes in Estimates

37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net

Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods."

16. While discussing the results of foreign operations of one particular project where substantial portion of receipts and expenditure is in local currency, one view was as to why not the percentage of completion and/or profitability be worked out in the local currency. Analysis of this reveals that this method will result in showing higher turnover and profitability in the initial years of the project. The counter view was that since the reporting currency of the company is INR and audited accounts are also in INR which incorporate the effect of exchange differences, adoption of local currency as the basis will distort the results unless reporting currency is changed to the local one since start of the project and necessary adjustments are made for the past period. Moreover, the percentage of expenditure to receipts in a particular currency may substantially vary not only at the initial stage of a contract but later on also when the expenditure is actually being incurred. Such an approach may also result in following different methods of revenue recognition in different projects. It was therefore decided to refer the matter for an expert opinion.

B. Query

17. Opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) is sought on the following issues:

(i) Whether the functional currency of different foreign projects should be different or INR for all projects or currency of country of the project?

(ii) Whether the project cost estimate/revised cost estimate being prepared as above is correct? If not, in which currency the project cost estimate should be prepared?

(iii) Whether percentage of completion and profitability as being worked out is correct? If not, how it should be worked out?

(iv) If any other method is suggested, how to account for the past transactions may also be advised.

C. Points considered by the Committee

18. The Committee notes that the basic issues raised by the querist relate to whether the functional currency of different foreign projects should be different or INR for all projects or currency of country of the project, and in which currency the project cost estimate/revised cost estimate and cost incurred should be computed to determine the stage of completion of the project. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from Facts of the Case, such as, allocation of various elements of cost to the project, determination of actual and estimated project cost, translation of various items of foreign operations in the financial statements of the company, whether determination of stage of completion by reference to the contract cost incurred upto the reporting date reliably measures the work performed, etc. For this purpose, the Committee has presumed that foreign operations are in respect of construction contracts which fall within the scope of AS 7 and the outcome of the contract of foreign operations can be estimated reliably. The Committee, while expressing its opinion, has dealt only with the method of determination of stage of completion of the project and has not gone into determination of amounts to be reported in the financial statements related to construction contracts.

19. With regard to foreign currency transactions, the Committee notes the following paragraphs of AS 11:

> ***"7.6 <u>Foreign currency</u> is a currency other than the reporting currency of an enterprise."***
>
> ***"7.15 <u>Reporting currency</u> is the currency used in presenting the financial statements."***
>
> **"Initial Recognition**
>
> ***9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction."***

“Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transactions; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.”

20. On the basis of the above, the Committee notes that AS 11 prescribes that the reporting currency should be used in recording foreign currency transactions and for presenting financial statements. Accordingly, the Committee notes that AS 11 does not follow the ‘functional currency’ concept. However, the Committee notes that as per AS 11, the methodology used to translate the financial statements of a foreign operation depends on the classification of the foreign operations as integral or non-integral. In this regard, the Committee notes the following paragraphs of AS 11:

“7.10 Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.”

"7.13 <u>Non-integral foreign operation</u> is a foreign operation that is not an integral foreign operation."

"18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification."

On the basis of the above, the Committee is of the view that since determination of appropriate classification of foreign operations into integral and non-integral is a matter of judgement, the company should apply the criteria specified in the above paragraphs considering its own facts and circumstances.

21. With regard to the determination of stage of completion, the Committee notes that the objective is to determine the extent of contract work completed/ performed so as to provide information on contract activity and performance during a period. Thus, the purpose is to determine reliably the stage of completion and not reporting *per se.* Therefore, AS 11 which prescribes reporting requirements for foreign operations would not govern the determination of stage of completion. In this regard, the Committee notes that AS 7 also does not provide explicit guidance as to which currency

should be used for computing project cost estimates/revised cost estimates and actual cost incurred to determine the stage of completion of the project when costs and revenues are denominated in different foreign currencies. However, AS 7 prescribes various methods for determining stage of completion including survey of work performed and completion of a physical proportion of the contract work and requires to use that method which measures the stage of physical completion of work reliably. The Committee further notes that where stage of completion is determined by reference to contract costs incurred upto the reporting date, only those costs are included which reflect the work performed. Accordingly, the Committee is of the view that since the effect of foreign exchange fluctuations in themselves do not reflect the performance of contract activity, i.e., the work performed, as a matter of principle, the same should be ignored while determining the stage of completion.

22. With regard to the currency to be used while determining the stage of completion, the Committee is of the view that in order to ignore the effect of foreign exchange fluctuations and to reflect only the level/extent of work performed, only one currency and one fixed exchange rate(s) should be used for computing the actual cost incurred and the total estimated costs in the determination of the stage of completion of a contract in a particular country. The effect of foreign exchange fluctuation on the stage of completion can be explained with the help of following illustration:

It is presumed for the sake of convenience that salary is the only component of cost, which is expected to be incurred on the foreign project at USD 10, when the exchange rate was USD 1= Rs. 40/-

The actual cost (salary) incurred as on the reporting date is USD 5

Exchange rate on the date of transaction is Rs. 50 per USD

Exchange rate at the end of reporting year is Rs. 60 per USD

Thus, it can be seen from the above that if the effect of exchange rate is ignored, the stage of completion would be 50% whereas, if the effect of foreign exchange fluctuations is included, the stage of completion would be determined as follows:

Actual cost incurred = Rs. 50*5 = Rs. 250

Total estimated cost = Actual cost incurred + Remaining expected cost at the end of reporting year = Rs. 250 + Rs. (5*60) = Rs. 550

Thus, %age of completion = 250/550 *100 = 45.45%

The above illustrates how the inclusion of or ignoring the effects of foreign exchange fluctuations affect the stage of completion. Accordingly, the Committee is of the view that the present practice being followed by the company would be correct only if it approximates the stage of completion reliably, as discussed above.

23. With regard to the accounting for past transactions, the Committee is of the view that if the practice of the company to determine the stage of completion is not correct as discussed in paragraphs 21 and 22 above, this would result into reporting of incorrect figures of revenue and profits in the financial statements of earlier years. Accordingly, in that case, the same should be rectified and disclosed in the current year as a 'prior period item' in accordance with the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. In this regard, the Committee notes the definition of prior period item and paragraph 15 of AS 5 as follows:

> ***"4.3. <u>Prior period items</u> are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."***
>
> ***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***

D. Opinion

24. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 16 above:

(i) AS 11 does not follow the 'functional currency' concept. Therefore, the question of using functional currencies of different foreign projects does not arise, as discussed in paragraph 20 above.

(ii) & (iii) Since the effect of foreign exchange fluctuations does not reflect the performance of contract activity, i.e., the work performed, the same should be ignored for the purpose of determination of stage of completion. Regarding the currency to be used for computation of cost estimates/revised cost estimates and costs incurred while determining the stage of completion, the Committee is of the view that in order to ignore the effect of foreign exchange fluctuations and to reflect only the extent of work performed, one currency and one fixed exchange rate(s) should be used for computing the afore-mentioned amounts, as discussed in paragraph 22 above. Accordingly, the Committee is of the opinion that the present practice being followed by the company would be correct only if it approximates the stage of completion reliably, as discussed in paragraphs 21 and 22 above.

(iv) The Committee is of the opinion that if the practice of the company does not determine the stage of completion reliably, as discussed in paragraphs 21 and 22 above, the same should be treated as prior period item. In that case, the same should be rectified and disclosed separately in the current year as a 'prior period item' in accordance with the requirements of AS 5, as discussed in paragraph 23 above.

Annexure – A

Project: ABC

Calculation of Percentage of completion and Percentage of Profitability

Year	**Particulars**	**Amount in INR**		**Amount in MYR/Eqiv. MYR of other Currencies****	
		Expenditure	**Receipts**	**Expenditure**	**Receipts**
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
2007-08	Expenditure/ Receipts in INR are audited	22	22	2	2
2008-09		540	600	40	45
2009-10		690	900	50	65
2010-11		790	1,070	55	75
2011-12		800	1,110	50	70
2012-13	-do-*	705	870	40	50
	Total	3,547	4,572	237	307
	Estimated remaining Expenditure/Receipts till completion	390	525	22	30
	Total	3, 937	5,097	259	337
	Profit	1,160		78	
	Profit %	22.76%		23.15%	
	Percentage completion	90.09%		91.51%	

Note * Finalised figures are subject to audit
** Based on back up records

Query No. 14

Subject: ***Restatement of foreign currency monetary liabilities covered (hedged) by plain vanilla call option.*** [1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') operates in the entire value chain of generation, transmission and distribution of electricity. The company has majority of its operations in India and consequently, majority of its revenue is generated from its domestic operation. The company has funded its various projects through domestic and foreign currency debt. Furthermore, the company is also importing coal, oil and project related capital goods on a regular basis. The company hedges the risk of foreign currency exposure (i.e., long-term and short-term) through hedging instruments such as forward contract and plain vanilla call option contract.

2. *Accounting practices followed by the company:*

The accounting practices followed by the company relating to treatment of exchange differences and accounting for forward contracts and plain call option contracts are as articulated hereunder:

- *Treatment of exchange differences:*

  Exchange differences arising on settlement/restatement of short-term foreign currency monetary assets and liabilities of the company and its integral foreign operations are recognised as income or expense in the statement of profit and loss. The exchange differences on restatement/settlement of loans to non-integral foreign operations that are considered as net investment in such operations are accumulated in a 'foreign exchange translation reserve' until disposal/recovery of the net investment. The exchange differences arising on revaluation of long-term foreign currency monetary items are capitalised as part of the depreciable fixed assets to which the monetary items relate and depreciated over the remaining balance life of such assets and in other cases amortised over the balance period of such long-term foreign currency monetary items. The unamortised balance is carried in the balance sheet as 'foreign currency monetary item translation account' net of the tax effect thereon.

[1] Opinion finalised by the Committee on 1.5.2014.

- *Accounting for forward contracts:*

  Premium/discount on forward exchange contracts, which are not intended for trading or speculation purposes, are amortised over the period of the contracts if such contracts relate to monetary items as at the balance sheet date.

  The exchange differences (i.e., difference in exchange rate prevailing at time of contract taken and at reporting period or on cancellation/ settlement date) on forward contracts, which are not intended for trading or speculation purposes and taken to hedge the foreign currency risk of existing assets and liabilities are recognised in the statement of profit and loss at each reporting period or on settlement.

- *Plain Call Option Contracts:*

  Premium/discount on plain call option contracts, which are not intended for trading or speculation purposes, are amortised over the period of the contracts if such contracts relate to monetary items as at the balance sheet date.

Marked to market (MTM) losses are recognised in the statement of profit and loss while gains arising on the same are not recognised until realised on the ground of prudence.

3. The querist has stated that the company hedges its monetary foreign currency exposures by taking suitable hedging products which can be broadly classified into forward exchange contracts and plain vanilla call option contracts. Paragraph 11 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', provides that all foreign currency monetary items as on the balance sheet date are required to be reported using the closing rate or at exchange rate which, according to the querist, more likely reflects the reasonably accurate amount to be paid or to be received. Further, AS 11, while expressly covers the accounting treatment to be given in respect of forward exchange contracts in paragraph 36, is silent on treatment to be given in case of plain call option contracts. Paragraph 36 of AS 11 is reproduced below:

> *"**36. An enterprise may enter into 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. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period."***

In view of the above, the accounting practice followed in respect of forward contract and plain vanilla option is summarised as below:

Particulars	***Forward Contract***	***Plain Call Option***	***Impact***
Premium/Cost of hedges	*Amortised over the period of contract*	*Amortised over the period of contact*	*Accounting treatment is same for both the instruments*
Restatement of liabilities and hedges at each reporting period	*The MTM gain/loss at each reporting period is recorded in the statement of profit and loss.*	*The gain in MTM is ignored but the loss is recognised in the statement of profit and loss.*	*Due to this different accounting practice, the liabilities covered by plain call will always show the loss though it is known that maximum liability will be to the extent of strike rate of the call option.*

4. According to the querist, while the above treatment in respect of forward contracts reflects the *true and fair* state of affairs, in the case of liabilities covered by plain call options, it is reflecting an incorrect picture. The following example will demonstrate the impact:

— Assume the company has a forex loan outstanding of USD 1 million and it has been recognised at exchange rate as on transaction date which is say Rs. 51/ $. The company has hedged this exposure with following products.

Case 1 - Forward contact to buy USD at Rs. 51 by paying premium say Rs. 2 per $ or

Case 2 - Currency call option on USD at strike rate of Rs. 51 by paying premium say Rs. 2 per $

The accounting treatment as at the end of each reporting period would be as under:

(a) Premium/ cost of hedges – Rs. 2/per $ (say) will get amortised over the period of hedges in both the scenarios.

(b) Impact of restatement of liabilities at each reporting period:

Each Rate at each reporting date at which liability gets re-stated	***Gain/(loss) in forward contract rate of* Rs. *51 per $ (Rs./$)***	***Effective Each rate if hedged through forward***	***Gain in Plain Call Option with strike of Rs. 51/$***	***Effective exchange rate if hedged through plain call***
48.00	(3.00)	51.00	0.00	48.00
49.00	(2.00)	51.00	0.00	49.00
50.00	(1.00)	51.00	0.00	50.00
52.00	1.00	51.00	1.00	51.00
53.00	2.00	51.00	2.00	51.00
54.00	3.00	51.00	3.00	51.00
55.00	4.00	51.00	4.00	51.00

It can be seen from the above example that:

(a) the *maximum rate* at which liability will get paid off is *at Rs.51 in both the cases.*

(b) a plain vanilla call contract, in effect, has the same effect of a forward contract in terms of mitigating the potential risk. Further, it allows the flexibility of enjoying the benefit of favourable movement by charging a small premium, which forward contracts do not provide (i.e., below Rs. 51 in given case).

(c) by not recognising the MTM/restated gain in the statement of profit and loss for plain vanilla call option contract, the very purpose of hedging gets defeated and it also goes against the principle of using reasonable accurate exchange rate as mentioned in *paragraph 11* of AS 11.

(Emphasis supplied by the querist.)

Impact of current accounting practice on profit and loss account:

5. The querist has stated that in the above example, the MTM gain/ (loss) of the underlying liability as well as corresponding plain vanilla call option in spirit is supposed to offset each other at each accounting period. By not allowing the accounting for gain on plain vanilla call in the profit and loss account, the whole purpose of the hedge for that particular accounting period is getting defeated as illustrated below:

MTM rate (Rs.)	**Loss in Underlying liability (Rs.)**	**Notional gain in MTM of plain call option (Rs.)**	**Charge in the statement of profit and loss for accounting period if gain in plain call option is not recognised (Rs.)**	**Charge in the statement of profit and loss for accounting period if gain in option is recognised (Rs.)**
52.00	(1.00)	1.00	Amortised premium+1.00	Amortised Premium
53.00	(2.00)	2.00	Amortised premium+2.00	Amortised Premium
54.00	(3.00)	3.00	Amortised premium+3.00	Amortised Premium
55.00	(4.00)	4.00	Amortised premium+4.00	Amortised Premium

B. Query

6. Considering the above facts, the querist has sought the opinion of the Expert Advisory Committee as to whether the liabilities covered by plain vanilla call options can be restated at the lower of strike rate or spot price as at the reporting date, which, as per the querist, will reflect the true and fair view of such transactions and also be in consonance with paragraph 11 of AS 11.

C. Points considered by the Committee

7. The Committee notes that the basic issues raised by the querist relate to treatment of foreign currency liabilities covered by plain vanilla call option contracts and MTM gains/losses on plain vanilla call options contracts undertaken to hedge against the losses on such liabilities. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as accounting for forward contracts, accounting for exchange differences on foreign currency liabilities other than those covered by plain vanilla call options, accounting for integral/non-integral foreign operations, accounting policy of the company in respect of exchange differences, etc.

8. The Committee notes that a call option is a type of derivative instrument whereby a person gets the right to buy at an agreed amount an underlying asset (foreign currency in the extant case) on or before the specified future date, although he is not under an obligation to do so. Thus, the buyer of an option contract can make a loss of no more than the option premium paid to the seller but the possible gain is unlimited. Accordingly, the Committee is of the view that an option contract cannot be considered in substance as a forward contract as in case of a forward contract, both the parties are under an obligation to complete the contract on the specified date and accordingly, the gain/loss on the settlement of a forward contract is also unlimited. In this regard, the Committee also notes the definition of forward exchange contract as per AS 11, notified under the Companies (Accounting Standards) Rules, 2006 as follows:

> ***"7.8 <u>Forward exchange contract</u> means an agreement to exchange different currencies at a forward rate."***

9. The Committee notes that the foreign currency liability is denominated in a foreign currency and is also repayable in the same currency. The fact that the company has mitigated its foreign currency risk on the foreign currency liability to the maximum of strike price of the call option contract does not alter this fact that the company has incurred INR liability to the lender. Under the call option agreement, if the strike price is less than the spot rate, the company gives INR to the counterparty of the option and that party actually remits foreign currency to the company at the strike price. Further, the company uses the foreign currency, so received, to settle its foreign currency liability. Thus, the foreign currency loss risk is mitigated by undertaking an option contract. However, it does not alter the fact that the

company has the obligation to repay the liability in foreign currency to the lender.

Further, the Committee 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 liability, which is an underlying transaction and the call option contract to hedge against any loss arising on the aforesaid liability should be treated as two separate transactions.

10. Accordingly, the Committee is of the view that the foreign currency liability 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 Standards) Rules, 2006, 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 liability should be restated at the exchange rate prevailing on that date and exchange differences should be charged to the statement of profit and loss. Accordingly, the foreign currency liabilities covered by plain vanilla call options cannot be restated at the lower of strike rate or spot price as at the reporting date, as being suggested by the querist.

11. As regards accounting treatment of call option 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 8 above, the call option contract cannot be considered in substance as a forward contract. Accordingly, call option is not within the scope of AS 11.

12. With regard to the contention of the querist regarding incorrect picture of state of affairs by recognising only losses and not recognising MTM gains on plain call option contract, as stated above, the Committee notes that the Announcement issued by the Institute of Chartered Accountants of India on 'Application of AS 30, *Financial Instruments: Recognition and Measurement*' clarifies, inter alia, that to the extent of accounting treatments covered by any of the existing notified accounting standards, such as AS 11, the existing accounting standards would continue to prevail over AS 30. Accordingly, the Committee is of the view that while AS 30, 'Financial Instruments: Recognition and Measurement', issued by the Institute of Chartered Accountants of India, is not yet notified under the 'Rules', the company should follow the requirements of AS 30 to the extent that it does not contradict the requirements of existing notified accounting standards.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that as per the requirements of AS 11, the foreign currency liability, which is an underlying transaction and the call option contract to hedge against any loss arising on the aforesaid liability should be treated as two separate transactions, as discussed in paragraph 9 above and that at each reporting date, foreign currency liability should be restated at the exchange rate prevailing on that date as per the requirements of paragraph 13 of AS 11, as discussed in paragraph 10 above. Accordingly, the foreign currency liabilities covered by plain vanilla call options cannot be restated at the lower of strike rate or spot price as at the reporting date.

Query No. 15

Subject: Recognition of revenue from contract for repairs and upgradation of submarine.[1]

A. Facts of the Case

1. A public sector company is engaged in construction of ships, repair of ships and repair/ refit of submarines. In January 2006, the company secured the medium refit order of submarine INS Sindukirthi from Indian Navy with a contract value of Rs. 629 crore and to be completed in 36 months (3 years).

2. In this regard, the following points are pertinent:

   (a) Indian Navy gets their submarines and other vessels repaired based on the respective operation-cum-refit (OCR) cycles as a part of their maintenance programme.

   (b) The repairs are carried out based on the item-wise defect lists and additional work requisitions.

   (c) The Indian Navy also modifies/ reduces/ enhances/ deletes the scope of work during the execution of the contract based on their requirements.

   (d) Further, the necessity of repairs/ renewals/ replacements other than those included in the scope of work may also arise during the repairs. Such changes in the scope of work have cost and time implications as mutually agreed by the company and the Indian Navy.

   (e) The contract between the company and Indian Navy for the subject refit provides for additional work, growth of works and other changes in the scope of work as brought out above along with the corresponding cost and time implications.

   (f) Due to additional growth of work, the INS Sindukirthi contract value has been increased to Rs. 990 crore and the repair/ refit work is scheduled to be completed in the year 2014.

3. The querist has stated that revenue recognition on the said project has

[1] Opinion finalised by the Committee on 6.6.2014.

been accounted for as per the accounting policy disclosed in the notes forming part of the accounts as under:

> "Income from other services including ship repair and submarine refit activities is accounted for on accrual basis by adopting proportionate completion method."

4. The above said accounting treatment of revenue as per Accounting Standard (AS) 9, 'Revenue Recognition', for refit of INS Sindukirthi has been accepted by statutory auditors and Government auditors for the last six years (Financial Year (F.Y.) 2006-07 to 2011-12) without any objection and accordingly, this method of accounting is consistently followed over the years.

5. This being the position, the Government audit had issued a sub-direction to the statutory auditors in the F.Y. 2012-13 to examine the adequacy and appropriateness of all the accounting policies of the company. The statutory auditors in their audit report on the accounts of the company for F.Y. 2012-13 had made a qualification that:

> "The company has not recognised retrofit income as per AS 7 'Construction Contracts' issued by the Institute of Chartered Accountants of India (ICAI) which constitutes a departure from the accounting standards referred to in sub-section 3(c) of section 211 of the Act. The company has recognised retrofit income in accordance with AS 9, 'Revenue Recognition', and in order to attain finality in this regard has decided to seek the views of the Expert Advisory Committee of the ICAI.
>
> Had such income and provision for future loss been recognised as per AS 7 instead of AS 9, the loss of the company for the year ended 31st March, 2013 and the reserves (deficit) of the company as at 31st March, 2013 would have been higher by Rs. 1,301.34 lakhs; thereby resulting in net loss of Rs. 6,818.73 lakhs for the year."

6. The querist has stated that the company, on considering the salient features of the contract for repairs of Indian Navy submarine INS Sindukirthi, had adopted AS 9 for revenue recognition. The salient features of the said contract are as under:

(i) Ownership of the submarine rests with Indian Navy only. The submarine has been only docked for repairs/ refit at the company.

(ii) The company has neither managerial involvement with ownership nor effective control over the submarine as it continues to be under the ownership of Navy.

(iii) Revenue under this contract can be reliably measured as job-wise revenue based on the agreed defect list is indicated and identifiable in the contract. Therefore, economic benefits under the contract will flow to the company as per the progress of repairs work in terms of the agreed item-wise defect list.

(iv) Costs of the item-wise defects agreed in the contract can be measured reliably with reference to corresponding revenue. The cost/revenue of additional/growth of work or deleted items is also identifiable reliably.

(v) The medium repair cum upgradation of submarine INS Sindukirthi is neither a contract for construction of a new asset nor a contract for destruction/ restoration of asset and the restoration of the environment following the demolition of assets. It is a contract for repairs and upgradation of submarine owned by Indian Navy and the activities do not result into creation of new asset.

7. The querist has separately clarified that the repair activity under the scope of the contract includes medium repairs, modernisation work and upgrading the submarine by installing Club-s-system known as under missile firing system. The scope of work is being executed jointly by the company and a sub-contractor M/s XYZ, Russia. The querist has pointed out that majority of the materials for repairs of the submarine are being imported from the sub-contractor. The total contract price has been divided into Rupee and Dollar component. The details of the same are given hereunder:

S. No.	Description	Russian scope of work (USD)	The company's scope of work Rs. in Cr.	Total Rs. in Cr.
1.	MR Package	76,827,664.00	190.96	527.00
2.	Import of Documents (RTD)	12,000,000.00	Nil	52.48
3.	Infrastructure	Nil	50.00	50.00
	TOTAL			**629.00**

With reference to the above table, the querist has explained that the scope of work of M/s XYZ includes supply of repair spares and modernisation of Club-s-system. Further, the querist has submitted that all the contracts with M/s XYZ including Club-s-system and modernisation works have been concluded as back to back contracts with M/s XYZ and these contracts include supply of material as well as their installation. The entire amount of US $ 76,827,664/- is payable towards various contracts with M/s XYZ. For the purpose of undertaking the repair works on this submarine, the company had imported RTD (Repair technical documents) from M/s XYZ for an amount of 12 milliion US Dollars.

8. The querist has also stated that the revenue recognition on the INS Sindukirthi contract is in consonance with the conditions stipulated in AS 9 as furnished below:

(i) AS 9 deals with the recognition of revenue arising in the course of ordinary activities of the enterprise from the rendering of services. The subject contract for repairs of INS Sindukirthi is a service contract.

(ii) The 'Proportionate Completion method' followed by the company for recognition of revenue on the said contract is in line with AS 9 (paragraph 7.1(i)).

(iii) As per AS 9 (paragraph 7.1(i)), under 'Proportionate Completion method', revenue can be recognised proportionately by reference to the performance of each act. As brought out at paragraphs 6 (iii) & (iv) above, under the salient features of the contract, revenue and cost for each act/ defect/ job has been accounted for with reference to progress of work of each act/ job.

(iv) AS 9 does not prohibit revenue recognition for service contracts that span for more than one accounting period.

Thus, recognition of revenue on the contract for repairs of INS Sindukirthi of Indian Navy in line with AS 9 is in order as per the company.

B. Query

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

(a) Whether the recognition of revenue from repair/refit of the submarine as per AS 9 is correct.

(b) If not so, whether any change is required in the accounting policy of the company to bring in line with AS 7 as observed by the statutory auditors.

C. Points Considered by the Committee

10. The Committee notes that the basic issue raised by the querist is whether revenue from repair/refit of the submarine should be recognised as per AS 9 or AS 7. Therefore, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of increase in contract value and time period, accounting in the books of contractee as to whether such repairs/refit would be capitalised or expensed off, accounting for any sub-contract or joint contract with M/s XYZ, etc.

11. The Committee notes the following paragraphs of AS 7, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> "**Objective**
>
> The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria."
>
> ***"2.1 A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use."***

"3. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

4. For the purposes of this Standard, construction contracts include:

(a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

(b) contracts for destruction or *restoration of assets*, and the restoration of the environment following the demolition of assets." (Emphasis supplied by the Committee.)

The Committee notes from the above that the nature of activities covered under AS 7 involves or relates to construction of an asset, such as, construction of complex piece of equipment, as well as the contracts for restoration of assets. The Committee is of the view that restoration covered under AS 7 is the activity which would bring back the asset to its original condition. However, day-to-day repairs and maintenance activities, such as, AMC contracts, would fall outside the scope of AS 7. Further, the Committee notes that the objective of AS 7 is to cover those construction activities which, due to the nature of the activity being undertaken, fall into more than one accounting period.

12. The Committee notes that the contract in the extant case is that of refit of submarine based on its operation-cum-refit cycle as a part of its maintenance programme which involves upgradation of the submarine *by installing Club-s-system known as under missile firing system, modernization work,* medium repairs/ renewals/ replacements, etc. Further, the Committee notes that the contract in the extant case was secured in January 2006 and was expected to be completed in 36 months, i.e., more than one accounting period. On the basis of the above, the Committee is of the view that the activities covered under the contract for refit of submarine are such that would bring back the submarine into its original condition after its prolonged use as a part of its operation-cum-refit cycle. Apart from this, there are certain activities, such as, modernization, upgrading the submarine by

installing Club-s-system, etc. which would not only bring back the submarine into its original condition but may also enhance its operating efficiency and future benefits. Accordingly, the Committee is of the view that the contract in the extant case is of the nature of restoration contract although some of the activities covered in the contract may involve normal repairs and maintenance activities. Accordingly, considering that a single composite restoration contract has been undertaken by the company that also falls in more than one accounting period, it falls within the scope of AS 7. Accordingly, recognition of revenue in the extant case as per AS 9 is not correct. The Committee is further of the view that in the extant case, AS 7 would be applicable and, therefore, in accordance with the requirements of AS 7, the expected loss on the contract should be recognised as an expense immediately.

13. In the context of application of AS 9, the Committee wishes to point out that both AS 7 and AS 9 contain similar requirements in terms of recognition of revenue under proportionate completion method. Further, in the context of recognition of provision for expected losses on the contract, it may be noted that where there is an expected loss on the contract covered within the scope of AS 9, provision should be recognised as per Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Rules, considering its requirements in the context of 'onerous contract'.

D. Opinion

14. 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) & (b) Considering that a single composite restoration contract has been undertaken by the company that also falls in more than one accounting period, the contract in the extant case falls within the scope of AS 7, as discussed in paragraph 12 above. Accordingly, recognition of revenue in the extant case as per AS 9 is not correct. The Committee is further of the view that in the extant case, AS 7 would be applicable and, therefore, in accordance with the requirements of AS 7, the expected loss on the contract should be recognised as an expense immediately.

Query No. 16

Subject: Determination of stage of completion in construction contracts.[1]

A. Facts of the Case

1. A company was incorporated under the Companies Act, 1956 on 24.05.1980. It is a state public sector undertaking (PSU) and is owned by the Government of Odisha. The total paid-up equity capital of the company is Rs. 5.63 crore, which is entirely held by the Government of Odisha. The company is an unlisted public company.

2. The primary objects of the company are as follows:

   (i) To undertake construction of buildings for the housing of police personnel of the Government of Odisha.

   (ii) To formulate and execute housing schemes for the benefit of serving police personnel of the Government of Odisha.

   (iii) To undertake construction of buildings for residential and non-residential purposes for the police, vigilance, prison and fire service departments of the Government of Odisha.

   (iv) To undertake construction of buildings necessary for conducting schools, hospitals, clubs and other welfare measures for the benefit of the police personnel of the Government of Odisha.

3. The querist has stated that the head office of the company is located at Bhubaneswar, the state capital of Odisha. There are nine divisions spread all across Odisha to execute the works. Each division is headed by a civil engineer with a rank of executive engineer and designated as Joint Manager/ division head. The company executes projects spread all over Odisha through these nine divisions. The average number of projects executed by the company is more than two thousand at any time during a year (emphasis supplied by the querist).

4. The querist has further stated that since the company has been incorporated specifically for execution of projects of Home Department of the Government of Odisha, it does not participate in tender for obtaining

[1] Opinion finalised by the Committee on 6.6.2014.

orders from various Government departments (called as user departments). The procedures of obtaining orders from user departments are as follows:

a. The Government departments, that intend to undertake a project, request the company to submit an estimate for the project as per Odisha Public Works Department (OPWD) Schedule of Rates (SoR).

b. The company prepares estimates as per OPWD SoR and submits them to the user departments. These estimates include costs of material, labour, other overheads and supervision charges of the company. The amount of supervision charges are calculated at a certain percentage of estimated project cost (presently 10% of estimated cost). The supervision charges are included in the project estimate to meet the salary, administrative and other overheads of the company as it does not get any budgetary support from the Government.

c. Upon getting the estimates, the user departments accord approval for the project, known as 'Administrative Approval' and release the funds limited to the amount of 'Administrative Approval'.

d. OPWD SoR are uniform for projects spread all over Odisha, whereas, the market prices of material, labour and other overheads vary from location to location and are generally higher than the OPWD SoR.

e. Contract value is fixed to the amount of 'Administrative Approval' received. Contract value will not be increased unless otherwise the scope of work increases and the cost overrun, if any, attributable to the user departments.

f. After receipt of Administrative Approval, the company decides to execute the project either of its own, known as departmental execution (Contract K-2) or through e-tender process (Contract F-2).

    i. Under K-2, divisional heads of the company procure materials and engage labour contractors for execution of the project. Costs of materials and labour are finalised through yearly tenders.

ii. Under F-2, the company invites open tenders and allots the project to eligible contractor on a turnkey basis.

g. Once it is finalised whether the project is to be executed under K-2 or F-2, work orders are accordingly issued to the respective division head for execution either under K-2 or to the eligible contractor for execution under F-2.

h. Subsequently, works are executed as per work orders issued under K-2 and F-2 and handed over to the clients/ user agencies after completion.

i. Due to variation in the market price and estimated price of construction cost (material, labour and other overheads) of a project, the outcome of a project cannot be estimated reliably unless and until the project is completed and handed over.

5. *Revenue recognition by the company:*

The contracts executed by the company are in the nature of fixed price contracts. Since the company is executing more than 2000 projects at a time, it is not practically possible for the company to estimate the contract cost to complete the balance work and calculate the stage of contract completion as on the balance sheet date. Further, since there is no correlation between the estimated cost and actual cost of execution, it is not practically feasible to derive the outcome of such huge number of projects unless and until the projects are completed and handed over to the user departments.

6. Due to the aforesaid reasons, the company is recognising its revenue and expenditure in its annual financial accounts as per paragraphs 31(a), 31(b) and 32 of Accounting Standard (AS) 7, 'Construction Contracts', issued by the Institute of Chartered Accountants of India (ICAI) as follows:

(i) Revenues are recognised only to the extent of contract costs incurred of which recovery is probable.

(ii) Contract costs are recognised as expenses in the period in which they are incurred.

(iii) Amount of surplus or deficit in a particular project is not included in the revenue of that project, during a particular year, unless and until the project is completed and handed over to the user departments.

(iv) As per past records, the actual surplus of projects never matches with the surplus mentioned in the estimate and there are cases where the projects have ended up with losses/deficit inspite of surplus stated in the estimate.

The following are the few Police Station (PS) buildings executed by the company, where the contact value and estimated cost are same but the outcome of the projects are different:

Project Name	***Contract Value (Rs.)***	***Estimated Cost (Rs.)***	***Actual Cost (Rs.)***	***Outcome Profit/(-) Loss (Rs.)***
PS at Sheragada	5,000,000.00	4,347,826.00	5,078,706.00	- 78,706.00
PS at Chakapada	5,000,000.00	4,347,826.00	5,041,995.00	- 41,995.00
PS at Jamda	5,000,000.00	4,347,826.00	4,793,969.00	206,031.00
PS at Rairangpur	5,000,000.00	4,347,826.00	4,861,111.00	138,889.00
PS at Karanjia	5,000,000.00	4,347,826.00	5,125,094.00	- 125,094.00
PS at Raruan	5,000,000.00	4,347,826.00	4,821,682.00	178,318.00
PS at Sohel	5,000,000.00	4,347,826.00	4,458,177.00	541,823.00
PS at Abhayachandapur	5,000,000.00	4,347,826.00	6,437,014.00	-1,437,014.00
PS at Biswanathpur	5,000,000.00	4,347,826.00	5,519,048.00	- 519,048.00
PS at Jhirpani	5,000,000.00	4,347,826.00	5,685,137.00	- 685,137.00

7. *Opinion of statutory auditors:*

a. The statutory auditors of the company, appointed by the Comptroller and Auditor General (CAG) of India, are of the opinion that since surplus/ margin is not included in the revenue of on-going (non-completed) projects in the annual accounts, the company is failing to comply with Accounting Standard (AS) 7, 'Construction Contracts', issued by the ICAI.

b. The statutory auditors are insisting for:

i. physical measurement of all projects, which are more than 2000 in numbers.

ii. valuing the percentage of completion on the basis of original estimate, and

iii. including estimated surplus in the revenue of non-completed projects, which, as per the querist, is not practically feasible to derive correctly.

8. The querist has also provided an illustrative example of revenue recognition by the company for the perusal of the Committee which is given below:

Example

During the financial year (F.Y.) 2011-12, the company was awarded for construction of four police stations at different locations of the State, by Police Department of Government of Odisha. Estimates for these projects were prepared on the basis of SoR of 2011. Estimated costs of these projects are as follows:

Rs. In Lakh

Particulars	***Project – A***	***Project – B***	***Project – C***	***Project – D***
Material	60.00	60.00	60.00	60.00
Labour	25.00	25.00	25.00	25.00
Other Overheads	15.00	15.00	15.00	15.00
Total Estimated Cost	**100.00**	**100.00**	**100.00**	**100.00**
Supervision Charges/ Margin	10.00	10.00	10.00	10.00
Administrative Approval/ Contract Value	**110.00**	**110.00**	**110.00**	**110.00**

Projects A & B were supposed to be completed and handed over during the F.Y. 2011-12 and Projects C & D were supposed to completed and handed during the year 2012-13. Actual costs incurred on various projects during the F.Y. 2011-12 & 2012-13 are as follows:

Rs. in Lakh

Name of Project	Contract Value	Estimated Cost	Actual Incurred Costs		
			2011-12	2012-13	Total Costs incurred
Project A	110.00	100.00	105.00	-	105.00
Project B	110.00	100.00	106.00	-	106.00
Project C	110.00	100.00	75.00	33.00	108.00
Project D	110.00	100.00	68.00	39.00	107.00

Recognition of revenue and expenditures made by the company in the accounts of F.Y. 2011-12 are as follows :

Statement of Profit and Loss of the company for F.Y. 2011-12

Expenditures	*Rs. In Lakh*	*Revenues*	*Rs. In Lakh*
Project – A	105.00	Project – A	110.00
Project – B	106.00	Project – B	110.00
Project – C	75.00	Project – C	75.00
Project – D	68.00	Project – D	68.00
Margin/ Earning	9.00		
Total	**363.00**	**Total**	**363.00**

Note:

Since Projects C and D have not been completed it is not practically possible to ascertain whether the projects will have any surplus or not, therefore, contract costs which are recoverable have been taken as revenue.

Recognition of revenue and expenditures made by the company in the accounts of F. Y. 2012-13 are as follows :

Statement of Profit and Loss of the company for F.Y. 2012-13

Expenditures	***Rs. In Lakh***	***Revenues***	***Rs. In Lakh***
Project – C	33.00	Project – C	35.00
Project – D	39.00	Project – D	42.00
Margin/ Earning	5.00		
Total	**77.00**	**Total**	**77.00**

Note:

1. Revenue of Project C is arrived at Rs. 35.00 lakh after reducing the turnover of Project C taken during the year 2011-12 i.e., Rs. 75.00 lakh from the contract value of Rs. 110.00 lakh.

2. Revenue of Project D is arrived at Rs. 42.00 lakh after reducing the turnover of Project D taken during the year 2011-12 i.e., Rs. 68.00 lakh from the contract value of Rs. 110.00 lakh.

B. Query

9. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting procedure followed by the company for recognition of revenue and expenditure, which, as per the querist, are as per paragraphs 31(a), 31(b) and 32 of AS 7, is in conformity with AS 7 or not.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by querist relates to whether the accounting procedure currently followed by the company for recognising revenue and costs is in conformity with AS 7 or not. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case. The Committee presumes from the Facts of the Case that the contracts in the extant case are separate and independent fixed price contracts.

11. The Committee notes from the Facts of the Case that the company, on the basis of inquiry received from various Government departments, submits estimates for each project separately as per Odisha Public Works Department (OPWD) Schedule of Rates (SoR). The estimates are submitted after including cost of materials, labour, other overheads and supervision charges

which includes its profit margin. The Committee further notes that the querist has stated that the company is following paragraphs 31 and 32 of AS 7 as the outcome of the construction contracts in its case cannot be estimated reliably. In this regard, the Committee notes the following paragraphs of AS 7, notified under the Companies (Accounting Standards) Rules, 2006:

> ***"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.***
>
> ***22. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:***
>
> > ***(a) total contract revenue can be measured reliably;***
> >
> > ***(b) it is probable that the economic benefits associated with the contract will flow to the enterprise;***
> >
> > ***(c) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and***
> >
> > ***(d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates."***
>
> "28. An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes:
>
> > (a) each party's enforceable rights regarding the asset to be constructed;
> >
> > (b) the consideration to be exchanged; and
> >
> > (c) the manner and terms of settlement.

It is also usually necessary for the enterprise to have an effective internal financial budgeting and reporting system. The enterprise reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably."

"31. When the outcome of a construction contract cannot be estimated reliably:

(a) ***revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and***

(b) ***contract costs should be recognised as an expense in the period in which they are incurred.***

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

32. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35."

"35. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately."

12. The Committee notes from the Facts of the Case that the querist has stated two reasons for the company not being able to measure the outcome of the project reliably. Firstly, it is stated that the company is executing large number of projects due to which it is not practically possible to estimate the contract cost to complete the balance work and calculate the stage of

completion as on the balance sheet date. Secondly, it is stated that since there is no correlation between the estimated cost and actual cost of execution due to estimates being based on SoR, it is not practically feasible to derive the outcome of such huge number of projects unless these are completed and handed over to the user departments.

13. As far as the first reason for not measuring the outcome of the project reliably due to practical difficulties of having large number of projects is concerned, the Committee notes that AS 7 identifies certain situations/ conditions in paragraphs 22, 28 and 32, where, in fixed price contracts, it can be stated that the outcome of the project cannot be estimated reliably. The Committee notes that as per AS 7 in case of fixed price contracts, ordinarily, the company would be able to estimate the outcome of the contract reliably except in certain situations, for example, in early stages of a contract and, therefore, should recognise contract costs and revenue based on stage of completion of the contract. The Committee also notes that as per the provisions of AS 7, stage of completion of a contract can be determined either by reference to the contract costs incurred or by reference to physical completion of the contract using survey of work performed or completion of a physical proportion of the contract work method. The Committee is of the view that only practical problems due to large number of projects cannot be considered as a ground for not being able to estimate the outcome of the contract reliably as even in large number of projects where the stage of completion is being determined by reference to contract costs incurred, the company, on the basis of estimates of various costs, such as, labour, material, etc. would generally be able to reasonably estimate the outcome of various projects. However, for this purpose, in order to overcome the practical difficulties due to large number of projects, the company should develop an effective reporting system from all the projects to obtain the data required at the head office for determining the stage of completion as per AS 7.

14. As far as the second reason of no correlation between the estimated cost and actual cost of execution of the contract, the Committee is of the view that although for submission of an estimate for a project to the Government departments, it might be essential for the company to use the rates given in SoR, for the purposes of implementation of AS 7, estimates should be based on the costs expected to be incurred on the project and should also be revised from time to time depending on the changes in the circumstances. The Committee is of the view that for this purpose, the company should develop an effective budgeting system so as to have the

reliable data available for estimating the outcome of the contracts at any stage and for determining the stage of completion. The Committee is of the view that a proper budgeting and reporting system is not only required from the angle of implementation of AS 7 but is also necessary to effectively manage various contracts.

15. The Committee further notes that the querist has stated that the amount of surplus or *deficit* in a particular project is not included in the revenue of that project, during a particular year, unless and until the project is completed and handed over to the user departments. As per past records, the actual surplus of projects never matches with the surplus mentioned in the estimate and there are cases where the projects have ended up with losses/deficit inspite of surplus stated in the estimate. Hence, it can be inferred that where there are expected excesses of total contract costs over total contract revenues for the contracts, these have not been recognised immediately as per the above-reproduced paragraphs 31, 32 and 35 of AS 7. In this regard, the Committee wishes to point out that any expected loss on the contract should be recognised immediately as an expense in the statement of profit and loss.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the accounting procedure followed by the company is not in accordance with the requirements of AS 7, as discussed in paragraphs 12 to 15 above. The Committee is of the view that to overcome the practical difficulties due to large number of projects, the company should develop an effective reporting system from all the projects to obtain the data required at the head office for determining the stage of completion as per AS 7. With regard to company presently having no correlation between the estimated cost and actual cost of execution of the contract, the Committee is of the view that for the purposes of implementation of AS 7, estimates should be based on the costs expected to be incurred on the project rather than based on the rates given in SoR, and for this purpose, an effective budgeting system should be developed, as discussed in paragraph 14 above.

Query No. 17

Subject: Accounting for interest on delayed payment by power generation companies against coal supplied under Fuel Supply Agreement.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is wholly owned subsidiary of a government company, engaged in extraction of coal. The company is located in the eastern part of India and its fields of operations are in the states of West Bengal and Jharkhand. The company supplies coal to:

- Power houses
- Steel sector
- Cement companies and
- Others

For the year 2012-13, the company has produced 33.91 metric ton (MT) of coal and has achieved a net turnover of Rs. 9,191.91 crore.

2. The company supplies coal to power houses under fuel supply agreement (FSA) (copy of the said agreement has been furnished by the querist for the perusal of the Committee), the salient features of which are enumerated below:

Modalities for billing claims and payments

- The seller shall raise bills for coal supplied to the purchaser on declared grade, on rake to rake basis for delivery by rail and on daily basis for delivery other than by rail, within 7 days of delivery (clause 11.1.1 of the Agreement).
- The purchaser shall make advance payment for a month in three installments i.e., on 1st, 11th and 21st of every month to make available coal supplied from the seller (clause 11.1.2(a) of the Agreement).

[1] Opinion finalised by the Committee on 6.6.2014.

- The advance made by the purchaser shall be non-interest bearing (clause 11.1.4 of the Agreement).
- In the event of delay in payment/adjustment, the seller can charge interest as per clause 12.0 of the Agreement.

3. The querist has stated that although the power houses are generally irregular in releasing payment, the company has not resorted to stop the supply of coal under the terms of FSA having regards to the national interest. The company is claiming interest on the delayed payment by the power houses in terms of the provisions of FSA. However, such claim towards interest on delayed payment by the company is not recognised as revenue in view of the uncertainty of ultimate collection having regard to the provision of Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') which is quoted as under:

> "9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments."

4. The company is following a constant practice of making provision towards debts doubtful of recovery, which is stated in the clause no. 4.1 of the additional notes on accounts of the company (Note 34) quoted as under:

> "Provision of sundry debtors is generally made on case to case basis. Normally, no provision of sundry debtors is made on unsettled amount of debtors at the initial years. In the 2nd year provision is made up to 50% amount of unsettled amount of debtors, and the rest is provided in 3rd year if remains unsettled. Further, no provision is made on vendible stock except deterioration of old stock due to fire, theft, etc."

B. Query

5. Considering the above facts, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed by the company with respect to claim of interest on delayed payments under

the terms of agreement with its customers and its postponement of the recognition of revenue till the claim is admitted, is consistent with the provisions of AS 9 relating to recognition of revenue.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to whether accounting treatment followed by the company with respect to claim of interest on delayed payments under the terms of the agreement with its customers and its postponement of recognition as revenue till the claim is admitted is in consistence with the principles of AS 9. 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, revenue recognition with respect to coal supply, accounting policy of the company for making provision for doubtful debts, legal interpretation of the Fuel Supply Agreement, etc.

7. The Committee notes the following paragraphs of AS 9, notified under the Rules:

> ***"4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. ..."***
>
> "8.1 The use by others of such enterprise resources gives rise to:
>
> (i) interest—charges for the use of cash resources or amounts due to the enterprise;
>
> ..."
>
> "9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
>
> 9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is

postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded."

"9.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised."

"13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: On a time proportion basis taking into account the amount outstanding and the rate applicable.

..."

From the above, the Committee notes that interest represents charge for the use of cash resources or amounts due to the enterprise. Interest on delayed payments is thus in the nature of interest and should, therefore, be accounted for in accordance with the principles laid down for recognition of revenue. The Committee also notes that revenue arising from the use by others of enterprise resources yielding interest should only be recognised when no significant uncertainty as to measurability or collectability exists. It should be recognised on a time proportion basis taking into account the amount outstanding and the rate applicable.

8. The Committee also notes the following paragraphs of the Fuel Supply Agreement, as supplied by the querist for the perusal of the Committee:

"12.0 Interest on delayed payment

In the event of delay in payment/adjustment of any amount payable/recoverable pursuant to the provisions of this Agreement, the Seller/the Purchaser shall be entitled to charge interest on such sum remaining outstanding for the period after the due date till such time the payment is made. The interest charged by the Seller/Purchaser pursuant to this Clause shall be at the Interest Rate, as per Clause 1.1 (dd)."

"1.1 DEFINITIONS:

...

(dd) "**Interest Rate"** shall mean the repo rate of Reserve Bank of India (RBI) as applicable on the due date of payment of the Purchaser plus 3% (three)."

The Committee further notes that the payment mechanisms by the purchaser have also been specified in the Agreement.

9 From the above, the Committee notes that the amount of claim of interest for delayed payment from the customers is reasonably determinable as it is contractually agreed between the parties and it is clearly stated in the Agreement how the same would be calculated. Further, the Committee notes from the Facts of the Case that it has been explicitly stated by the querist in paragraph 3 above that although the company is claiming interest on the delayed payment by the power houses in terms of the provisions of FSA, such claim towards interest on delayed payment by the company is not recognised as revenue in view of the uncertainty of ultimate collection. The Committee is of the view that to assess the certainty or uncertainty of ultimate collection is a matter of judgement, which should be exercised considering various factors, such as, on the basis of past experience, etc. Accordingly, the Committee is of the view that to the extent and till the time such uncertainty of collection exists, revenue recognition should be postponed. The revenue needs to be recongised when it is reasonably certain that the ultimate collection will be made. The Committee is further of the view that in such cases, where the revenue recognition is postponed, disclosures should be made as per paragraph 14 of AS 9 which is reproduced below:

"14. In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties."

D. Opinion

10. On the basis of above, the Committee is of the opinion that to assess the certainty or uncertainty of ultimate collection is a matter of judgement, which should be exercised considering various factors, such as, on the basis of past experience, etc. Accordingly, to the extent and till the time such uncertainty of collection exists, revenue recognition should be postponed. The revenue needs to be recognised when it is reasonably certain that the ultimate collection will be made. The Committee is further of the view that in such cases, where the revenue recognition is postponed, disclosures should be made as per paragraph 14 of AS 9, as discussed in paragraph 9 above.

Query No. 18

Subject: Disclosure of the revenue as per AS 9.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is primarily engaged in the business of owning and running hotels and resorts. The company receives bookings for the hotel and resort rooms and related facilities from individuals, corporates and travel agents. The company's primary revenue streams are:

(a) Revenue from sale of rooms (rent),

(b) Revenue from sale of food,

(c) Revenue from other facilities at resort (Departmental stores, health club, laundry, telephone, local tours and sport activities), and

(d) Revenue from running ayurvedic treatment centre.

[1] Opinion finalised by the Committee on 6.6.2014.

2. The company has a tariff card (rate list) for all the room types which is inclusive of all taxes. Ideally, when a customer approaches the company, he is offered the tariff rate.

(i) However, the company has been using various marketing strategies to attract guests. As a strategy, the company offers discounts to the guest discretionally, based on various factors. The company has observed that when the guest is given discount, he feels happy about it and becomes a loyal customer of the resort. This strategy has given to the company an edge over its competitors and thereby helped the company to increase its turnover year on year.

(ii) Revenue recognition policy adopted:

Revenue from sale of rooms, food, facilities and services is recognised as and when the services are rendered.

(iii) Billing method adopted :

Currently, the billing method used is as follows:

Particulars	**Amount (Rs.)**
Rack rate	9,000/-
Less: discount	2,000/-
Net rate	7,000/-
Add: taxes	1,000/-
Total bill value	**Rs. 8,000/-**

(iv) *Accounting entry :*

Particulars	**Debit (Rs.)**	**Credit (Rs.)**
Discount	2,000	
Guest Account	8,000	
Room revenue (rack rate)		9,000
Taxes payable		1,000
	10,000	**10,000**

3. The querist has stated that as per Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006, revenue has been defined as follows:

> ***"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."***

Further, the disclosure of sales transaction is mentioned in the Explanation to paragraph 10 of AS 9 as follows:

> ***"Explanation:***
>
> ***The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit and loss:***

Turnover (Gross)	***XX***	
<u>Less:</u> Excise Duty	***<u>XX</u>***	
Turnover (Net)		***XX***

> ***..."***

4. The querist has further stated that the company is currently recognising revenue at rack rate and is treating discount as an expense. The company intends to disclose the revenue in the following manner on the face of the statement of profit and loss:

XYZ Limited
Statement of Profit and Loss for the year ended 31st March, 2013

	Particulars	Note No.	For the year ended 31st March, 2013	For the year ended 31st March, 2012
I.	**Gross Revenue from operations**		2,00,000	1,75,000
	Less : Duties & taxes		20,000	17,500
	Revenue from operations net of taxes	21	1,80,000	1,57,500
	Less : Discounts		30,000	23,000
	Net Revenue from operations		**1,50,000**	**1,34,500**
II.	**Other Income**	22	17,500	10,250
III.	**Total Revenue (I + II)**		**1,67,500**	**1,44,750**

B. Query

5. The querist has requested the Expert Advisory Committee to clarify whether the above disclosure of the revenue would be in compliance with the disclosure required in AS 9.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist is the accounting treatment of the discount(s) allowed by the company and its presentation in the statement of profit and loss as per AS 9. Accordingly, the Committee has considered this issue only and has not considered any other issue that may arise from the Facts of the Case, such as, timing of recognition of discount and related revenue, presentation of duties and taxes in the financial statements, etc.

7. The Committee notes that in order to determine the accounting treatment of the discount(s) allowed and presentation requirements, the nature of discount being allowed in the extant case needs to be determined. For this purpose, the Committee notes the following definitions given in the Guidance

Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India (ICAI):

> **“3.13 Cash Discount**
>
> A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.”
>
> **“16.04 Trade Discount**
>
> A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.”

8. In accordance with the above definitions, any discount allowed on invoice price for prompt payment or for payment within stipulated time is cash discount and any other discount allowed on invoice price is trade discount. The Committee notes that in the extant case, the basic objective of providing discount is to use it as a marketing strategy to attract guests so as to give the company an edge over its competitors and thereby helping the company to increase its turnover year on year. The Committee is of the view that as the discount is not allowed for prompt payment, rather it is allowed for increasing its turnover, therefore, the nature of the discount being allowed by the company is that of a trade discount.

9. With regard to accounting and presentation of trade discount, the Committee notes that Appendix A illustrating the application of AS 9, notified under the Companies (Accounting Standards) Rules, 2006, *inter alia*, provides as follows:

> *“9. Trade discounts and volume rebates*
>
> Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.”

The Committee notes from the above that trade discount is not encompassed within the definition of revenue since it represents a reduction of cost and accordingly, the revenue is determined and recognised after deducting the trade discount. Further, the Committee also notes the definition of ‘revenue’ as reproduced in paragraph 3 above. From this, the Committee is of the view that the revenue is the charge made to customers which in case of trade discount is the amount net of discount. Accordingly, the Committee is of the view that the proposed presentation of the company to present the revenue on gross basis and then to present the trade discount as deduction from the revenue is not correct and is not in accordance with the requirements of AS 9.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that the proposed presentation of the company to present the revenue on gross basis and then to present the trade discount as deduction from the revenue is not correct and is not in accordance with the requirements of AS 9. The amount of the revenue to be presented in the Statement of Profit and Loss should be net of the discount, as discussed in paragraph 9 above.

Query No. 19

Subject: Treatment of foreign exchange fluctuations and interest cost on issuance of FCCB. [1]

A. Facts of the Case

1. A listed company (hereinafter referred to as the 'company' or the 'issuer') has issued Foreign Currency Convertible Bonds (FCCB) amounting to USD 25 million on 26 April, 2013 to a Singapore based entity (bondholders). The tenure of the FCCB is five years and one day.

2. The querist has stated that utilisation of FCCB has been done after receipt on 26.04.2013 and expected to complete by 31.03.2014. As per the relevant FCCB subscription agreement ('the agreement'), a copy of which has been provided by the querist for the perusal of the Committee, some of the relevant features of the FCCB are as below:

[1] Opinion finalised by the Committee on 6.6.2014.

- FCCB is convertible after five years and one day at a pre-determined rate of Rs. 218/- per share at a pre-determined rate of USD @ Rs. 54.16.
- The rate of USD is open in case of repayment of FCCB but fixed in case of conversion into equity.
- The purpose of FCCB is to make capital expenditure.
- The present market price of the shares is Rs. 230 per share and are being traded at NSE and BSE.

3. The querist has stated that FCCB is convertible into equity at a pre-determined equity price and also on a pre-determined dollar rate meaning thereby that the number of shares to be issued are fixed at inception itself. As per the querist, though FCCB is convertible at the option of investors, as per Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', the impact of mark-to-market (M2M) on FCCB has to be incorporated in the accounts, it being monetary item but in view of convertibility into equity it falls under non-monetary item and as per accounting standard, the restatement of liability is not required. The querist has also stated that in view of pre-determined dollar rate, the number of shares have been fixed at inception and the entire transaction has become contingent; therefore, this transaction has to be dealt with as per Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets'. The querist is of the view that considering the principles of AS 29, there is a possible obligation but probably will not require outflow of resources due to pre-determined dollar price in case of issuance of equity, and, hence, no provision is to be recognised and only disclosure is required for contingent liability.

4. The querist has further stated that the amount of FCCB is meant for capital expenditure and is a pre-condition for raising FCCB as per RBI guidelines. Therefore, the total amount of interest on FCCB, whether used or yet to be used for capital expenditure, has to be capitalised.

B. Query

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

(a) What should be the treatment of foreign exchange fluctuation on the reporting date in view of option to convert FCCB into equity after five years and one day at a pre-determined equity rate and a pre-determined USD rate?

(b) What should be the treatment of interest on FCCB used for capital expenditure progressively from April 2013 to March 2014 on the reporting date?

C. Points considered by the Committee

6. The Committee notes that the basic issues raised by the querist relate to whether the FCCB should be considered as a monetary item or a non-monetary item considering that it is convertible into fixed number of equity shares at a pre-determined USD rate and the treatment of interest on FCCB. 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, treatment of foreign exchange fluctuations in case the company opts to exercise the option under paragraphs 46/46A of AS 11, premium on conversion of FCCBs, etc.

7. The Committee notes some of the relevant features of the FCCB as per the relevant FCCB subscription agreement ('the agreement'), a copy of which has been provided by the querist for the perusal of the Committee, as below:

- The bonds constitute direct, unsubordinated and unconditional obligations of the issuer and shall at all times rank *pari passu* and without any preference or priority among themselves. The payment obligations of the issuer under the bonds shall, save for such exceptions as may be provided by mandatory provisions of applicable law and subject to certain covenants specified in the agreement, at all times rank at least equally with all of its other present and future direct, unsubordinated and unconditional obligations.

- The bonds bear interest at the rate of 5.44 percent per annum which is payable semi-annually in arrears.

- Unless previously redeemed, converted or purchased and cancelled as provided in the agreement, the issuer will redeem the bonds on the maturity date in year 2018. The issuer may not redeem the bonds at its option prior to that date except in case of occurrence of specific events, i.e., change in control or delisting/ suspension of trading of company's shares, or events of default, as detailed in the agreement.

- The repayment of principal and payment of interest to the bondholders would be in US$ only.
- Bondholders have the right to convert their bonds into shares at any time during the 'conversion period' as per the agreement before the maturity date subject of the provisions of the agreement.
- The number of shares to be issued on conversion of a bond will be determined by dividing the principal amount of the bond to be converted (translated into Rupees at the fixed rate of Rs. 54.16 = US$ 1.00) by the conversion price in effect at the conversion date.
- The conversion price will initially be Rs. 218 per share but will be subject to adjustment in the manner specified in the agreement on occurrence of specific events, such as free distribution, bonus issue, division, consolidation, reclassification of shares, declaration of dividend etc. as described in the agreement.
- No adjustment involving any increase in the conversion price will be made, except in the case of consolidation of shares.
- The issuer shall use the proceeds of the offering of the bonds for capital expenditure, repayment of rupee loan and other eligible purposes in compliance with applicable law, and subject to receipt of all applicable approvals and consents (if required).

8. The Committee notes the following definition of 'monetary items' given in AS 11, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> ***"7.11 <u>Monetary items</u> are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money."***

Further, paragraph 12 of AS 11 provides that cash, receivables, and payables are examples of monetary items.

9. The Committee notes from the above that the essence of the definition of monetary items is that, inter alia, the asset to be received or liability to be paid should be in fixed or determinable amounts of money. The Committee notes that in the extant case, the nature of FCCB is that of a loan taken by the company which is repayable in fixed amount of money after a fixed tenure. The bondholder has an option to settle the loan by receiving the equity shares of the company. Accordingly, the company is under an obligation to deliver a fixed amount of cash till the time conversion option is exercised by the bondholder. The bondholder has a right to receive the principal amount of FCCB along with the interest thereon till the time conversion option is exercised and the company has a corresponding obligation. Therefore, the nature of FCCB is of a loan till the time the option is exercised. In view of this, the Committee is of the view that the FCCB is in the nature of a monetary item within the meaning of AS 11 and accordingly, should be reported using the closing rate at the balance sheet date considering the requirements of AS 11. In this regard, the Committee also notes that revised Schedule VI to the Companies Act, 1956 as well as Schedule III to the Companies Act, 2013 also require the presentation of bonds/ debentures with conversion options, as a part of borrowings. Borrowings are considered as monetary items as per the provisions of AS 11.

10. The Committee also notes the contention of the querist that the entire transaction is contingent and should be dealt with under AS 29. The Committee is of the view that there is no uncertainty regarding the payment of convertible bonds. The principal amount as well as interest thereon to be paid is fixed - only the mode of settlement can be in cash or through issuance of shares in case conversion option is exercised by the bondholder. Considering this, the Committee is of the view that AS 29 is not relevant in the current context.

11. Another issue raised by the querist relates to the accounting treatment of borrowing costs on FCCB in the financial statements of the company. The Committee notes that AS 16 defines a 'qualifying asset' as "***an asset that necessarily takes a substantial period of time to get ready for its intended use or sale".*** AS 16 further explains that "***what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances***

of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered". Considering the above, the Committee is of the view that the company first needs to determine whether capital expenditure being funded from FCCB meets the definition of a qualifying asset.

12. The Committee also notes paragraphs 6, 8 and 10 of AS 16, notified under the Rules, as below:

> ***"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."
>
> ***"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."***

Accordingly, in the extant case, the company needs to evaluate the purpose of obtaining the FCCB, including the purpose/ usage of rupee loan (which is proposed to be repaid by the proceeds from FCCB).

13. The Committee also notes paragraph 14 of AS 16 which deals with commencement of capitalisation as follows:

> ***"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."***

The Committee notes from the above that all the above conditions need to be satisfied for commencement of capitalisation. Therefore, merely the fact that the FCCB is meant for capital expenditure as per RBI guidelines and therefore, the total amount of interest on FCCB, *whether used or yet to be used for capital expenditure*, has to be capitalised, as stated by the querist, would not be sufficient.

14. The Committee also notes that as per paragraph 4(e) of AS 16, borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Therefore, the company also needs to determine the portion of foreign exchange fluctuation, arising on the restatement of FCCB as at the reporting date, which can be considered as borrowing costs and treated accordingly.

D. Opinion

15. Based on the above, the Committee is of the following view on the issues raised in paragraph 5 above:

(i) The FCCB should be considered as a monetary item and, accordingly, should be reported using the closing foreign exchange rate at each balance sheet date, as per the requirements of AS 11.

(ii) The accounting treatment of interest cost on FCCB should be in accordance with paragraphs 11 to 14 above.

Query No. 20

Subject: Accounting Treatment of Contribution to a Cluster Project.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is an unlisted public limited company and an auto-ancillary engaged in the business of manufacture of Cast Iron (C.I.), castings and machining of castings automobile parts. The foundry and the machining facilities are located at Kolhapur in the state of Maharashtra.

2. The company requires to use substantial quantity of silica sand in the foundry for making moulds. The sand once used cannot be used again and it becomes waste sand.

3. The disposal of waste sand is becoming difficult due to non-availability of proper place for dumping and on account of environmental issues and stringent restrictions from pollution control department. The problem of disposal of the waste sand is becoming costly and severe day by day.

4. The availability of fresh sand is also diminishing owing to measures being taken by the State Government to protect the environment for silica sand mining, which in turn, has increased the costs of procurement of silica sand.

5. This problem is faced by all the foundries located in and around Kolhapur and for that matter, anywhere in India. To deal with the said problem, the foundries from Kolhapur came together through their association and decided to undertake a cluster project mainly to set-up a sand reclamation plant. The Central and the State Governments have declared incentives and benefits in the form of subsidies for formation of such cluster projects which provide common utilities and services to its members.

6. Accordingly, a cluster project is undertaken by the industrialists of Kolhapur and the company has joined the said cluster project as one of its members. A limited company registered under section 25 of the Companies Act, 1956 is formed as a Special Purpose Vehicle (SPV).

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[1] Opinion finalised by the Committee on 24.7.2014.

7. The aforesaid cluster project is being set up to provide various services, utilities and facilities to the cluster members and one of the main activities proposed is to set up a sand reclamation plant.

8. The capital cost of the sand reclamation plant is substantially high and the capacity utilisation thereof for one foundry will not be full. Therefore, for an individual foundry owner, it is not viable/feasible to set up such sand reclamation plant on his own.

9. The features of the cluster project are as under:

(i) The project will be funded through contributions from members and subsidies from both the Central and State Governments.

(ii) Each member of the cluster has to contribute amounts calculated based on its requirement of sand reclamation.

(iii) The services of reclamation of sand of such quantity will be assured to the members at reasonable cost.

(iv) The other infrastructure and facilities created in the cluster project will also be available to the members of the cluster at reasonable cost.

(v) The objectives of the cluster company (i.e., the SPV) are not to make profit.

10. The company is required to pay a non-refundable one-time contribution on the basis of formula for contribution decided by the cluster (ensuring about 700 M.T. of sand reclamation). This formula is decided by the cluster and is mentioned in the scheme for membership circulated by the cluster under the head ‘Membership’ Sr. No. 3 which reads as under:

MEMBERSHIP

Sl. No.	Member Category	Contribution
1.	Membership - A	Min. Rs. 1.00 Lac
2.	Membership - B	Min. Rs. 25,000/-(B Class members cannot avail the facility of Export-Import House.) Generous Donation/ Contribution are requested from industries once and above the membership etc. *Members will get 25% discount on Testing Facilities.
3.	Sand Reclamation	One time Contribution – Rs. 6,000 PMT per month.Processing charges: as per actual only.Estimated payback: 2 years

11. The querist has clarified that the company is a general member under 'Sand Reclamation Category'. The contribution for sand reclamation category is one time at Rs. 6,000/- per metric tonne/per month of sand reclamation requirement. At this rate, the company desires to make one time contribution of Rs. 42.00 lakhs with a view to book the capacity of 700 tonnes. According to the querist, the sand reclamation benefits are permanent and it is not envisaged that the entitlement would exhaust any time. The mention of the payback period in the Scheme is based on very rough estimation. The above payback period of two years is estimated by the management of the cluster on the basis of saving of about 25 paise per kg/per month, i.e., Rs. 250/- per month saving for one tonne sand reclamation per month. The one time contribution is Rs. 6,000/- per tonne. With Rs. 250/- per month saving, the payback period will be about 24 months i.e. 2 years. The amount of saving per tonne is based on very rough estimation. The actual saving per month will be worked out once the facilities are started, and the more correct estimation of payback period will be worked out to decide the period/ years within which the amount of total contribution is to be amortised.

12. The company has paid an advance against its contribution and the balance is required to be paid in five equal installments. The advance paid is shown as advance under long-term loans and advances.

13. The querist has pointed out that it may not be possible to workout the actual saving in the cost of reclamation of sand due to various factors such

as no comparative costs being available and various advantages are of qualitative nature such as compliance with environmental issues, etc.

14. The querist has clarified that the company has not received any ownership rights over the SPV and neither the membership nor the benefits can be transferred.

15. The following accounting treatment has been suggested to the company for accounting the expenditure by way of contribution to the cluster project:

(a) Treat the amount now contributed as an advance till the cluster facility is set up and commences providing the services. Upon such commencement, treat the amount contributed as deferred revenue expenditure and amortise the same over a reasonable period of 3 to 5 years.

(b) Charge the amortised amount to the statement of profit and loss and balance shall appear in the balance sheet under loans and advances (non-current assets).

B. Query

16. The querist has sought the opinion of the Expert Advisory Committee as to whether on the basis of above facts, the accounting treatment as suggested in paragraph 15 above is proper and in accordance with the generally accepted accounting principles. If not, then what is the appropriate accounting treatment?

C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to accounting treatment of the contribution made by the company to a cluster project for a sand reclamation plant through a Special Purpose Vehicle company. 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, legal interpretation of Memorandum and Articles of Association of the SPV (supplied by the querist for the perusal of the Committee), implications of the recommended accounting treatment for income-tax purposes, etc. Since the querist has mentioned that the company has not received any ownership rights over the SPV, the Committee proceeds on this premise.

18. The Committee notes that as stated in paragraphs 5 and 6 above, a Special Purpose Vehicle (SPV) has been set up by the industrialists in the Kolhapur region in the form of a not-for-profit section 25 company under the Companies Act, 1956, to undertake a cluster project to set up a sand reclamation plant for the benefit of its members including the company. Each member of the SPV company is required to contribute a non-refundable amount towards the cost of setting-up the sand reclamation plant based on its monthly requirement of sand reclamation. The question now arises is whether such contribution can be capitalised as an asset or should be expensed.

19. The Committee notes that Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. In this context, the Committee notes the definitions of the terms 'intangible asset' and 'asset' given in paragraph 6 of AS 26 and meaning of 'control' dealt with in paragraph 14 thereof as reproduced below:

> ***"6.1 An <u>intangible asset</u> 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 <u>asset</u> 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."

20. The Committee notes from the above that an item can be classified as an intangible asset only if it fulfills 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, the contribution entitles the company the service of reclamation of sand upto 700 M.T. per month and various other services, utilities and facilities provided by the SPV at a reasonable cost. Thus, contribution made by the company gives rise to a membership right in the SPV for the company, which is identifiable and from which future economic benefits are expected to flow to the company. Further, with regard to control, the Committee notes that to the extent of its entitlement for sand reclamation of 700 M.T. per month, the company enjoys unrestricted services. Thus, although the company does not get any ownership right over the SPV, the company has the control over sand reclamation entitlement and other benefits attached with the membership rights. Accordingly, the Committee is of the view that the membership right received as a consideration of the total contribution of Rs. 42 lakh made by the company to the cluster project should be recognised as an intangible asset. In view of this, the accounting treatment proposed by the company to treat the contribution as deferred revenue expenditure is not appropriate. However, till the time such right is not available for its intended use due to cluster project being in progress and other factors, the contribution made by the company should be treated as an advance.

21. With regard to the amortisation of the intangible asset, the Committee notes paragraph 63 of AS 26, notified under the Rules, which requires as below:

> ***"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 as the future economic benefits embodied in an intangible asset are consumed over time, the cost of the asset should be systematically allocated over the asset's useful life. In this regard, the Committee notes the definition of the term 'useful life' as per paragraph 6.9 of AS 26, notified under the Rules, which provides as follows:

"6.9 Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise."

From the above, the Committee notes that useful life is the period of time for which the asset is expected to be used by the enterprise. The Committee is of the view that useful life is different from the pay-back period, which is merely an estimate of the period over which the cost incurred (contribution towards the cluster project) will be recovered. In the extant case, since the economic benefits of membership right would be available to the company even after the pay-back period, the useful life should be determined considering the period over which the economic benefits are expected to arise from the use of the membership right. Further, the Committee is of the view that for determining the useful life of an intangible asset, various factors, such as, the expected usage of the asset, the period of control over the asset and legal or similar limits on the use of the asset etc., as indicated in paragraph 64 of AS 26, need to be considered. Accordingly, the contribution made by the company to the cluster project should be amortised over its useful life rather than the pay-back period or a period of 3-5 years, considered reasonable by the company, as proposed in paragraph 15 above. In this context, the Committee also notes that the amortisation method should be in accordance with paragraph 72 of AS 26, notified under the Rules, as reproduced below:

"72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset."

22. With regard to the querist's contention that the sand reclamation benefits are permanent and it is not envisaged that the entitlement would exhaust any time, the Committee further notes paragraphs 67 and 68 of AS 26, notified under the Rules, which state as below:

> "67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:
>
> (a) amortises the intangible asset over the best estimate of its useful life;
>
> (b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and
>
> (c) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset. ..."
>
> "68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short."

From the above, the Committee is of the view that an intangible asset may have a useful life longer than ten years but it is always finite. The company should disclose the reasons if the presumption of useful life of 10 years is rebutted and the factor(s) that played a significant role in determining the useful life of the asset. Thus, keeping in view the facts and circumstances of each case, the useful life of an intangible asset has to be determined.

D. Opinion

23. On the basis of the above, the Committee is of the opinion that as explained in paragraph 20 above, the membership right received as a consideration of the total contribution of Rs. 42 lakh made by the company to the cluster project should be recognised as an intangible asset. In view of this, the accounting treatment proposed by the company to treat the contribution as deferred revenue expenditure is not appropriate. However, till the time such right is not available for its intended use due to cluster project being in progress and other factors, the contribution made by the company should be treated as an advance. Further, such intangible asset should be amortised over the estimated useful life as explained in paragraphs 21 and 22 above.

Query No. 21

Subject: Accounting treatment of 'Amounts Billed to Clients' and 'Work-in-Progress'. [1]

A. Facts of the Case

1. A Government of India enterprise (hereinafter referred to as 'the company') is an integrated engineering project management and construction company having rich experience of handling wide range of projects and turnkey execution capabilities in major areas of operation. The projects undertaken are spread over a number of years and are being executed in India and abroad. The accounting policy followed by the company is as follows:

Accounting Policy No. 3 (Revenue recognition)

(a) Work done

(i) Work done for the year is arrived at by subtracting opening work in progress from the accumulated work in progress for each contract. In respect of cases where ultimate collection with reasonable certainty is lacking at the time of claim, recognition is postponed till collection is made.

(ii) Valuation of work-in-progress: Work-in-progress is valued by taking cumulative actual costs incurred upto the end of the year without considering miscellaneous income, plus proportionate estimated profit, based on contract cost reviewed at the end of each year allocated on "percentage of completion method".

(iii) At the year-end, works executed but not measured /partly executed are accounted for based on the certification by engineers, entries arising out of such accounting are reversed in the following accounting year. Accordingly, statutory obligations are met with at the time of actual receipt /issue of bills/claims.

[1] Opinion finalised by the Committee on 24.7.2014.

(iv) In case of projects foreclosed/terminated, revenue is recognised only to the extent of contract value of which recovery is probable.

(v) Revenue from consultancy services is recognised on proportionate completion method. In respect of cases where ultimate collection with reasonable certainty is lacking at the time of claim, recognition is postponed till collection is made.

(vi) In case of contracts where the contract costs exceed the contract revenues, anticipated loss is recognised immediately.

(b) Escalation and extra works not provided for in the contract with client, claims out of arbitration awards and insurance claims are accounted for on receipt basis.

(c) Liquidated damages arising from contractual obligations in respect of contracts under dispute/negotiation and not considered payable/ receivable are not accounted for till final settlement.

Accounting Policy No. 5 (Inventory/ Work in Progress)

The contract is considered as closed for accounting purposes upon final billing, commissioning certificate, commercial run, foreclosure and /or termination, whichever is earlier. Till closure of each contract, cumulative value of 'amount billed to client' is shown under 'other current liabilities' and cumulative amount of work done is shown as 'work-in-progress' under 'Inventories'. On closure/foreclosure/termination of a contract 'amount billed to client' is set off against value of 'work-in-progress'.

2. While finalising the annual accounts of the company for the financial year 2012-13, the statutory auditors have raised an objection that the presentation of work-in-progress (WIP) and amount billed to client is not in line with Accounting Standard (AS) 7, 'Construction Contracts' and not as per the practice followed by other construction companies. Presently, as per the accounting policy no. 5, "till closure of the contract, cumulative value of amount billed to client is shown under other current liabilities and cumulative amount of work done is shown as work-in-progress under inventories. On

closure of contract, amount billed to client is set off against value of work-in-progress". In this connection, the company assured the statutory auditors that it will seek the opinion from the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) during the financial year 2013-14 in respect of presentation of amount billed to client and work-in-progress.

3. The querist has explained the accounting treatment followed by the company with the help of the following illustration:

Suppose the company is executing a project worth Rs. 110 crore. The project is expected to earn a profit of Rs. 10 crore after taking into account the project expenses of Rs. 100 crore over the 3 year duration, as per the following break-up:

<u>Expenses</u>

Ist Year	Rs. 25 crore
IInd Year	Rs. 50 crore
IIIrd Year	Rs. 25 crore
Project Expenditure	Rs. 100 crore

The Journal entries to be passed are as under:

<u>Ist Year</u>

1. <u>When expenses are incurred</u>

Civil Work (Expense)	Dr.	25 crore	
To Bank (Current Asset)	Cr.		25 crore
(Being expenses incurred)			

2. <u>When income is recognised as per AS 7</u>

(a) Calculation of profit to be recognised as per percentage of completion method

$$= \frac{\text{Cost incurred to date}}{\text{Total estimated cost to be incurred}} \times \text{Total expected profit}$$

$$= \frac{25}{100} \times 10$$

= 2.5 crore

Therefore, total income to be recognised

Cost incurred to date + profit to be recognised

= 25+2.5

= 27.50 crore

(b) For recognition of income

Work-in-Progress (Current Asset)	Dr.	27.50 crore	
To Income (Work Done) (Income)	Cr.		27.50 crore

(Being income recognised)

3. When bill is raised on client for Rs. 27.50 crore

Sundry Debtors/ Bank (Current Asset)	Dr.	27.50 crore	
To Amount Billed To Client (Current Liability)	Cr.		27.50 crore

(Being bill raised on client)

IInd Year

1. When expenses are incurred

Civil Work (Expense)	Dr.	50 crore	
To Bank (Current Asset)	Cr.		50 crore

(Being expenses incurred)

2. When income is recognised as per AS 7

(a) Calculation of profit to be recognised as per percentage of completion method

$$= \frac{\text{Cost incurred to date}}{\text{Total estimated cost to be incurred}} \times \text{Total expected profit - Profit already recognised}$$

$$= \frac{75}{100} \times 10 - 2.5$$

= 5.0 crore

Therefore, income to be recognised in IInd year

Cost incurred + profit to be recognised

= 50 + 5.0

= 55 crore

(b) For recognition of income

Work-in-Progress (Current Asset)	Dr.	55 crore	
To Income (Work Done) (Income)	Cr.		55 crore

(Being income recognised)

3. When bill is raised on client for Rs. 55 crore

Sundry Debtors/ Bank (Current Asset)	Dr	55 crore	
To Amount Billed To Client (Current Liability)	Cr.		55 crore

(Being bill raised on client)

IIIrd Year

1. When expenses are incurred

Civil Work (Expense)	Dr.	25 crore	
To Bank (Current Asset)	Cr.		25 crore

(Being expenses incurred)

2. When income is recognised as per AS 7

(a) Calculation of profit to be recognised as per percentage completion method

$$= \frac{\text{Cost incurred to date}}{\text{Total estimated cost to be incurred}} \times \text{Total expected profit - Profit already recognised}$$

$$= \frac{100}{100} \times 10 - 7.5$$

= 2.5 crore

Therefore, income to be recognised in IIIrd year

Cost incurred + profit to be recognised

= 25 + 2.5

= 27.5 crore

(b) For recognition of income

Work-in-Progress (Current Asset)	Dr.	27.5 crore	
To Income (Work Done) (Income)	Cr.		27.5 crore

(Being income recognised)

3. When bill is raised on client for Rs. 27.5 crore

Sundry Debtors/ Bank (Current Asset)	Dr.	27.5 crore	
To Amount Billed To Client (Current Liability)	Cr.		27.5 crore

(Being bill raised on client)

When the project is closed at the end of IIIrd year

Amount Billed To Client (Current Liability)	Dr.	110 crore	
To Work-in-Progress (Closed projects) (Current Asset)	Cr.		110 crore

(Being closure entry on completion of project)

Ledgers:

Work-in-progress:

Dr. Cr.

1st year	27.50 crore	1st year	
2nd year	55.00 crore	2nd year	
3rd year	27.50 crore	3rd year	
		On project closure	110.00 crore
Total	110.00 crore	Total	110.00 crore

Amount billed to client:

Dr. Cr.

1st year		1st year	27.50 crore
2nd year		2nd year	55.00 crore
3rd year		3rd year	27.50 crore
On project closure	110.00 crore		
Total	110.00 crore	Total	110.00 crore

4. The querist has mentioned that in the year 1987, the EAC of the ICAI had issued an opinion on presentation of work-in-progress and amount billed to client. The opinion was published in Volume VII of the Compendium of Opinions (Query No. 1.19), wherein it was opined that:

“(i) The revenue should be recognised in respect of the value of work accomplished on the contracts by evaluating the work-in-progress.

(ii) Work-in-progress should be shown under the head ‘Current Assets’ and valued at cost incurred on the contract plus profit taken thereon in accordance with the formulae followed by the company, less cash received from the clients (progress payments). Alternatively, progress payments can be shown under the head ‘Current Liabilities’.

(iii) In view of the above, 'Amount billed to clients A/c' and 'Clients A/c' will not appear anywhere on the 'Liabilities' and 'Assets' side of the balance sheet."

B. Query

5. In view of the above, the querist has requested the Expert Advisory Committee of the ICAI to give its opinion as to whether the accounting treatment followed by the company with regard to presentation of work-in-progress as envisaged in the company's accounting policy no. 5 as stated above, is correct or not. Further, as per the revised AS 7, whether there is any change in the opinion on the above subject dated July 29, 1987 of the Committee.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to whether the accounting treatment followed by the company with regard to presentation of work-in-progress as envisaged in the company's accounting policy no. 5 as stated above, is correct or not. 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, correctness of accounting policies followed by the company as explained in paragraph 1 above, viz., recognition of revenue from consultancy services, accounting of claims out of arbitration awards, insurance claims, liquidated damages arising from contractual obligations, entries passed by the company for works executed but not measured/partly executed and reversal of such entries in the following accounting year, etc. The Committee presumes that the extant query has been raised in the context of contracts entered into during accounting periods commencing on or after 1.4.2003, to which revised AS 7 is applicable.

7. The Committee notes from the Facts of the Case that the company is recognising 'amount due from customers for contract work done' as 'receivables', and is also recognising cumulative value of 'amount billed to client' as 'other current liability'. Further, the cumulative amount of work done is shown as 'work-in-progress' under 'Inventories' on the assets side of the balance sheet at cumulative actual costs incurred upto the end of the year and proportionate estimated profit. On closure/foreclosure/termination of a contract, 'amount billed to client' is set off against value of 'work-in-progress'.

8. The Committee notes that Accounting Standard (AS) 7 (revised 2002), 'Construction Contracts' notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), requires in paragraph 21, that ***"contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date".*** The Committee further notes that paragraph 24 of AS 7 (revised 2002), notified under the Rules states that "the recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method".

9. The Committee further notes the following paragraphs of AS 7 (revised 2002), notified under the Rules:

> **"**25. Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.
>
> 26. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress."
>
> ***"39. An enterprise should disclose the following for contracts in progress at the reporting date:***
>
> ***(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;***
>
> ***(b) the amount of advances received; and***
>
> ***(c) the amount of retentions."***
>
> ***"41. An enterprise should present:***
>
> ***(a) the gross amount due from customers for contract work as an asset; and***

> ***(b) the gross amount due to customers for contract work as a liability.***
>
> 42. The gross amount due from customers for contract work is the net amount of:
>
> (a) costs incurred plus recognised profits; less
>
> (b) the sum of recognised losses and progress billings
>
> for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings."

10. From the above, the Committee is of the view that under the percentage of completion method, revenue is recognised on the basis of stage of completion irrespective of the fact whether or not payment has been received or settled. Work-in-progress can be recognised and presented only in respect of costs incurred by an enterprise that relate to future activity on the contract, provided these are capable of recovery. For example, an enterprise might have bought construction material which will be used in future for completing the contract. The Committee, however, notes from the Facts of the Case that the company is treating even the costs that relate to construction activities completed and estimated profit element thereon as work-in-progress, which is not correct. The Committee is further of the view that the amount corresponding to the contract revenue less progress billings should be presented as receivable from the client, generally termed as 'unbilled revenue' on the assets side of the balance sheet in accordance with paragraph 42 of AS 7 reproduced above. The Committee is of the view that it is the advance payment received from the customers that does not relate to the contract activity performed which is recognised as a liability. Accordingly, the Committee is of the view that the recognition of liability as 'Amount Billed to Clients A/c' in respect of work completed and setting it off against value of 'work-in-progress' which is also cumulative value of work done on the closure/foreclosure/termination of the contract is not correct. In view of disclosure requirements prescribed in paragraph 39 of AS 7 reproduced above, with regard to contracts in progress, the company should disclose in the notes to accounts, the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date.

11. With regard to the earlier opinion as referred to by the querist, the Committee is of the view that the earlier opinion with regard to valuation of

work-in-progress was given considering the requirements of paragraph 15.1 of pre-revised AS 7, which required to disclose the progress payments either as a liability or as a deduction from the amount of contract work-in-progress. Since pre-revised AS 7 is not applicable in the extant case due to issuance of revised AS 7, which contains specific requirements with regard to the costs that can be classified as contract work-in-progress as discussed above, the earlier opinion of the EAC is not applicable.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the accounting treatment, followed by the company with regard to presentation of work-in-progress as envisaged in the company's accounting policy No. 5 as stated above, is not correct. Work-in-progress should be recognised and presented only in respect of costs incurred by an enterprise that relate to future activity on the contract, provided these are capable of recovery, as discussed in paragraph 10 above.

With regard to earlier opinion as referred to by the querist, the Committee is of the view due to issuance of revised AS 7, the earlier opinion of the EAC, which was based on pre-revised AS 7 is not applicable, as discussed in paragraph 11 above.

Query No. 22

Subject: Accounting treatment of interest on Non-Performing Assets (NPAs) of a co-operative bank.[1]

A. Facts of the Case

1. A bank (hereinafter referred to as the 'bank') is a co-operative bank. The bank is enjoying the 'Schedule Bank' status since 1989. In the year 2001, the bank was registered under Multi-State Co-operative Societies Act, 1984. With this, the bank has opened a branch in Mumbai, economic capital

[1] Opinion finalised by the Committee on 24.7.2014.

of India and has become Multi-State Scheduled Co-operative Bank. The bank has developed in manifolds with the time. Membership (shareholders) of the bank has already crossed 2,50,000 mark which is a record by itself. The bank has more than 900 employees working across 29 branches and has various departments of its Head Office. As of 31st March, 2013, the bank has more than 9,56,000 deposit accounts and more than 46,000 advance accounts. As of now, the bank has deposit base of Rs. 2,700 crore and advances are to the tune of Rs. 1,700 crore.

2. Few important financial parameters as of 31st March, 2013 are given hereunder:

(Rupees in Crores)

Particulars	Amount
Deposits	2,572.13
Advances	1,679.29
Total Income	304.31
Total Expense	264.94
Gross Profit	60.02
Net Profit	39.37
Particulars	**%**
Cost of Deposit	8.50%
Yield on Advance	13.20%
Yield on Investments	8.68%
Weighted Cost of Fund	8.18%
Weighted Yield on Assets	10.65%
Net Spread	2.47%
Net Interest Margin	3.14%
CRAR (Capital or Risk Weighted Asset Ratio)	13.48%

At the outset, the querist has stated that it wishes to seek the opinion of the Expert Advisory Committee on treatment of interest on Non-Performing Asset (NPA) and its presentation in its financial statements vis-à-vis regulatory validity and effect on Gross NPA.

3. (A) At present the bank is accounting for monthly interest on Non-Performing Assets (NPAs) as under:

Debit - Interest Receivable Account

Credit - Overdue Interest Reserve Account

(The querist has clairified that this entry would be passed through system without manual intervention and without routing it through the profit and loss account.)

At the time of recovery of interest in NPA Accounts, the following book entries are passed:

Debit - Actual Inflow (Cash/Clearing/Transfer)

Credit - Profit and Loss Account (Interest Account)

and

Debit - Overdue Interest Reserve

Credit - Interest Receivable Account

Interest due on standard accounts is similarly accounted for by the bank on a monthly basis by initially debiting 'Interest Receivable Account' and crediting 'Overdue Interest Reserve Account', which is not routed through its profit and loss account. At the time of preparation of balance sheet and the profit and loss account, i.e., at the end of every quarter, interest portion of standard account would be taken to the profit and loss account and the same would be clubbed in total advance (and not to individual advance account). Further, the following accounting entries would be passed through the system without manual intervention:

Debit - Overdue Interest Reserve Account

Credit - Interest Receivable Account

and

Debit - Advances Account (all standard accounts clubbed amount)

Credit - Interest Account (P&L)

On the very next day of the end of every quarter, the following accounting entries would be passed through the system without manual intervention:

Debit: Interest Receivable Account

Credit: Overdue Interest Reserve Account

Debit: Interest Account (P&L)

Credit: Advances Account (all standard accounts clubbed amount)

However, interest portion of NPA accounts will not be considered as income and hence, will not be taken into the profit and loss account and the same would simply form contra entries (Interest Receivable and Overdue Interest Reserve). The querist has also clarified the above entries by way of an example illustrated at Annexure A.

(B) In case of recovery relating to NPA accounts, the allocation of the total amount recovered to various components, i.e., charges, principal and interest is done firstly to charges, secondly to principal and finally to interest. In case of Standard Accounts, the allocation of recovery is done firstly to charges, secondly to interest and finally to principal. The querist has stated that both the above treatments are being followed according to bank's board resolution as per the discretion given by the Master Circular on Prudential Norms on Income Recognition, Asset Classification, Provisioning & Other Related Matters (Updated up to June 30, 2004) No. RBI/2004-05/286 UBD.BSD.IP.MC.No. 15/12.05.05/2004-05, dated December 2, 2004, relevant extract of which is given here under for reference of the Committee:

> **"7.1.6 Appropriation of recoveries**
>
> **What is the practice to be adopted by banks regarding appropriation of recoveries in NPA Accounts?**
>
> In the absence of a clear agreement between the bank and the borrower for the purpose, banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner."

4. The querist has stated that Interest Receivable Account and Overdue Interest Reserve Account consist of overdue interest recovery in NPA accounts and standard advances for one month or in excess of one month's interest. However, the majority amount of overdue interest is of NPA advances.

5. The querist has also stated that as per the accounting system of the bank, it is maintaining memorandum accounts for each NPA account where monthly interest application, recovery amount etc., is recorded since it is prudent to not to credit the interest in the books. However, for record purpose, the bank is passing the entry as mentioned above. As on 31st March, 2013, the interest receivable and overdue interest reserve amount is Rs. 1004.52 crore as against total advances as of that day of Rs. 1,679.29 crore, which, as per the querist, shows the absurd figures. According to the querist, the alternative is to keep 'Interest Receivable' and 'Overdue Interest Reserve' as a note to balance sheet but the same is not permitted by the Reserve Bank of India in case of urban cooperative banks like the bank in the extant case.

B. Query

6. In view of the above, the querist has sought the opinion of the Expert Advisory Committee on correctness of the above accounting treatment or the alternative treatment, if any, suggested by the Committee.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting treatment of interest on NPA and the presentation thereof in the bank's financial statements. The Committee, therefore, restricts itself to this issue and has not examined any other issue that may arise from the Facts of the Case such as, accounting for interest on performing advances or standard accounts, the reasonability of the balance in the 'Overdue Interest Reserve' Account vis-à-vis the aggregate balance of the advances, the manner and tenure of computation of the interest on non-performing advances, accounting for bank charges, correctness of various accounting entries passed by the bank, etc. At the outset, the Committee also wishes to point out that the Committee has expressed its opinion purely from accounting perspective and not from legal perspective, such as legal interpretation of RBI guidelines, etc. The Committee has, therefore, presumed that the

accounting treatment being presently followed by the company is in line with the RBI guidelines issued from time to time.

8. The Committee notes from the Facts of the Case that interest due on Non-Performing Assets (NPA) is accounted by the bank on a monthly basis by debiting 'Interest Receivable Account' and crediting 'Overdue Interest Reserve Account', which is not routed through its profit and loss account. On receipt of interest on such NPA, the aforesaid entry is reversed to the extent of the interest received and the amount received is credited to the profit and loss account.

9. The Committee further notes that the Reserve Bank of India Master Circular No. RBI/2004-05/286/UBD.BSD.IP.MC.No.15/12.05.05/2004-05 dated December 2, 2004 on Prudential Norms on Income Recognition, Asset Classification, Provisioning & Other Related Matters, as referred to by the querist in the extant case has been updated by Master Circular No. RBI/ 2014-15/74/DBOD.NO.BP.BC.9/21.04.048/2014-15 dated July 1, 2014. However, since the financial year 2012-13 has been referred to in the Facts of the Case, the Committee has considered Master Circular No. RBI/2012-13/64/ UBD.BPD.(PCB) MC No.3 /09.14.000/2012-13 dated July 2, 2012 in the extant case. In terms of paragraph 4.5.3 of both the Master Circulars dated December 2, 2004 and July 2, 2012, "With a view to ensuring uniformity in accounting the accrued interest in respect of both the performing and non-performing assets, the following guidelines may be adopted notwithstanding the existing provisions in the respective State Co-operative Societies Act: (i) interest accrued in respect of non-performing advances should not be debited to borrowal accounts but shown separately under 'Interest Receivable Account' on the 'Property and Assets' side of the balance sheet and corresponding amount shown under 'Overdue Interest Reserve Account' on the 'Capital and Liabilities' side of the balance sheet." The Committee also notes that the balance sheet format prescribed under the Third Schedule to the Banking Regulation Act, 1949 (as applicable to co-operative banks) also requires these accounts to be presented in the similar way on the face of the balance sheet. Further, paragraph 4.1.1 of the Master Circular states that "the policy of income recognition has to be objective and based on the record of recovery. Income from non-performing assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, banks should not take to income account interest on non-performing assets on accrual basis".

10. The Committee notes from the above that in the extant case, considering the RBI Circular, the bank is not charging interest on NPA on accrual basis, i.e., when interest becomes due; rather, it is charging interest on receipt basis. The Committee further notes that in terms of the requirements of the RBI Circular, the 'Interest Receivable Account' and the 'Overdue Interest Reserve Account' in respect of interest receivable from NPA accounts, are reflected by the bank on the 'Property and Assets' side and 'Capital and Liabilities' side of the balance sheet, respectively. The Committee is of the view that 'Interest Receivable Account' and 'Overdue Interest reserve account' are of the nature of memorandum accounts, which should not be reflected in the balance sheet. In this regard, the Committee also notes that the similar RBI Circular in respect of commercial banks also recognises that accrued interest account in respect of NPA is a memorandum account and the interest receivable from NPA accounts should not be reflected in the balance sheet. Accordingly, the Committee is of the view that though treatment followed by the bank in the extant case to incorporate these memorandum accounts in the balance sheet is in compliance with RBI Circular, the same is not appropriate from the accounting principles perspective.

11. Further, with regard to recognition of interest on NPA accounts, the Committee notes that as per paragraph 10 (c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', issued by the ICAI, accrual is one of the fundamental accounting assumption. As per 'accrual', "Revenues and costs are accrued, that is, reognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate". Further, as per paragraph 16 of AS 1, "the primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date". As per paragraph 17 of AS 1, one of the major considerations governing the selection and application of accounting policies is 'Prudence'. As per 'Prudence', "In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash".

12. The Committee also notes that as per paragraph 13 of Accounting Standard (AS) 9 'Revenue Recognition', issued by the ICAI, ***"Revenue arising from the use by others of enterprise resources yielding interest,***

royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists". Accordingly, as per AS 9, to the extent and till the time such uncertainty of collection exists, revenue recognition should be postponed. The revenue needs to be recongised when it is reasonably certain that the ultimate collection will be made. The Committee also notes that paragraph 2.1.2 of the Reserve Bank of India Master Circular dated July 2, 2012 on Prudential Norms on Income Recognition, Asset Classification, Provisioning & Other Related Matters, inter alia, states that "with effect from March 31, 2004, a non-performing asset shall be a loan or an advance where: (i) Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a Term Loan". Therefore, the Committee is of the view that when an advance becomes an NPA, it means that recoveries of dues (including interest) in respect of such NPA is not as per the agreed terms. Thus, in case of NPAs, there is an uncertainty of collection of interest as well as principal amount of the advance. The Committee also notes that as per paragraph 4.1.1 of the Master Circular, a bank cannot recognise income (interest) on any advance which has become a Non-Performing Asset. The Committee is of the view that similar principle is laid down in paragraph 13 of AS 9 for recognition of revenue by way of interest while requiring not to recognise revenue when significant uncertainty as to its collectability exists. Accordingly, the Committee is of the view that the accounting treatment for recognition of revenue followed by the bank referred to in paragraph 10 above considering the guidelines of the Reserve Bank of India is in compliance with the provisions of AS 9. As far as the manner of appropriation of recoveries to interest portion, bank charges and to principal amount of advance is concerned, the Committee is of the view that appropriation/allocation is an internal matter of the bank and does not have any accounting considerations. The same should be decided by the bank keeping in view its regulatory environment.

13. As far as presentation and disclosures in the financial statements are concerned, the Committee is of the view that apart from the disclosure requirements as per the RBI guidelines and Banking Regulation Act, where the revenue recognition is postponed, disclosures should also be made as per paragraph 14 of AS 9 which is reproduced below:

> ***"14. In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies', (AS 1), an enterprise should also disclose the circumstances in which revenue***

recognition has been postponed pending the resolution of significant uncertainties."

D. Opinion

14. On the basis of the above, Committee is of the view that although treatment followed by the bank to incorporate the 'Interest Receivable Account' and 'Overdue Interest Reserve' Account which are memorandum accounts in the balance sheet is in compliance with the RBI circular, same is not appropriate from the accounting perspective, as discussed in paragraph 10 above. The accounting treatment for recognition of revenue followed by the bank referred to in paragraph 10 above considering the guidelines of the Reserve Bank of India is in compliance with the provisions of AS 9, as discussed in paragraphs 11 and 12 above. Further, the Committee is of the view that apart from the disclosure requirements as per the RBI guidelines and Banking Regulation Act, disclosures should also be made as per paragraph 14 of AS 9, as discussed in paragraph 13 above.

Annexure A

Example:

XYZ got cash credit (CC) from bank (withdrawn the amount) worth Rs. 5,00,00,000.00 (Rupees five crore) on 1st April, 2009. Interest rate was fixed at 13%.

Until 30th June, 2009 above CC account was running satisfactorily, i.e., every month by 5^{th}, interest amount was deposited promptly (4,55,000 - 4,74,000 - 5,40,000), Charges debited to the account worth Rs. 35,000.00 on 31st May, 2009 was paid on 3rd June, 2009.

From 1st July, 2009 account remain fully utilised without having sufficient drawing power.

For July, August and September, 2009 XYZ could not pay the interest on the above CC account and account remained overdrawn.

On 1st October bank marked this account as NPA. At that time unrecovered interest amount was Rs. 16,42,668. Unrecovered charges were Rs. 55,000.00 (charged on 31st August, 2009).

On 1st January, 2010 XYZ made payment of Rs. 15,00,000.

Accounting Entries

1st April, 2009

Cash Credit Account - XYZ	Dr.	5,00,00,000.00	
To Cash			5,00,00,000.00

(Being CC sanctioned amount withdrawn by XYZ from CC Account)

30th April, 2009

Interest Receivable Account	Dr.	4,55,000.00	
To Overdue Interest Reserve Account			4,55,000.00

(Being interest amount of XYZ CC account for the April 2009)

5th May, 2009

Cash Account	Dr.	4,55,000.00	
To Interest on CC Account			4,55,000.00

(Being April 2009 interest amount charged to XYZ CC Account received)

Overdue Interest Reserve Account	Dr.	4,55,000.00	
To Interest Receivable Account			4,55,000.00

(Being reversal of April 2009 Interest Receivable and Overdue Interest Reserve Account entry on actual amount recovered.)

31st May, 2009

Cash Credit Account - XYZ	Dr.	35,000.00	
To Charges Account			35,000.00

(Being charges paid on behalf of XYZ charged to CC XYZ Account.)

31st May, 2009

Interest Receivable Account	Dr.	4,74,000.00	
To Overdue Interest Reserve Account			4,74,000.00

(Being interest amount of XYZ CC Account for the May, 2009)

3rd June, 2009

Cash Account	Dr.	35,000.00	
To Cash Credit Account - XYZ			35,000.00

(Being charges amount debited to XYZ CC Account recovered)

5th June, 2009

Cash Account	Dr.	4,74,000.00	
To Interest on CC Account			4,74,000.00

(Being May 2009 interest amount charged to XYZ CC Account received)

Overdue Interest Reserve Account	Dr.	4,74,000.00	
To Receivable Account			4,74,000.00

(Being reversal of May 2009 Interest Receivable and Overdue Interest Reserve Account entry on actual amount recovered.)

30th June, 2009

Interest Receivable Account	Dr.	5,40,000.00	
To Overdue Interest Reserve Account			5,40,000.00

(Being interest amount of XYZ CC Account for the June, 2009.)

5th July, 2009

Cash Account	Dr.	5,40,000.00	
To Interest on CC Account			5,40,000.00

(Being June 2009 interest amount charged to XYZ CC Account received.)

Overdue Interest Reserve Account	Dr.	5,40,000.00	
To Interest Receivable Account			5,40,000.00

(Being June 2009 reversal of Interest Receivable and Overdue Interest Reserve Account entry on actual amount recovered.)

31st July, 2009

Interest Receivable Account	Dr.	5,41,667.00	
To Overdue Interest Reserve Account			5,41,667.00

(Being interest amount of XYZ CC Account for the July, 2009.)

31st August, 2009

Interest Receivable Account	Dr.	5,47,535.00	
To Overdue Interest Reserve Account			5,47,535.00

(Being interest amount of XYZ CC Account for the August, 2009.)

31st August, 2009

Cash Credit Account - XYZ	Dr.	55,000.00	
To Charges Account			55,000.00

(Being charges paid on behalf of XYZ charged to CC XYZ Account.)

30th September, 2009

Interest Receivable Account	Dr.	5,53,466.00	
To Overdue Interest Reserve Account			5,53,466.00

(Being interest amount of XYZ CC Account for the September, 2009.)

1st October, 2009

XYZ CC Account turned NPA

Since the profit and loss account is not credited at the time of charging monthly interest and the same is credited to profit and loss account at the time of actual recovery, there is no need to pass any accounting entry.

Query No. 23

Subject: Whether amortisation of premium paid on foreign currency (USD) buy forward covers can be treated as borrowing cost.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') manufactures copper cathode, gold, silver and Di-ammonium phosphate (DAP). The main raw material for manufacture of copper is the Copper Concentrate (CC) and it contains various metals primarily being copper, gold and silver.

2. The company sources its raw materials almost entirely from outside India. The prices are settled in USD at the benchmark international rate. As per the normal trade practice, 90% of payment is to be made within 3-4 days of the arrival of the material. This is because the rates and quality are settled later on. Balance 10% is paid upon finalisation of quality and quantity. The company has two options to make the payment to the supplier either from internal resources/accruals or by way of short-term borrowings from bank. The company mainly borrows from banks. For this purpose, the company has an option either to borrow in Indian Rupee (INR) or in USD in the form of buyer's credit for a period of 3-6 months. The company borrows mainly in USD in the form of buyer's credit as the rate of interest is linked to LIBOR plus spread ranging between 100-200 bps. However, borrowings in USD have some associated costs like withholding tax under section 195 of the Income-tax Act, 1961 and also the cost of hedging (premium) for taking the forward cover for repayment of the loan. However, even after considering these costs, i.e., LIBOR plus spread and the premium paid for taking the forward cover, the cost of borrowings in USD are cheaper than the cost of borrowings in INR.

3. Entire sales of copper, gold and silver are denominated in USD whether it is exported or sold in the domestic market. As such, the business model works as natural hedge wherein the borrowings in USD are repaid in USD by selling the products. However, in this natural hedge scenario there is always a timing mismatch between the date of repayment of loan and the sales realisations. In order to take care of this timing mismatch, which is almost 10-15 days, the company takes forward buy covers to hedge the risk for any currency fluctuation between the realisation of sales and the

[1] Opinion finalised by the Committee on 24.7.2014.

repayment of the borrowing. These forward covers are provided by the bank at current spot rate plus a premium which is based on the market condition proportionately for the period of the cover.

Present accounting treatment:

4. The querist has stated that as required by Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', the premium paid on forward covers is amortised over life of the contract and is charged to the statement of profit and loss of the company as exchange rate difference which is included under the head 'other expenses'. This is considered as a part of segment result (defined as earnings before interest and tax). At the same time, since the borrowings are monetary items as per AS 11, the same are restated at the month-end spot rate and such restatements are part of segment result.

Proposed accounting treatment:

5. With a view to align accounting for premium on related forward covers with risk management objectives, it is considered more appropriate to include amortisation of forward premium as part of borrowing cost. According to the querist, this will only lead to change in presentation while reported net result from operation of the company will not undergo any change.

B. Query

6. On the basis of the above, the company seeks the opinion of the Expert Advisory Committee on the following issues:

(i) Whether amortisation of premium on forward covers can henceforth be treated as 'other borrowing cost' under the head 'finance cost' under Schedule III to the Companies Act, 2013 as per Accounting Standard (AS) 16, 'Borrowing Costs'.

(ii) If the answer to (i) is yes, whether it can be excluded for the purpose of disclosing segment result.

(iii) If the answers to (i) and (ii) above are in affirmative, whether it is necessary to effect such change from the beginning of financial year.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to whether amortisation of premium on forward contract undertaken in connection with short-term foreign currency borrowings/buyers' credit (which are repayable in foreign currency) can be treated as a part of the borrowing cost as per the provisions of AS 16, notified under the Companies (Accounting Standards) Rules, 2006 and therefore, whether it can be disclosed as 'other borrowing costs' under the head 'finance cost' under Schedule III to the Companies Act, 2013 and excluded under segment results. 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 interest on the short-term borrowings/buyers' credit, accounting for exchange differences arising on borrowings/buyers' credit, accounting for buyers' credit, accounting for foreign currency transactions and hedging contracts, accounting treatment of exchange differences arising on forward contracts as at the reporting date or the settlement date, applicability of paragraph 4(e) of AS 16, computation and presentation of segment results, etc.

8. The Committee notes from the Facts of the Case that the company wishes to treat the premium on forward cover as a part of borrowing costs as per AS 16. In this regard, the Committee notes the following paragraphs of AS 16, notified under the Companies (Accounting Standards) Rules, 2006:

> "***3.1 <u>Borrowing costs</u> are interest and other costs incurred by an enterprise in connection with the borrowing of funds."***
>
> "4. Borrowing costs may include:
>
> (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
>
> (b) amortisation of discounts or premiums relating to borrowings;
>
> (c) amortisation of ancillary costs incurred *in connection with the arrangement of borrowings*;
>
> ..."
>
> (Emphasis supplied by the Committee.)

From the above, the Committee notes that other costs/ancillary costs included in the definition of borrowing costs are the costs incurred in connection with the *arrangement of borrowings,* viz., for obtaining the borrowings whereas the premium on forward cover is a hedging cost, incurred to enter into forward contracts, for hedging or mitigating the risks associated with adverse movement of foreign exchange rate variations on foreign currency borrowings and not for arranging the borrowings themselves. Therefore, premium on forward covers cannot be considered as ancillary costs incurred for arrangement of borrowings.

9. With regard to presentation of amortisation of premium on forward covers as ‘other borrowing costs’ under the head ‘finance cost’ under Schedule III to the Companies Act, 2013, the Committee notes paragraphs 9.5.5 and 9.5.7 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956 and paragraphs 5.6 and 5.7 of Accounting Standard (AS) 17, ‘Segment Reporting’, notified under the Companies (Accounting Standards) Rules, 2006, as follows:

> *Guidance Note on the Revised Schedule VI to the Companies Act, 1956*
>
> ***“9.5.5 As per Note 3 of the General Instructions for the Preparation of the Statement of Profit and Loss, disclosure of Finance costs is to be bifurcated under the following:***
>
> …
>
> **B) Other borrowing costs**
>
> Other borrowing costs would include commitment charges, loan processing charges, guarantee charges, loan facilitation charges, discounts/premium on borrowings, other ancillary costs incurred in connection with borrowings, or amortization of such costs, etc.”
>
> **“9.5.7 Other Expenses**
>
> All other expenses not classified under other heads will be classified here. …”
>
> *AS 17*
>
> **“5.6 <u>Segment expense</u> is the aggregate of**
>
> ***(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and***

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

Explanation:

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment are not included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories. In case interest is included as a part of the cost of inventories where it is so required as per AS 16, Borrowing Costs, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest is considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest is disclosed by way of a note to the segment result.

(c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) income tax expense; and

(e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level

> ***and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.***
>
> ***5.7 Segment result is segment revenue less segment expense."***

From the above, the Committee is of the view that since the requirements of Schedule III to the Companies Act, 2013 are similar to the requirements of Revised Schedule VI to the Companies Act, 1956, the above-reproduced requirements of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, are equally applicable. Further, since the premium on forward covers cannot be considered as ancillary costs in connection with arrangement of borrowings, as discussed in paragraph 8 above, the Committee is of the view that such premium cost cannot also be considered as 'other ancillary costs incurred in connection with borrowings' for the purposes of paragraph 9.5.5, 'other borrowing costs' of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956. The Committee further notes that the amortisation of premium on forward covers is not covered by any other item as mentioned in paragraph 9.5.5 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, reproduced above. Accordingly, the Committee is of the view that amortisation of premium on forward covers cannot be presented and disclosed as 'other borrowing costs' under the head 'finance cost' under Schedule III to the Companies Act, 2013. Instead, it should be disclosed under the head 'other expenses' as it cannot be classified under any other head specified under Schedule III. Further, for similar reasons, the Committee is of the view that the premium on forward covers should not be excluded from the segment results considering it as an interest expense. The Committee is also of the view that since in the extant case, premium on forward covers relates to liabilities in respect of purchase of raw materials which are attributable or allocable to segments, it should be included in the segment expenses for determination of segment result for segment reporting as per AS 17.

D. Opinion

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

(i) No, premium on forward covers cannot be considered as a 'borrowing cost' under the provisions of AS 16, as discussed in paragraph 8 above. Amortisation of premium on forward covers cannot be presented and disclosed as 'other borrowing costs' under the head 'finance cost' under Schedule III to the Companies Act, 2013. Instead, it should be disclosed under the head 'other expenses'.

(ii) The premium on forward covers should not be excluded from the segment results considering it as an interest expense, as discussed in paragraph 9 above.

(iii) In view of (i) and (ii) above, answer to this question does not arise.

Query No. 24

Subject: Recognition of deferred tax asset on unabsorbed business loss and unabsorbed depreciation. [1]

A. Facts of the Case

1. A company, which is a public sector undertaking, is a subsidiary of an oil company. The company is engaged in the business of petroleum refining and its products are sold predominantly to Oil Marketing Companies (OMCs). The company has two refineries located at Chennai and Nagapattinam in the State of Tamilnadu with a combined refining capacity of 11.50 MMTPA.

2. The cost of raw material (crude oil) is based on the prices quoted in the international markets and applicable foreign exchange rates. Similarly, the sale price of products, i.e., refinery transfer price is based on the product prices prevailing in the international markets and applicable foreign exchange rates. Thus, profitability of the company is dependent on factors like (a) volatility in international crude oil and product prices, (b) volatility in foreign

[1] Opinion finalised by the Committee on 24.7.2014.

exchange rates, and (c) under-recoveries arising out of discount, lower export realisation, Central Sales Tax (CST) payment, coastal movement, etc. The company incurred losses in the last two financial years mainly due to the above factors which were beyond the control of the company.

3. The aggregate carry forward unabsorbed depreciation/unabsorbed business loss/short term capital loss available for set off against future taxable income as per the income tax return of the company is as below:

(Rs. In Crore)

Financial Year (F.Y.)	***Unabsorbed Depreciation****	***Unabsorbed Business Loss***	***Short term capital loss***	***Available for set off upto Asst. Year***
2008-09	—	—	6.27	2017-18
2011-12	325.56	—	—	No time limit
2012-13	472.92	1306.64	—	2021-22
2013-14 *	314.14	—	—	No time limit
Total	**1112.62**	**1306.64**	**6.27**	

* Unabsorbed depreciation for financial year (F.Y.) 2013-14 is provisional as income tax return for F.Y. 2013-14 is yet to be filed. Deferred tax liability (DTL) on timing difference on depreciation recognised in the balance sheet is as follows:

(Rs. In crore)

Financial Year	***DTL***
2012-13	707.09
2013-14	704.40

4. The relevant extract of the accounting policy of the company on taxes on income is as follows:

> "Provision for current tax is made as per the provisions of the Income-tax Act, 1961. Deferred tax liability/asset resulting from 'timing difference' between book and taxable profit is accounted for considering

> the tax rate and laws that have been enacted or substantively enacted as on the balance sheet date. Deferred tax asset is recognised and carried forward only to the extent that there is virtual certainty that the asset will be realised in future."

5. The querist has stated that deferred tax asset (DTA) on the above unabsorbed carry forward loss/depreciation was not recognised in the books of account as on 31.03.2014 in line with paragraph 17 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', which, inter alia, states as below:

> ***"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised".***

In the oil refining industry, the future taxable income based on profit projections, would be difficult to demonstrate with certainty, as the profits are subject to external factors, like volatility in international crude and product prices and foreign currency exchange rates and change in government policies, etc.

6. *Views of the company on recognition of DTA:*

Paragraph 17 of AS 22, mentioned above, refers to availability of taxable income with virtual certainty in the future, such that the DTA created can be realised. Paragraph 4.2 of AS 22 defines taxable income/ (tax loss) as follows:

> ***"4.2 <u>Taxable income (tax loss)</u> is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined."***

While determining 'taxable income' as per the Income-tax Act, 1961, the book depreciation would be disallowed and the tax depreciation be allowed. Hence, any excess of tax depreciation claimed in the current year will get reversed in the future years, since in the future years the tax depreciation claimed would be lower as compared to book depreciation resulting in higher future taxable Income. It is clear from the above that the reversal of depreciation itself would result in increase in taxable income in the future years, notwithstanding any operational profits/ losses made by the company, which if positive, may further contribute to increase in taxable income. Thus, to the extent of such reversal of timing differences on account of depreciation, there is a virtual certainty in taxable income.

7. Also, in the scenario of continued losses in the future years, there would be no liability to pay tax even with the reversal of timing differences. Thus, even in the event of future profits and future losses, company's tax liability is reduced or there would be no liability for payment of tax. Accordingly, the company should recognise only a lower net deferred tax liability by way of creation of deferred tax asset. Hence, to the extent of the availability of future taxable income, if any, by virtue of the future reversal of any timing differences recognised at the balance sheet date, the deferred tax assets should be recognised.

8. Further, the querist has stated that it is worth referring paragraph 18 of AS 22, which provides as follows:

> "The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

It is clear from the above that a company with history of losses can recognise DTA to the extent of deferred tax liability subject to the following:

(a) Certainty in reversal of timing differences that would result in sufficient income (or)

(b) Other convincing evidence that sufficient future taxable income will be available.

9. The querist has stated that in the case of the company, there is a certainty in 'reversal of timing differences' arising on account of depreciation. Hence, the same justifies the creation of deferred tax asset on unabsorbed business loss/depreciation to the extent of deferred tax liability. Accordingly,

DTA that can be recognised by the company on unabsorbed depreciation and unabsorbed business loss works out to Rs. 822 crore as detailed below:

(Rs. in crore)

Particulars	***Unabsorbed Depreciation***	***Unabsorbed Business Loss***	***Total***
Aggregate amount	**1112.62**	**1306.64**	**2419.26**
DTA @ 33.99 %	378.18	444.13	822.31

However, DTA on unabsorbed depreciation and unabsorbed business loss has to be restricted to the extent of DTL of Rs. 704.4 crore (representing timing differences on depreciation) as per paragraph 18 of AS 22.

10. The querist has also reproduced certain pronouncements of the Institute of Chartered Accountants of India (ICAI) in support of the above treatment as follows:

(i) Expert Advisory Committee (EAC) Opinion

In this regard, the querist has stated that for recognising deferred tax asset on unabsorbed depreciation/unabsorbed business loss to the extent of reversal of deferred tax liabilities, it would not be necessary to consider the level of virtual certainty supported by convincing evidence based on the opinion of the Expert Advisory Committee, published in Volume XXIX of the Compendium of Opinions as query no. 18 and 27.

(ii) Financial Reporting Review Board (FRRB) publication

The FRRB publication, 'A Study on Compliance of Financial Reporting Requirements' (published in January, 2010 at page No. 146) has stated, inter alia, that " However, in the instant case, the company has not recognised deferred tax assets even to the extent of deferred tax liability recognised in the financial statements, which is contrary to AS 22".

(iii) Background Material for Seminars on AS 22 (published in April 2003, by the ICAI)

The view expressed in this regard, in the Background Material for Seminars on AS 22 (published in April 2003 by the ICAI) is also worth referring. Reply to Frequently Asked Questions (FAQs) – Question 9(ii) (Page 22 of the Material) clarifies that *in respect of tax losses of the company, which can be* *carried forward at the balance sheet date, deferred tax asset can be recognised to the extent that the reversal of the deferred tax liability will give rise to sufficient future taxable income against which such deferred tax asset can be realised.* (Emphasis supplied by the querist.)

11. *Statutory auditors' view on recognition of DTA*

(i) The company's contention of recognising deferred tax asset on unabsorbed business loss/depreciation to the extent of deferred tax liability based on paragraph 18 of AS 22 is not acceptable as the reversal of the timing differences should result in sufficient taxable income, as defined in paragraph 4.2 of AS 22.

(ii) Reversal of timing differences on depreciation is one such component of the taxable income determined in accordance with tax laws and hence, the reversal of timing differences on depreciation in isolation will not contribute to sufficient future taxable income. Sufficient taxable income, in the opinion of auditors, means positive net taxable income after all adjustments including timing differences.

(iii) Recognition of deferred tax asset to the extent of deferred tax liability based on the principle that the reversal of timing differences on depreciation alone would result in sufficient future taxable income is not in line with the ICAI's publications.

B. Query

12. In the light of the above, the opinion of the Expert Advisory Committee is sought on the following:

(i) Can the company recognise DTA on unabsorbed depreciation/ unabsorbed business loss?

(a) to the extent of DTL entirely (Rs. 704.4 crore in the extant case), based on paragraph 18 of AS 22 considering the future taxable income arising out of reversal of timing differences.

(b) to the extent of unabsorbed business loss restricted to the reversal of DTL within the 8 year period (being the maximum period for which the business loss can be carried forward) plus entire unabsorbed depreciation (since the same is available for set off without time limit) ?

(ii) Can the reversal of timing difference alone be construed as sufficient future taxable income for the purpose of recognition of DTA as per paragraph 18 of AS 22, i.e., does the term taxable income imply only positive net taxable income after all adjustments including timing differences or it denotes individual elements like reversal of timing differences which contributes to increase in the taxable income/decrease in tax loss.

(iii) Since, the facts and circumstances remain the same for the previous years also, will the non–recognition of DTA as above in the previous years amount to prior period item under Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'?

(iv) a. Will the recognition of DTA on unabsorbed depreciation/ unabsorbed business loss to the extent of DTL (based on the principle of sufficient future taxable income arising out of reversal of timing differences) amount to change in the company's accounting policy?

b. If the company can recognise DTA to the extent of DTL as per (i) above, is the company required to change/reword its accounting policy?

(v) If the company does not recognise DTA even to the extent of DTL (based on the principle of sufficient future taxable income arising out of reversal of timing differences), would it be in contravention of AS 22?

(vi) What additional disclosures are to be made by the company in this regard?

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to recognition of deferred tax asset on unabsorbed depreciation and carry forward of losses to the extent of deferred tax liability as on the reporting date. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as,

offsetting of deferred tax assets and deferred tax liabilities, deferred tax implications of short-term capital loss, etc. Further, the Committee's opinion is based on accounting principles and it has not gone into the calculations or computation of deferred tax assets. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view.

14. The Committee notes paragraphs 8, 15, 17 and 18 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), which provide as follows:

> "8. Unabsorbed depreciation and carry forward of losses which can be setoff against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence (see paragraphs 15-18)."
>
> ***"15. Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised."***
>
> ***"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.***
>
> …
>
> 18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

From the above, the Committee notes that deferred tax assets should be recognised only to the extent that there is a reasonable certainty (or virtual certainty supported by convincing evidence in case of unabsorbed depreciation and carry forward of losses under tax laws), that sufficient future taxable income will be available against which such deferred tax assets (DTA) can be realised. The Committee further notes from paragraph 18 of AS 22 that when an enterprise has a history of recent losses, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income against which such deferred tax assets can be realised. The Committee also notes that the FAQ referred to by the querist also states that "deferred tax asset can be recognised to the extent that the reversal of the deferred tax liability will give rise to sufficient future taxable income against which such deferred tax asset can be realised". Similarly, the EAC opinion (published as Query No. 18 of Volume XXIX of the Compendium of Opinions) referred to by the querist also, inter alia, states as follows:

> "A deferred tax asset can be created to the extent that *future taxable income will be available from future reversal of any deferred tax liability* recognised at the balance sheet date. To that extent, it would not be necessary to consider the level of virtual certainty supported by convincing evidence." (Emphasis supplied by the Committee.)

Thus, the EAC opinion also states that in case deferred tax liability (DTL) is used as the basis of recognsing deferred tax asset, it is not necessary to consider the level of virtual certainty supported by convincing evidence and the DTA should be recognised to the extent that future taxable income will be available from future reversal of deferred tax liabilities against which deferred tax assets can be realised. Thus, the Committee is of the view that all the above-mentioned pronouncements of the Institute provide the same view that in case of carry-forward of losses and unabsorbed depreciation, to the extent of reversal of DTL resulting into sufficient future taxable income, the company should recognise DTA.

15. In the above context, the Committee notes that when DTL arises due to lower expense from the accounting perspective as compared with taxation perspective, then, in such situations, the reversal of timing differences due to DTL would lead to lower expense from income-tax perspective in future and thus, to that extent, it would generally lead to a taxable income in future. Similarly, there may be situations where an item of income receivable

might accrue in the financial statements in one year, but may be taxed in a subsequent year when actually received. Such situations would give rise to DTL in the first year, the reversal of which would generate taxable income in subsequent year. Thus, even in case of continued future losses from tax perspective, reversal of DTL in future would give rise to taxable income and the DTA would be realised in financial statements. Therefore, the reversal of timing differences should be construed as sufficient future taxable income. Accordingly, the Committee is of the view that in case of carry forward of losses and unabsorbed depreciation, the company should recognise deferred tax assets only to the extent that it has timing differences, the reversal of which will result in sufficient taxable income. The Committee notes that in the extant case, the company has DTL of Rs. 704.40 crore as on 31st March, 2014, representing timing differences on depreciation, which will get reversed in future years irrespective of whether the company incurs any business loss or not. Therefore, the Committee is of the view that to the extent of deferred tax liability which is capable of reversal in future, it would be correct to recognise DTA on unabsorbed depreciation and carry forward of losses, as being contended by the company.

16. With regard to the accounting treatment to be followed by the company in the financial year 2013-14 for rectifying the treatment made by it in previous years in relation to the above transaction, the Committee notes the definitions of the terms 'prior period items' and 'accounting policy' as defined in Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the 'Rules' and paragraph 15 thereof, as follows:

> ***"4.3 <u>Prior period items</u> are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.***
>
> ***4.4 <u>Accounting policies</u> are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements."***
>
> ***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***

On the basis of the above, the Committee is of the view that since the company in the extant case has not recognised deferred tax asset on the unabsorbed depreciation and carry forward of losses inspite of there being DTL as on 31.03.2014, there is an error in the preparation of the financial statements. Therefore, it is a prior period item and cannot be treated as a change in accounting policy. Accordingly, the company should rectify its error of prior accounting periods by making appropriate changes in the current reporting period by treating it as a 'prior period item' as per the principles of AS 5.

17. As far as disclosures to be made by the company are concerned, the Committee is of the view that the company should make disclosures as per paragraphs 27 to 32 of AS 22 and paragraph 15 of AS 5.

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 12 above:

(i) In case of carry forward of losses and unabsorbed depreciation, the company should recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income. Accordingly, the company can recognise DTA on unabsorbed depreciation and carry forward of losses to the extent of DTL of Rs. 704.40 crore, which will get reversed in future, as discussed in paragraph 15 above.

(ii) For the purpose of recognition of DTA as per paragraph 18 of AS 22, the reversal of timing difference should be construed as sufficient future taxable income, as discussed in paragraph 15 above.

(iii) The non–recognition of DTA as above in the previous years would amount to prior period item under AS 5, as discussed in paragraph 16 above.

(iv) The recognition of DTA on unabsorbed depreciation/unabsorbed business loss to the extent of DTL (based on the principle of sufficient future taxable income arising out of reversal of timing differences) would not amount to change in the company's accounting policy, as discussed in paragraph 16 above.

(v) If the company does not recognise DTA to the extent of DTL (based on the principle of sufficient future taxable income arising out of reversal of timing differences), it would be in contravention of AS 22 as discussed in paragraph 15 above.

(vi) The company should make disclosures as per paragraphs 27 to 32 of AS 22 and paragraph 15 of AS 5, as discussed in paragraph 17 above.

Query No. 25

Subject: Accounting for discount allowed to dealers. [1]

A. Facts of the Case

1. A company (hereinafter referred as the 'company') was incorporated on 30.11.1972 under section 25 of the Companies Act, 1956 as a not-for-profit company with the main objective of benefiting the disabled persons to the maximum extent possible by manufacturing and supplying quality rehabilitation aids and appliances. The company is a Schedule 'C' Central Public Sector Enterprise (CPSE) in consumer goods sector under the administrative control of Ministry of Social Justice and Empowerment with 100% shareholding by the Government of India. The registered office and the main production plant of the company are located in Kanpur, Uttar Pradesh. The company started its manufacturing activities from October, 1976.

2. The authorised capital of the company is Rs. 300.00 lakh and its paid up capital is Rs. 196.50 lakh. Other production units of the company are located at Bhubaneshwar, Jabalpur, Bangalore and Chanalon (Punjab). Apart from the above places, regional marketing centers are at New Delhi, Mumbai, Kolkata and Guwahati.

3. The company is major implementing agency of the Government of India's scheme 'Assistance to Disabled Persons (ADIP)' since 1981 and is

[1]Opinion finalised by the Committee on 5.9.2014.

sole implementing agency of 'Assistance to Disabled Persons under Sarva Shiksha Abhiyan (ADIP-SSA)' since 2004.

4. The accounts of the company are subjected to audit by the Comptroller and Auditor General of India (C&AG) under section 619(3) of the Companies Act, 1956 and the turnover of the company for the year 2012-13 has been Rs. 130.23 crore.

5. Apart from sale of aids and appliances under the scheme, the company sells its products to National Institutes, State Governments, fabricating agencies and also through its dealer network.

6. The company does not have a system of credit sales. Credit sales, however, are within the delegation of power of Chairman and Managing Director (CMD) only under exceptional circumstances. There was no provision of any cash discount in the financial years 2012-13 and 2013-14. The company mainly resorts to turnover discounts.

7. The querist has provided the following information with regard to the discount policy:

Discount based on order value

Invoice value (excluding packing and freight (P & F) charge)	***Discount % on Ex-Factory Price***
Upto Rs. 10 Lakh	5%
Above Rs. 10 Lakh and upto Rs. 20 Lakh	6%
Above Rs. 20 Lakh and upto Rs. 50 Lakh	7%
Above Rs. 50 Lakh	8%

(i) Discount as above shall only be payable to dealers against every individual order/invoice.

(ii) Dealer will also be entitled to incremental discount of 1% or 2% or 3% depending on the cumulative value of all the orders placed by the dealer during the financial year exceeding Rs. 10 lakh or Rs. 20 lakh or Rs. 50 lakh. For example, the first sales made during a financial year amounted to Rs. 8 lakh and after 5% discount, i.e., net of discount, Rs. 7,60,000. Another sale for Rs. 8 lakh is further made in the same financial year, 5% discount will be given on invoice/ order value as per discount policy. Incremental discount will be given at the end of the year on cumulative sales during the year. The incremental discount shall be payable to the dealers by the end of 1st quarter of the succeeding financial year after computing annual sales. For example, if the total value of all the invoices raised in a financial year exceeds Rs. 50 lakh (say 5 invoices each of around Rs. 10 lakh), the dealer shall be entitled for additional discount of 3 % at the end of the year in addition to 5% discount already availed against each invoice. However, the sum of both discounts cannot exceed the maximum limit as mentioned in discount policy.

The querist has stated that from the above, it may be seen that the discount, as per the table, strictly speaking, is a turnover discount where the company encourages its dealers to book single order of higher values. Any order placed by the dealer is entitled to discount as per the rates mentioned in the above table which are reflected in the invoice. However, as per (ii) above, a calculation is done at the end of the financial year and the total discount including the incremental discount is determined, from which discount already given in invoice is deducted and credit note for residual amount is raised.

8. The disclosure, at present, is that the gross sales value is shown as part of income from operations and is included as turnover. The discount appears as discount expenses under ‘Other Expenses’ as per the Schedule VI to the Companies Act, 1956.

9. While carrying out the supplementary audit under section 619(3)(b) of the Companies Act, 1956, the audit party on behalf of the C&AG raised the following audit point :

> **“Other expenses - sales discount**
>
> Above head includes an amount of Rs. 109.04 lakh pertaining to sales discount given by the company to dealers. Scrutiny of related records as made available to audit revealed that the bills are raised on dealers net of discount. As such, the same should have been shown as a deduction from the revenue.
>
> This has resulted in overstatement of revenue and expenditure by Rs. 109.04 lakh.”

10. To the above audit query, the company gave explanations as given in paragraphs 6 and 7 above. Ultimately, the company assured C&AG that the opinion in this regard would be obtained from the Institute of Chartered Accountants of India (ICAI) and hence, the query has been forwarded to the Expert Advisory Committee of the ICAI for its comments and guidance.

B. Query

11. Based on the treatment being made by the company as explained above, the querist has sought the opinion of the Committee as to whether the disclosure made by the company is in conformity with Schedule VI to the Companies Act, 1956 and the Generally Accepted Accounting Principles (GAAPs).

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the discount(s) allowed by the company to the dealers and whether the accounting treatment followed by the company is as per Schedule VI to the Companies Act, 1956, and Indian GAAPs. Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case. At the outset, the Committee notes that Schedule VI to the Companies Act, 1956, does not contain any specific requirements in respect of presentation and disclosure of discount in the financial statements. However, it prescribes that in addition to its disclosure requirements, disclosure requirements specified in the Accounting Standards should be followed. Accordingly, the accounting for discount is examined from the perspective of compliance with the Accounting Standards.

13. The Committee notes that in order to determine the accounting treatment of the discount(s) allowed and its disclosure requirements, the nature of discount being allowed in the extant case needs to be determined. For this purpose, the Committee notes the definitions of 'cash discount' and 'trade discount' given in the Guidance Note on Terms Used in Financial Statements, issued by the ICAI:

> **"3.13 Cash Discount**
>
> A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period."

"16.04 Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment."

14. In accordance with the above definitions, any discount allowed on invoice price for prompt payment or for payment within stipulated time is a cash discount and any other discount allowed on invoice price including discount based on volume of sales is a trade discount. The Committee notes from the Facts of the Case that the company does not have the policy of making credit sales and the payment is always received in advance, i.e., prior to despatches. Further, the Committee notes that the discount as per the table in paragraph 7 above is allowed to dealers against every individual order/invoice and the same is shown as deduction in the invoice. The Committee also notes that in addition to the discount already allowed, the company allows an incremental discount of 1%/2%/3% at the end of the financial year depending upon the cumulative value of order placed by the dealer during the financial year. Thus, the discount in the extant case is allowed for increasing its turnover rather than for prompt payment as the payment is always received in advance. Therefore, the nature of the discount being allowed by the company is not of cash discount but is that of volume-based discount.

15. With regard to accounting and disclosure of volume-based discount, the Committee notes the definition of 'revenue' from Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006 and Illuatration A.9 thereof, illustrating the application of AS 9, which provide as follows:

"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

> *"9. Trade discounts and volume rebates*
>
> Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue."

The Committee notes from the above that volume discount/rebate is not encompassed within the definition of 'revenue', since 'revenue' is the charge made to customers, which in case of volume discount, is the amount net of discount. Accordingly, the Committee is of the view that the policy of the company of recognising revenue at gross amount and showing discount allowed as an expense is not in accordance with the requirements of Indian GAAPs and Schedule VI to the Companies Act, 1956.

D. Opinion

16. With regard to the issue raised, the Committee is of the opinion that the discount allowed by the company is volume-based discount and, therefore, the revenue should be recognised net of volume discount, as discussed in paragraphs 14 and 15 above. Accordingly, the accounting treatment being followed by the company of recording turnover at the gross amount and showing discount allowed as an expense is not as per the requirements of Indian GAAPs and Schedule VI to the Companies Act, 1956, as discussed in paragraph 15 above

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Query No. 26

Subject: Depreciation on processing facilities.[1]

A. Facts of the Case

1. A public sector undertaking under the administrative control of the Ministry of Petroleum and Natural Gas of India, is engaged in the exploration,

[1] Opinion finalised by the Committee on 5.9.2014.

development and production of oil and gas in various oil and gas fields and transportation of crude oil to refineries. In respect of accounting for oil and gas producing activities, the company follows the Successful Efforts Method of Accounting (SEM) and also the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised) 2013, issued by the Institute of Chartered Accountants of India (ICAI).

2. Various costs which are incurred in building up the oil and gas producing properties and eventually capitalised following SEM method of accounting, are as follows:

(a) (i) Acquisition costs include the cost of land acquired for drilling operations including the cost of temporary occupation of the land, crop compensation paid to farmers, registration fee, legal cost, signature bonus, brokers' fees, consideration for farm-in arrangements and other costs incurred in acquiring mineral rights; and

(ii) Costs incurred to gain access to and prepare well locations for drilling, including the cost of surveying well locations for the purpose of determining specific exploration/development drilling sites, clearing ground, draining including road building and relocating public roads, gas lines and power lines to the extent necessary in developing the proved oil and gas reserves; and

(iii) Costs incurred to drill and equip exploration/development wells, development-type stratigraphic test wells and service wells including the cost of platforms and of well equipment such as casing, tubing and the wellhead assembly for extraction of oil and gas up to the well head.

All the above are pre-well head activities related to lifting of the oil and gas to the surface, operation and maintenance of wells, extraction rights, etc.

(b) However, apart from above, the company needs to make further capital investment, post well head, for gathering, treating and processing of the extracted oil and gas, which includes cost to acquire, construct and install production/processing facilities such as, flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems.

3. The querist has stated that the company has set up these facilities at the oil and gas fields/group of fields, for initial processing of the crude oil so as to separate associated natural gas and water content from it, upto the outlet valve on the field and before transporting the crude oil to the refineries. It is also to be noted that these facilities are part of the producing properties and are essential and built at any oil and gas field, without which crude oil cannot be processed and transported to the refineries. Further, the utility of these assets is also directly linked to the existence of the producing fields. A flow chart has been provided by the querist to describe the process of the production of crude oil and natural gas for the perusal of the Committee. The individual functions of equipments used in processing have also been explained by the querist for the perusal of the Committee.

4. The querist has also stated that the company charges depletion field wise using the Unit of Production (UoP) method based on production and related proved developed reserves of the respective oil and gas fields for the assets covered under paragraph 2(a). However, for the assets covered under paragraph 2(b), depreciation is charged as per the rates provided in Schedule XIV to the Companies Act, 1956 under Written Down Value (WDV) method. The company is providing depreciation based on the specific rates given in the Schedule XIV read with footnote 8 of Schedule XIV for assets used by a mineral oil concern under the Clause II(B)(7) and II(D)(7). Besides these, the company is also applying general rates applicable for assets which are of general in nature like building (factory/office) and general plant & machinery.

5. The querist has further stated that paragraph 3(ii) of Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and paragraph 1(ii) of Accounting Standard (AS) 6, 'Depreciation Accounting', specifically state that these Standards do not deal with the accounting for wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources. Further, as per AS 10, expenditure on individual items of fixed assets used to develop or maintain the activities covered as above but separable from those activities, are to be accounted for in accordance with this standard.

6. According to the querist, in the absence of specific Accounting Standard on accounting for oil and gas activities, the Guidance Note on Accounting

for Oil and Gas Producing Activities (hereinafter referred to as the ‘Guidance Note’), issued by the Institute of Chartered Accountants of India (ICAI) is applicable to the company. As per the above Guidance Note, development costs cover all the direct and allocated indirect expenditure incurred in respect of the development activities, *inter alia*, costs incurred to acquire, construct, and install production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems. Further, as per the Guidance Note, all these assets are required to be depleted using the Unit of Production (UoP) method. As per the querist, the above provision of the Guidance Note revised in 2013 is exactly same as that of the original Guidance Note issued in 2003.

7. The querist has also referred to the opinion issued on 11.05.2010 by the Expert Advisory Committee, ICAI (Query No. 10, published in the Volume XXX on the subject, ‘Depreciation on facilities/ assets engaged in processing of crude oil’).

8. The querist has further stated that for assets described under paragraph 2(a) above, the company follows the depletion method which is in conformity with the Guidance Note and outside the purview of Accounting Standard (AS) 10 and Accounting Standard (AS) 6 (being clearly the expenditure on the exploration for and extraction of oil and natural gas). However, for the assets described under paragraph 2(b) above, the company has so far preferred to charge depreciation as per the rates provided under Schedule XIV to the Companies Act, 1956, presuming that such assets shall not fall under the exclusion criteria as indicated in AS 10 and AS 6 (considering that these may be treated as the individual items of fixed assets, separable from the main activities of exploration and extraction of oil and gas upto the well head). The yearly depreciation charged so far is higher than the amount of depletion under UoP method and this accounting treatment is being followed by the company consistently so far on conservative basis so as to ensure that the minimum rate of depreciation as prescribed under Companies Act is charged. Further, the querist also drawn attention to the EAC opinion dated 11.05.2010 (refer paragraph 7) on similar issue.

9. The querist has pointed out that the provisions of the Guidance Note on the subject issue remains unchanged even after its revision in 2013 (i.e. even after the EAC opinion dated 11.05.2010) and specifically includes all such assets as referred in paragraph 2(b) for application of depletion under UoP method.

10. The statutory auditors of the company in their limited review report on the accounts for the quarter/period ended 31.12.2013 have, without qualifying, drawn attention to the fact that the company has implemented Guidance Note on Accounting for Oil and Gas Producing Activities (revised 2013). However, the company has continued to provide depreciation on other production facilities being part of producing properties as per the rates prescribed under Schedule XIV to the Companies Act, 1956, in preference to the depletion method based on Unit of Production as recommended vide Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the Institute of Chartered Accountants of India.

11. In view of the facts mentioned in paragraphs 8, 9 and 10, it is felt that a fresh opinion on the subject issue needs to be obtained from the EAC with respect to the assets indicated in paragraph 2(b) above as to whether for such assets, depletion under UoP method needs to be applied following the Guidance Note instead of charging depreciation as per the rates prescribed under Schedule XIV to the Companies Act, 1956.

B. Query

12. The querist has sought the opinion of the Expert Advisory Committee (EAC) as to whether for such assets, as described in paragraph 2(b) above, depletion under UoP method needs to be applied following the Guidance Note instead of charging depreciation as per the rates prescribed under Schedule XIV to the Companies Act, 1956 taking into consideration all the relevant facts and context references as referred to above and any other references as deemed fit by the EAC.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to depreciation on assets/facilities as described under paragraph 2(b) above (hereinafter referred to as the 'processing facilities'). 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, depreciation on other assets and facilities as mentioned under paragraph 2(a), propriety of capitalisation of various costs incurred in building up the oil and gas producing properties, as discussed in paragraph 2 above, etc. Further, since the querist has raised the issue with reference to Schedule XIV to the Companies Act, 1956[2], the Committee has not examined the applicability of the Companies Act, 2013 in the extant case.

14. The Committee notes the earlier EAC opinion referred to by the querist wherein the Committee had opined that accounting for processing facilities would depend on whether the processing carried out by such processing facilities is a part of production process during the extraction of crude oil or after its extraction for the purpose of transportation and distribution thereof. In this context, the Committee had also noted paragraph 12 of the Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the Institute of Chartered Accountants of India, paragraph 3(ii) of AS 10, notified under the Companies (Accounting Standards) Rules, 2006 and paragraph 1(ii) of the notified AS 6, which provide as follows:

Guidance Note on Accounting for Oil and Gas Producing Activities

"12. Production activities consist of pre-wellhead (e.g., lifting the oil and gas to the surface, operation and maintenance of wells and extraction rights, etc.,) and post-wellhead (e.g., gathering, treating, field transportation, *field processing, etc., upto the outlet valve on the lease or field production storage tank,* etc.) activities for producing oil and/ or gas."

(Emphasis supplied by the Committee)

AS 10

"3. This standard does not deal with accounting for the following items to which special considerations apply:

...

(ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources;

...

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this Standard."

[2] Schedule XIV to the Companies Act, 1956 has been replaced with Schedule II to the Companies Act, 2013, which comes into force from April 1, 2014.

AS 6

"1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:–

(i) ...

(ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

..."

On the basis of the above, in the said earlier opinion, the Committee was of the view that the exclusions under AS 6 and AS 10 have been made in respect of expenditure on the exploration for and extraction of oil and gas and not in respect of processing after the extraction of oil and gas. Accordingly, in case processing is done after extraction, the Committee had opined that these Standards shall apply in respect of accounting for the 'processing facilities'.

15. The Committee notes from the Facts of the Case (paragraph 3 above) that the querist has explicitly stated that processing facilities in the instant case have been set up at the oil and gas fields/group of fields, for initial processing of the crude oil so as to separate associated natural gas and water content from it, *upto the outlet valve* on the field and before transporting the crude oil to the refineries. Further, it has been stated that these facilities are part of the producing properties and are essential and built at any oil and gas field, without which crude oil cannot be processed and transported to the refineries. Accordingly, considering the above principles laid down in the earlier opinion, the Committee is of the view that the production facilities in the extant case are part of production process (i.e., processing upto the outlet valve on the lease or field production storage tank).

16. With regard to application of UoP method on the above processing facilities, the Committee notes the following paragraphs of the Guidance Note on Accounting for Oil and Gas Producing Activities:

"Unit of Production (UOP) method: The method of depreciation (depletion) under which depreciation (depletion) is calculated on the

> basis of the number of production or similar units expected to be obtained from the asset by the enterprise."
>
> "22. Depreciation (Depletion) is calculated, using the unit of production method. The application of this method results in oil and gas assets being written off at the same rate as the quantitative depletion of the related reserve. ..."

The Committee is of the view that the basis of applying UoP method to oil and gas assets as per the Guidance Note is that the useful life of such assets depends primarily on the available oil and gas reserves. In other words, oil and gas assets as per the Guidance Note are such where depletion of the asset is coterminous with the depletion of related oil and gas reserves. Thus, if there are no oil and gas reserves, there will be no use of such assets and, therefore, these assets will have to be abandoned. Accordingly, the Committee is of the view that the UoP method should be followed by the company only in respect of those processing facilities (which are part of the production process) which can be considered as 'oil and gas assets'. Thus, both the conditions, i.e., being part of the production process as well as being 'oil and gas assets' are necessary to apply UoP method as per the Guidance Note. Accordingly, the Committee is of the view that if processing facilities in the extant case are 'oil and gas assets' as discussed above, UoP method as per the Guidance Note can be applied, provided it is allowed under the requirements of relevant statute, for example, in case of companies, the requirements of the Companies Act.

D. Opinion

17. On the basis of the above, the Committee is of the opinion that in order to apply the UoP method as per the Guidance Note, it is necessary that apart from being part of the production process, the processing facilities can also be considered as oil and gas assets, as discussed in paragraph 16 above. Accordingly, if processing facilities in the extant case are 'oil and gas assets' as discussed above, UoP method as per the Guidance Note can be applied, provided it is allowed under the requirements of relevant statute, for example, in case of companies, the requirements of the Companies Act.

Query No. 27

Subject: Accounting treatment of dividend received on own shares held under trust. [1]

A. Facts of the Case

1. A public sector undertaking (hereinafter referred to as 'the company'), registered under the Companies Act, 1956, is engaged in refining and marketing of petroleum products. The company mainly imports crude oil and after refining it through its various refineries across India, sells the finished petroleum products and after further processing, sells the petrochemicals throughout the country.

2. The company had acquired two companies (referred to as 'amalgamating companies') in May 2007 and March 2009 respectively. The querist has informed that before acquisition, both the amalgamating companies were subsidiaries of the company and upon merger, the shares of the company which were issued for its holding in amalgamating companies as per swap ratio (herein after referred as 'trust shares') were transferred to trusts formed for this purpose. The company was the sole beneficiary for the income of trust. In the year 2011-12, both the trusts were merged and named as 'Shares Trust'. These shares can be disposed off by the trust under the approval of the company by sale in open market. The querist has separately clarified that at the time of acquisition, the actual cost of the shares of amalgamating companies was treated as the cost of trust shares issued to the trusts in exchange of shares of erstwhile amalgamating companies. Further, Pooling of Interest method was adopted at the time of merger of both the companies.

3. The querist has stated that the trust is a separate legal entity having the tax status of its own. The amount of dividend paid by the company to the trust is received by trust in its bank account and afterwards, the trust transfers the income to the company. The transaction is recorded as receipt and payment in the financial statements of the trust. In income tax return also, the dividend received by trust is shown as income and exemption is claimed under sub-section 34 of section 10 of the Income-tax Act, 1961. The company also pays dividend tax on the dividend declared in relation to the shares held by the trust as in case of the other shares.

[1] Opinion finalised by the Committee on 5.9.2014.

4. The querist has informed that the present accounting and disclosure followed by the company is as below:

Shares held under Trust

Presently, the shares held under the trust are shown under 'Other Current Assets' as 'Receivables from Shares Trust' at cost (representing original cost of acquisition of shares in erstwhile companies). At each reporting date, the company tends to mark to market the value of these shares by creating a provision through the statement of profit and loss for the current period.

Income from Trust Shares

The querist has informed that as the company is the sole beneficiary of the income of trust, the dividend income from shares held under the shares trust is accounted for as dividend income under 'Other Income' in the year in which the right to receive dividend is established, i.e., when the dividend is approved by the shareholders in general meeting.

5. The querist has further informed that the company has decided to review the present accounting treatment followed in respect of the trust shares as well as the income from these shares and during the course of discussion with the statutory auditors, different views emerged on the subject accounting treatment. Thus, the company has decided to review the transaction in its entirety to follow the best practice in line with the accounting framework. The querist has stated that the following accounting areas have been identified for review in relation to the transaction:

a) <u>Shares held under Trust</u>

   Accounting for shares held under the trust as 'Other Assets' should be reviewed for disclosure of the same as 'Investments'. Further, once these shares are classified as investments, whether the same can be treated as long term/current investment based on the intention of the company to dispose (cancel/sale) these shares in line with the provisions of Accounting Standard (AS) 13, 'Accounting for Investments'. In this regard, the querist has separately clarified that the trust shares held by the company may be disposed off at the best possible opportunity, although, there is no intention either documented or otherwise for disposal of the same within 12 months as of today.

Alternatively, it may also be evaluated whether the shares held by the trust are to be shown as deduction from the share capital of the company and the difference between the face value of shares and acquisition cost/mark-to-market value may be treated as 'Investment' or 'Other Assets'.

b) Income from Trust Shares

Whether the income from trust shares is to be accounted for as income (dividend or otherwise) through the statement of profit and loss or the same is to be treated as an item of appropriation (as the income is from own shares), i.e., to be added back to the balance of statement of profit and loss at the time of appropriation.

Also, whether the income from trust shares is to be accounted for in the year in which the dividend is proposed by the board of directors or in the next year when the same is approved by shareholders and right to receive is established.

c) Consideration of Trust Shares while calculating Earnings Per Share (EPS) and Share Capital

Whether shares held by the trust should also be adjusted while calculating weighted average number of equity shares for the purpose of calculating basic and/or diluted earnings per share (EPS) as the sole beneficiary of these shares is the company only. If these shares are to be excluded for calculating basic EPS, then whether the same are also to be excluded for calculating diluted EPS as these shares may be considered dilutive.

6. The querist has stated that there is no statutory provision available regarding accounting for trust shares and income therefrom except guidance in Accounting Standard (AS) 9, Revenue Recognition, on timing of recognising the dividend income which is reproduced below:

> "8.4 Dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established."

The querist is of the view that in view of the above provisions of AS 9, the income can be recognised only when the right to receive dividend is established, i.e., on approval of dividend by shareholders in the general meeting.

The querist has drawn the attention of the Committee to the following provisions of Accounting Standard (AS) 20, 'Earnings Per Share', for the purpose of calculating weighted average number of equity shares outstanding during the period:

> "18. Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued during the reporting period as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. ..."

In view of the querist, as per the above provisions of AS 20, the shares held by trust, being issued as part of consideration in the amalgamation, are to be considered for the purpose of calculating EPS. The querist has stated that nothing is available in the accounting standard which guides for exclusion of the equity shares held by the trust whose beneficiary is the company only for the calculation of EPS.

7. The querist has further stated that as there is no statutory provision regarding accounting for trust shares and income therefrom, the querist has analysed the practice followed by some other companies on accounting for such shares and related dividend income, which is summarised in the table below:

S. No	***Company Name***	***Accounting of Trust Shares***	***Accounting of Income on Trust Shares***	***Adjustment of Shares for EPS purpose***	***Timing for accounting of Income***
1	A Ltd.	Long term Investments	As appropriation item	No	Next year, i.e., the year in which the right to receive dividend is established.
2	B Ltd.	Long term Investments	As appropriation item	Yes	
3	C Ltd.	Long term Investments	As Other Income (but not Dividend Income)	No	

As per the querist, as can be seen from above, there are varied practices across companies with respect to subject issue.

8. The querist has further stated that as the company is the sole beneficiary of the trust, it may be argued that in the standalone financial statements of the company, the share capital of the company should be presented only in respect of shares held by the outsiders, i.e., after deducting the face value of the shares held by the trust. However, in that case, the question that needs to be determined is of the treatment of the difference between present book value of these shares in the books of the company and their face value, as raised in paragraph 10 (e) below.

9. In the context of consolidated financial statements, the querist has stated that the trust, being an entity wholly owned and controlled by the company, can be considered as a group entity for the purpose of consolidated financial statements wherein adjustments can be made from share capital of consolidated entity for holdings of subsidiary in parent company as per the provisions of Accounting Standard (AS) 21, 'Consolidated Financial Statements'.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Whether the disclosure of trust shares as under 'Other Current Assets' is in order. If not, how the same should be disclosed in the standalone financial statements?

(b) Whether the accounting treatment followed in respect of income on trust shares by treating it as dividend income is in order. If not, how the same should be accounted for in the standalone financial statements?

(c) Whether the timing of accounting for income from trust currently followed by the company, i.e., when the right to receive is established is in order. If not, when the same should be accounted for in the light of related statutory provisions?

(d) Whether the equity shares held by the trust should be deducted while calculating weighted average number of shares for the purpose of basic or dilutive EPS in the standalone financial statements of the company. If yes, for which EPS?

(e) Whether the trust shares can be presented as deduction from share capital in standalone financial statements of the company. If yes, how the difference between face value and acquisition price/mark-to-market value is to be accounted for?

(f) Whether the trust can be treated as group entity for consolidation as per AS 21. If yes, how the trust shares and income therefrom shall be accounted in this case under standalone financial statements and consolidated financial statements of the company?

C. Points considered by the Committee

11. The Committee notes that, as per the querist, before acquisition, the company had held some of the shares of amalgamating companies and, upon merger, the shares of the company which were issued towards its shareholding in amalgamating companies were transferred to trusts formed for this purpose. The Committee has examined this matter purely from accounting point of view and, accordingly, has not evaluated the compliance or otherwise of this matter with the applicable laws and regulations since as per Rule 2 of the Advisory Service Rules of the Committee, the Committee does not answer issues that involve only interpretation of enactments. Similarly, the Committee has not evaluated any tax implications of the acquisition and the subsequent accounting thereof.

12. The Committee notes that in the present case, the trusts (later on merged as one trust) had been established for the primary purpose of holding

the shares of the company which were allotted to the trusts in lieu of the shares of the amalgamating companies held by the company pursuant to the trust deeds and respective schemes of amalgamation. As a result of this, while all the net assets of the amalgamating companies had been incorporated in the stand-alone financial statements of the company pursuant to the respective schemes of amalgamation, the investments in the amalgamating companies held by the company prior to the amalgamation continued in its stand-alone financial statements in the form of amount recoverable from trusts (with subsequent provisions towards decline in the market value of shares). The Committee notes that, if the company had cancelled the shares held by it in the amalgamating companies (considering these shares as consideration given up), the extant situation would not have arisen and, to that extent, lesser number of the shares of the company would have been issued as a part of amalgamation. The Committee also notes that as per the trust deed, the trusts have been established for the exclusive benefit of the company for the purpose of, inter alia, holding the shares of the company exclusively *on behalf of and for the benefit of the company*. Therefore, the trust is holding these shares merely as a legal owner although the beneficial owner is the company.

13. Considering the above background and the very objective for which trusts have been formed, as discussed above, the Committee is of the view that the amounts reflected as recoverable from trusts in the stand-alone financial statements of the company, represent its own shares, in substance, although in form the trust is a separate legal entity.

14. The Committee also notes the definition of 'investments' from Accounting Standard (AS) 13, 'Accounting for Investments', notified under the Companies (Accounting Standards) Rules, 2006 , as below:

> ***"3.1 <u>Investments</u> are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'."***

The Committee notes that an essential requirement to consider an asset as an 'investment' is that the asset should be held for earning income, capital appreciation or for other benefits. The Committee notes that in the present case, the income in the form of dividend income or capital appreciation is from the company's own shares and does not represent any incremental benefit to the company as such.

15. In view of the above, considering the 'substance over form' principle, the Committee is of the view that the accounting for the shares issued to two trusts (later on merged as one trust) in lieu of shares held by the company in the amalgamating companies should portray the same picture as if no shares have been issued to these trusts since, the company cannot issue shares to itself. In substance, the company, as a part of amalgamation, had issued shares only to the minority shareholders of the amalgamating companies since rest of the shareholding of amalgamating companies was already owned by it. In view of this, the Committee is of the view that the shares of the company held by the trust should be presented as a deduction from the share capital to the extent of face value of these shares. The difference between the carrying amount of the 'amounts recoverable from trusts' (shown as other current assets) and the face value should be presented as an adjustment to different components of reserve and surplus as if no shares have been issued, as explained above. The company should give a suitable note in the notes to accounts to explain the nature of these deductions.

16. The Committee also notes the definition of 'income' as per the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, as stated below:

> "*Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities *that result in increases in equity*, other than those relating to contributions from equity participants." (Emphasis supplied by the Committee.)

In the current case, the receipt of dividend income from trust does not result in any increase in economic benefits resulting into an increase in equity, since, in substance, the company is receiving dividend income from its own shares. The company is first making a payment of dividend on the shares held by trust and then receiving back the same amount as dividend from the trust. Therefore, the recognition of dividend received from the trust as 'other income' is not appropriate. Consistent with the accounting treatment prescribed in paragraph 15 above, the dividend, to the extent it relates to the shares held by the trust, should be presented as a deduction from the dividend appropriated. Since, the dividend on own shares does not fulfill the definition of income, the requirements of AS 9, as stated by the querist, are not relevant.

17. In line with the accounting treatment prescribed above, the company should exclude the shares held by trust from the calculation of earnings per share.

18. Considering the accounting treatment prescribed in paragraphs 15-17 above, the Committee is of the view that the question of trust being a 'group entity' does not arise and, accordingly, the accounting treatment followed in stand-alone financial statements, should also be followed in the consolidated financial statements.

19. The Committee is also of the view that while carrying out the accounting treatment, as specified in above paragraphs, the company should also follow 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 Companies (Accounting Standards) Rules, 2006 with regard to prior period items.

D. Opinion

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

(a) The shares of the company held by the trust should not be presented as under 'Other Current Assets'. Instead, these should be presented as deduction from the share capital to the extent of face value of these shares, as discussed in paragraph 15 above.

(b) Since, the dividend on own shares does not fulfill the definition of income, the recognition of dividend received from the trust as 'other income' is not appropriate. The dividend to the extent it relates to the shares held by the trust, should be presented as a deduction from the dividend appropriated, as discussed in paragraph 16 above.

(c) In view of (b) above, answer to this question does not arise.

(d) The equity shares held by trust should be excluded while calculating earnings per share, as discussed in paragraph 17 above.

(e) The shares of the company held by the trust should be presented as deduction from the share capital to the extent of face value of these shares. The difference between the carrying amount of the 'amounts recoverable from trusts' (shown as other current assets) and the face value should be presented as an adjustment to different components of reserve and surplus as if no shares have been issued, as explained in paragraph 15 above. The company should also give a suitable note in the notes to accounts to explain the nature of these deductions.

(f) Considering the accounting treatment prescribed in paragraphs 15-17 above, the question of treating the trust being a 'group entity' does not arise and, accordingly, the accounting treatment followed in stand-alone financial statements of the company should also be followed in its consolidated financial statements.

Query No. 28

Subject: Applicability of tax rate in the quarterly financial results. [1]

A. Facts of the Case

1. A company is a central public sector undertaking (CPSU) under the administrative control of the Ministry of Mines, Government of India and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power in captive power plant for use in smelter plant and selling alumina and aluminium both in domestic and international market. It has a capacity to produce 21,50,000 metric tonne (MT) of calcined alumina and 4,60,000 of aluminium metal with 1,200 mega watt (MW) power.

2. Paid-up share capital of the company is Rs. 1,288.62 crore out of which 81.06% shares are held by the Government of India and 18.94% of its shares are listed in the Bombay Stock Exchange and National Stock Exchange. As per the provisions of clause 41 of the Listing Agreement, the quarterly un-audited financial results are to be furnished to stock exchanges and be published in news papers.

[1] Opinion finalised by the Committee on 5.9.2014.

3. The querist has enumerated the Facts of the Case as below:

   (a) Being a listed company, the quarterly financial results of the company are published in the news paper after being taken on record by the board of directors and limited review by the statutory auditors. While computing the quarterly financial results, the company considers provision for tax expenses considering the computed taxable income upto that period based on the applicable tax rate for the said financial year.

   (b) Accounting Standard (AS) 25, 'Interim Financial Reporting' was made mandatory from 01.04.2002 by the Institute of Chartered Accountants of India (ICAI) and was subsequently included in the Accounting Standards notified in the Companies (Accounting Standards) Rules, 2006 under section 211 (3C) of the Companies Act, 1956.

   (c) The principles for recognition and measurement of tax expenses are laid down in paragraph 29(c) of AS 25 which states that the tax expenses in each interim period are to be recognised based on the best estimate of the weighted average annual income tax rate expected for the full financial year. The principle has been illustrated at paragraphs 8 to 16 of Illustration 3 to AS 25.

   (d) As per the practice followed by the company consistently, at every quarter ending day, actual tax expenses are provided based on the financials/performance upto that period (computation of which has been provided by the querist for the perusal of the Committee). According to the querist, guidelines of AS 25 have not been considered as mandatory in respect of limited review of quarterly financial results in terms of clause 41 of the Listing Agreement but only of recommendatory in nature. The company is also in a position to compute actual tax liability upto that period and the company feels it appropriate as compared to estimate of the weighted average annual income tax rate expected for the full financial year as laid down in paragraph 29(c) of AS 25.

   (e) A question has arisen whether the principles mentioned in AS 25, particularly, the principles for recognition and measurement of tax expenses as laid down in paragraph 29(c) of AS 25 would apply to unaudited quarterly financial results prepared to comply with clause 41 of Listing Agreement with the Securities and Exchange Board of India (SEBI) which are subject to limited review by the statutory auditors.

(f) The question of applicability of above-mentioned principles to quarterly financial results prepared to comply with clause 41 of the Listing Agreement with the SEBI had been laid down in Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', which was published by the ICAI in March 2004 and which, according to the querist, states that the principles of recognition and measurement mentioned in AS 25 would apply to the financial results presented under clause 41 of Listing Agreement even though AS 25 does not apply to financial results presented under clause 41 of Listing Agreement.

(g) However, ASI 27 was not included in AS 25 when AS 25 was notified in 2006 under section 211 (3C) of the Companies Act, 1956. Therefore, it is considered that the principles mentioned in ASI 27 do not have any statutory backing in respect of companies.

(h) Subsequently in 2008, the ICAI has also withdrawn ASI 27 and issued the same as a Guidance Note of recommendatory nature. The Guidance Note on Applicability of AS 25 to Interim Financial Results, issued in 2008 clearly mentions the facts stated above. As per the querist, it has been clarified by the ICAI from time to time that pronouncements with recommendatory authority are neither binding on any entity nor these are binding on the members of the ICAI. Therefore, principles of recognition and measurement laid down in AS 25 are no longer mandatory in case of financial results presented under clause 41 of the Listing Agreement.

(i) Another factor which is required to be considered in connection with financial results being prepared in line with clause 41 of the Listing Agreement over the years is the principle of 'consistency'. The company has been following the accounting for provision for tax expenses on actual income/expenses upto the period over a period of time and as per the querist, will be construed to be giving proper picture of financial results unless the principles are diametrically opposite/widely variant from Accounting Standards/

generally accepted accounting principles (GAAPs). Besides above, Hon'ble Supreme Court in the case of Excel Industries has given due recognition to the principle of consistency.

B. Query

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

(i) Whether calculation of tax expenses based on "best estimate of the weighted average annual income tax rate expected for the full financial year" as laid down under paragraph 29(c) of AS 25 is mandatorily applicable for quarterly financial results being published in compliance to clause 41 of the Listing Agreement with the SEBI.

(ii) Whether the existing practice of recognising provision for tax expenses considering the computed taxable income for the relevant period based on applicable tax rate is in contravention of the provisions of AS 25.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to applicability of paragraph 29(c) of AS 25 to the quarterly financial results as per clause 41 of the Listing Agreement with the SEBI and recognition of provision for tax expenses. 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, other disclosure requirements as per clause 41 of the Listing Agreement, etc.

6. The Committee notes sub-clause IV (f) of clause 41 of the Listing Agreement and paragraphs 1, 2, 27 and 29 of AS 25, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') as follows:

Listing Agreement

"IV(f) The quarterly and year to date results shall be prepared in accordance with the recognition and measurement principles laid down in Accounting Standard 25 (AS 25 - Interim Financial Reporting) issued by the Institute of Chartered Accountants of

India (ICAI)/company (Accounting Standards) Rules, 2006, whichever is applicable."

AS 25

"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."

"Recognition and Measurement

Same Accounting Policies as Annual

27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis."

"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."

From the above, the Committee notes that clause 41 of the Listing Agreement specifically requires that quarterly and year-to-date results should be prepared in accordance with the recognition and measurement principles laid down in AS 25. The Committee also notes that the Guidance Note on applicability of AS 25 to Interim Financial Results, issued by the ICAI does not lay down any new accounting principle and is only providing guidance on the application of a mandatory Standard (viz., AS 25). Therefore, the Committee is of the view that the company should follow the requirements of AS 25 as explained in the Guidance Note and should apply the recognition and measurement requirements as contained in paragraph 29(c) of AS 25 to the interim financial results presented under clause 41 of the Listing Agreement. Thus, whether or not the Guidance Note is binding or is recommendatory in nature is not relevant as the relevant requirements of the Standard are binding on the company. The Committee further notes that paragraph 29(c) of AS 25 requires that income tax expense should be recognised in each interim period based on the best estimate of the weighted average *annual income tax rate expected for the full financial year,* application of which is also illustrated in paragraphs 8 to 11 and 14 to 15 of Illustration 3 to AS 25, notified under the Rules, as reproduced below:

> "8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.
>
> 9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Standard. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pretax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in Rs. Lakhs)

	1st Quarter	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**Annual**
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0"

"Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carryforwards

> 15. A deferred tax asset should be recognised in respect of carryforward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate."

7. The Committee notes from the Facts of the Case that while computing the quarterly financial results, the company considers provision for tax expenses considering the computed taxable income upto that period based on the applicable tax rate for the said financial year. On the basis of the above, the Committee is of the view that the accounting practice of the company to provide for tax expenses at the quarterly/ interim periods results based on the applicable tax rate for the said financial year would be correct provided such tax rate is the rate that would be applicable to the expected total annual earnings of the company for the whole year, that is, the estimated average annual effective income tax rate. In this regard, the Committee wishes to point out that the tax expense for each interim period is not to be determined on the basis of average of estimated annual tax expense rather it is to be determined on the basis of estimated average annual effective income tax rate applied to the portion of income earned in the interim period. Thus, if in an interim period, there is a profit but in other interim periods, there are losses resulting into nil taxable income for the financial year, tax expense in each interim period will be provided for by applying estimated average annual effective income tax rate to the income (profit or loss) of those interim periods. In other words, if there are profits in the first quarter, the company has to provide tax liability in the first quarter at the appropriate estimated average annual effective income tax rate, which would get reversed in subsequent quarters if there are losses. For the purpose of calculating the estimated average annual effective income tax rate, guidance may also be taken from the Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25, issued by the ICAI.

D. Opinion

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

(i) Paragraph 29(c) of AS 25 is mandatorily applicable for quarterly financial results being published in compliance to clause 41 of the Listing Agreement with SEBI, as discussed in paragraph 6 above.

(ii) The existing practice of recognising provision for tax expenses considering the computed taxable income for the relevant period based on applicable tax rate for the said financial year would be correct provided such tax rate is the rate applicable to the expected total annual earnings of the company for the whole year, that is the estimated average annual effective income tax rate.

Query No. 29

Subject: (i) Accounting for Principal only Currency Swaps.
(ii) Hedge accounting as per AS 30.[1]

A. Facts of the Case

1. The main business of a company is refining crude and marketing petroleum products manufactured out of it. These products are sold both in India and abroad. The querist imports majority of its crude from abroad and sources a small portion indigenously. The payment for the indigenously procured crude is made in USD and USD linked rupees. Hence, it can be said that the entire crude payments are in USD/USD linked rupees. The company sells substantial quantity of its products in the export market at internationally quoted prices and balance in the domestic market at internationally linked product prices. The formula for conversion is as per the practice consistently followed in the Indian oil industry. The Reserve Bank of India (RBI) reference exchange rate is used for conversion of dollars into rupees which is also the industry practice.

[1] Opinion finalised by the Committee on 7.11.2014.

2. The querist has stated that, in nutshell, the entire revenue and crude cost of the company is either in USD or USD linked rupees. The company's debt profile consists mainly of Rupee (INR) debts from Indian banks/financial institutions. The majority of the company's expenses (other than crude), including interest cost and repayment of term loans, are in INR resulting into an economic exposure for the company as mentioned below:

- Since the refining revenues are receivable in USD/USD linked rupees, any fluctuation in the USD-INR rate can have an impact on its cash flows and/or profitability. (Economic risk associated)
- As the company is having INR debt profile, the company has a risk on USD rate movement, e.g., if Rupee appreciates, revenue in INR will decrease whereas quantum of INR debt servicing (principal and interest) will remain the same. So the company will require more USD to pay for same Rupee expenditure/ repayment of loan, thus, affecting the cash flows, profitability and vice versa.
- To mitigate this risk, the company had taken principal only swap (POS)/cross currency swap (CCS) to effectively replace the INR term loans (liabilities) with USD liability. This has been permitted by RBI. Reference has been drawn by the querist to circular no. RBI/2013-14/5 dated July 1, 2013 (Paragraph A, Section I A1(iv)) in this regard.

3. *Substance of the Swap transactions:*

- With a view to reduce the volatility in the cash flows/profitability of the company, it entered into INR/USD swaps whereby INR term loans effectively got converted into USD liabilities. The quantum/notional value of the swaps were derived based on repayment schedule of the term loans.
- The swaps provided income from positive interest carry but have the associated foreign exchange fluctuations risk. However, the company's revenues being predominantly in USD or USD linked rupee, a natural hedge is available.

In the final analysis, the Swaps provide two fold benefits –

- Positive interest carry.

- Fluctuation in the profitability/ cash flow caused by USD-INR rate movement is mitigated/reduced.

By virtue of the above, in substance*, as on date of contract, the querist has paid rupee loan liabilities outstanding and converted rupee loan into foreign currency loans at a predetermined exchange rate. In consonance with the principle of economic substance over form, accounting treatment as under has been accorded to this transaction (*emphasis supplied by the querist):

Swap Notional Receivable (Receivable in INR) Dr.	Rs. ...	
To Swap Notional Payable (Payable in USD)		Rs. ...

The USD Swap notional payable is treated as a monetary item and revalued at every closing date and the forex fluctuation amount is taken to Foreign Currency Monetary Item Translation Difference Account (FCMITDA) and amortised in accordance with paragraph 46/46A of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'.

The querist has stated that an earlier opinion of the Expert Advisory Committee (EAC), which was published in the February, 2014 issue of the Institute's Journal, states that the POS/ CCS does not fall under AS 11. However, the company believes that the opinion has not considered the 'substance over form' aspect for this transaction and hence, there is a need to clarify that so long as the economic substance as stated above can be demonstrated, this accounting treatment should be applied.

4. Alternative accounting treatment:

When the company initiated the aforesaid POS/CCS transactions as a part of its risk management strategy, it had done an evaluation and concluded that as an alternate accounting treatment, Accounting Standard (AS) 30 'Financial Instruments: Recognition and measurement', (application of hedge accounting) could also be applied, in which case, the impact would have been taken to cash flow hedge reserve and/or profit and loss account, as applicable. However, with the introduction of paragraph 46/ 46A of AS 11, it was concluded that by and large the same accounting is achieved in as much as the cash flow hedge reserve or FCMITDA is treated as 'other comprehensive income' rather than fully impacting profit and loss account.

Hence, the company applied AS 11 despite having all the ingredients as on that date to follow 'Hedge Accounting' by applying the principles of AS 30. These requirements are summarised below for ready reference:

Question	Response
Can the POS and FCS be said to be backed by a highly probable forecast transaction?	Yes, future export sales can be considered and these are highly probable forecast transaction.
Does a hedging instrument exist?	Yes, the POS and FCS are hedging instruments.
Does a hedged item exist?	Yes, future US$ revenues is the hedged item.
Is the hedging relationship formally documented and designated?	Yes, the said relationship existed since inception of the instruments. A formal designation was made at the inception of the relationship. However, the querist believed that AS 11 had to be applied in this case as AS 30 (recommendatory Standard) cannot overrule AS 11 (a mandatory Standard).
Can hedge effectiveness be demonstrated throughout the life of instruments?	This can be demonstrated.

The querist has stated that as per the Announcement on Application of AS 30, *Financial Instruments: Recognition and Measurement*, issued by the Institute of Chartered Accountants of India (ICAI) published in the April 2011, issue of ICAI's Journal, the status of AS 30 would be as below:

"(i) To the extent of accounting treatments covered by any of the existing notified accounting standards (for eg. AS 11, AS 13, etc.) the existing accounting standards would continue to prevail over AS 30.

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above."

Since the company firmly believed that the POS/CCS transactions were covered under AS 11, a notified Standard, the accounting treatment was done accordingly. However, in view of the opinion of the EAC, the company proposes to follow AS 30 on POS and CCS from inception since all conditions needed for hedge accounting as per AS 30 existed as of that date.

B. Query

5. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) In the case of the company, with the facts and circumstances under which POS/CCS were taken having been explained, could the accounting treatment followed be considered as appropriate in view of the overarching principle of economic substance of the transaction and not merely by the legal form?

(ii) If no, then whether the querist can follow hedge accounting following the principles of AS 30 since inception i.e., from the day the hedge designation took place.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relate to appropriateness of accounting for Principal Only Swap (POS) transaction as per the principles of AS 11, viz., recognising notional USD liability in respect of Rupee loan liability as monetary item and recognising restatement gains/losses on such monetary item as per paragraphs 46 and 46A of AS 11, notified under the Companies (Accounting Standards) Rules, 2006 and whether such transactions can be accounted for as per AS 30. 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, measurement of MTM gains/ losses on POS contracts, accounting for interest on Rupee

loan, validity of POS/Cross Currency Swap (CCS) taken with respect to circular of RBI, assessing hedge effectiveness as per the principles of AS 30, correctness of using RBI rate for translating foreign currency balances, etc. The Committee also wishes to mention that since the Facts of the Case are based only in respect of the POS transactions, the Committee has presumed that CCS in the extant case are of the nature of POS only and accordingly, the Committee has examined the issue from that perspective only. Further, the Committee presumes that in the extant case, INR is the functional currency of the company.

7. The Committee notes from the Facts of the Case that the company has debts and loans (liabilities) in INR. However, since its revenues are in USD/USD linked Rupee, the company has effectively converted the INR liability to USD liability by entering into Principal Only Swap (POS). In this regard, the issue to be examined is whether the Rupee liability becomes a foreign currency liability by the existence of POS transaction or whether it should, in substance, be treated as a foreign currency liability by the existence of POS transaction.

8. The Committee notes from the Facts of the Case that the company has taken Rupee liability which has been swapped into USD. The Committee also notes that the liability of the company (viz., Rupee loan) is denominated in Rupee and is also repayable in the same currency. The fact that the company has swapped the Rupee liability exposure into USD currency exposure using the POS does not alter this position. The POS does not mean that the company has incurred USD liability to the lending bank. Thus, entering into the POS transaction does not alter the fact that the company has the obligation to repay the loan in Rupees to the lending bank. Further, the POS can be cancelled by the company (though it may not have the intention to cancel). Accordingly, the Committee is of the view that the Rupee liability does not become a foreign currency liability solely by the existence of POS transaction. The Committee is further of the view that the combination of the Rupee loan and the POS cannot be treated as a single transaction enabling treatment of the Rupee loan as a USD loan. This is because AS 11 does not recognise such ‘synthetic accounting’. Further, the legal effect of the terms of the Rupee loan (which is denominated in Rupee) and POS (which is cancellable) cannot be ignored. Hence, Rupee loan and POS transactions should be treated as two separate transactions.

9. The Committee further examines whether POS can be considered to be a foreign currency transaction within the scope of AS 11. Accordingly, the Committee notes the following paragraphs of AS 11, notified under the Companies (Accounting Standards) Rules, 2006:

> "1. This Standard should be applied:
>
> (a) in accounting for transactions in foreign currencies; and
>
> (b) in translating the financial statements of foreign operations.
>
> 2. This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts."
>
> "8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:
>
> (a) buys or sells goods or services whose price is denominated in a foreign currency;
>
> (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;
>
> (c) becomes a party to an unperformed forward exchange contract; or
>
> (d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency."

The Committee notes that POS does not result in borrowing of USD funds. It is simply a derivative which requires performance and settlement in future and is also cancellable. Hence, in the extant case, a foreign currency transaction within the scope of AS 11 may occur only if the POS transaction undertaken by the company can be considered to be an unperformed forward exchange contract, which is examined in paragraph 10 below.

10. The Committee notes the definitions of forward exchange contract and forward rate given in paragraphs 7.8 and 7.9 respectively of AS 11, which are reproduced below:

> ***"7.8 <u>Forward exchange contract</u> means an agreement to exchange different currencies at a forward rate.***

> ***7.9 <u>Forward rate</u> is the specified exchange rate for exchange of two currencies at a specified future date."***

The Committee notes that the POS may be argued to be a forward exchange contract as per the definition reproduced above. However, as per footnote 1 appended to paragraph 2 of AS 11, not all forward exchange contracts fall within the scope of AS 11, which reads as below:

> "This Standard is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities and is not applicable to the exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risks of future transactions in respect of which firm commitments are made or which are highly probable forecast transactions. A 'firm commitment' is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates and a 'forecast transaction' is an uncommitted but anticipated future transaction."

From the above, it might appear that with the exceptions mentioned in the above-mentioned footnote, all forward exchange contracts are within the scope of AS 11. However, the Committee notes that accounting treatment of forward exchange contracts is prescribed in paragraphs 36-39 of AS 11 and is of the view that if a forward exchange contract is not of the nature dealt with in those paragraphs, it is outside the scope of AS 11, even though it does not fall within the exceptions mentioned in the above-mentioned footnote. The Committee notes that a combined reading of paragraphs 36-39 of AS 11 indicates that those paragraphs prescribe accounting treatment for *only* those forward exchange contracts which are entered into for hedging foreign currency risk where the underlying transaction is denominated in a foreign currency, or for trading or speculation purposes. The Committee notes from the Facts of the Case that the underlying transaction is a Rupee loan that does not give rise to any foreign currency risk. It is the POS transaction in the extant case that exposes the company to foreign currency risk rather than mitigating the same. The Committee further notes that in the extant case, the querist has argued that by virtue of POS transaction, the INR liability would effectively be converted into a liability denominated in USD which would be the currency of the forecasted future revenues of the company and due to this, an effective natural hedge would be available. Thus, the purpose of entering into POS is to take the benefit of this natural hedge and not to hedge foreign currency risks on the existing liability undertaken, viz., the Rupee loan, etc. Accordingly, the Committee is of the view that since AS 11 covers only the forward contracts entered into for hedging the foreign currency risks of existing assets and liabilities, the POS in the extant case cannot be considered to be a forward contract entered into to hedge the foreign currency risk covered under the scope of AS 11. The Committee also notes that the POS is also not held for trading as the company is not a trader/dealer in foreign exchange. Further, the intention of entering into POS transaction does not appear to be speculative as there is an underlying INR loan and the company has initiated the POS transaction as a part of its risk management strategy and also intends to apply hedge accounting as per AS 30. Hence, in the extant case, the POS is not a forward exchange contract within the scope of AS 11 and therefore, is not a foreign currency transaction within the scope of AS 11. Accordingly, the Committee is of the view that the question of application of paragraphs 46 and 46A of AS 11 does not arise.

Further, the Committee is of the view that since AS 11 is not applicable to the exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risks of highly probable forecast transactions, POS, even if it is argued to be undertaken to hedge the foreign currency risks of future sales transactions, will not be covered under AS 11.

11. With regard to application of hedge accounting as per AS 30 in the extant case, the Committee notes the following paragraphs of AS 30 as stated below:

> ***"8.17 A <u>hedging instrument</u> is (a) a designated derivative or (b) for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 81-86 and Appendix A paragraphs A114-A117 elaborate on the definition of a hedging instrument).***
>
> ***8.18 A <u>hedged item</u> is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 87-94 and Appendix A paragraphs A118-A125 elaborate on the definition of hedged items).***

8.19 <u>Hedge effectiveness</u> is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs A129-A138).”

“Hedging

80. If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 95-98 and Appendix A paragraphs A126-A128, accounting for the gain or loss on the hedging instrument and the hedged item should follow paragraphs 99-113.”

“87. A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.”

“98. A hedging relationship qualifies for hedge accounting under paragraphs 99-113 if, and only if, all of the following conditions are met.

(a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or cash flows attributable to the hedged risk.

(b) The hedge is expected to be highly effective (see Appendix A paragraphs A129-A138) in achieving

offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 51 and 52 and Appendix A paragraphs A100 and A101 for guidance on determining fair value).

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated."

From the above, the Committee is of the view that in the extant case, the transactions in the extant case would qualify for hedge accounting as per AS 30 provided the conditions as prescribed in paragraph 98 of AS 30 including hedge effectiveness, such as, matching of cash flows of forecasted future sales realisations with the repayment schedule of term loans, etc. are fulfilled.

D. Opinion

12. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

(a) POS taken against INR liability, does not fall within the scope of AS 11, even in substance, as discussed in paragraphs 9 and 10 above and accordingly, the question of applying paragraphs 46 and 46A of AS 11 does not arise. Therefore, the accounting treatment followed by the company in the extant case is not appropriate.

(b) The company can follow hedge accounting following the principles of AS 30 since inception, provided the conditions of AS 30 including hedge effectiveness, as discussed in paragraph 11 above are fulfilled.

Query No. 30

Subject: Impact of differential treatment to a court approved scheme on the financial statements and audit report in the subsequent years. [1]

A. Facts of the Case

1. Company X Limited is a 100% subsidiary of company Y Limited. The scheme of arrangement ('Scheme') is presented under sections 391 to 394 and other applicable provisions, if any, of the Companies Act, 1956 for vesting as a going concern the business undertakings of company X into company Y. The said scheme was approved by the Honorable High Court of Delhi in March, 2013 and the effect of the same was given in the financial statements for the year ended 31st March, 2013.

2. The said scheme prescribes accounting treatment not fully compliant with Accounting Standard (AS) 14, 'Accounting for amalgamations'. Accordingly, the company X and Y would make disclosures in their financial statements for the year ended 31st March, 2012 as required by AS 14. AS 14 requires that in case of divergence from the requirements of the Standard due to court-approved scheme, certain disclosures are required to be made. In this regard, the following paragraph of AS 14 may be noted:

> ***"42. Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Where the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves***

[1] Opinion finalised by the Committee on 7.11.2014.

of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme, the following disclosures should be made in the first financial statements following the amalgamation:

- ***(a) A description of the accounting treatment given to the reserves and reasons for following the treatment different from that prescribed in this Standard.***
- ***(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.***
- ***(c) The financial effect, if any, arising due to such deviation."***

In addition to above, section 211 of the Companies Act, 1956 states as below:

> "(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:-
>
> (a) the deviation from the accounting standards;
>
> (b) the reasons for such deviation; and
>
> (c) the financial effect, if any, arising due to such deviation."

Excerpts from an Announcement, 'Disclosures in cases where a Court/ Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard', issued by the Institute of Chartered Accountants of India (ICAI), should also be noted:

> "... if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

1. A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/ Tribunal Order.

2. Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.

3. The financial impact, if any, arising due to such a difference."

The querist has stated that in addition to the disclosures made in the financial statements, since the amounts recognised by virtue of accounting treatment prescribed under Court scheme were significant, an emphasis of matter paragraph was given in the audit report drawing attention to the accounting aspects which due to the wording of the scheme were not in accordance with AS 14.

3. *Auditor's analysis*

(i) Under Indian Generally Accepted Accounting Principles (GAAP), accounting treatment prescribed in a scheme approved by a Court or Tribunal overrides the accounting standards and other constituents of Indian GAAP. Further, it is also well-established that a scheme approved under sections 391-394 of the Companies Act, 1956 ('the Act') has an over-riding effect vis-à-vis other provisions of the Act (including the requirements of Accounting Standards prescribed under section 211 of the Act). Thus, as far as the company is concerned, it is bound to follow the accounting treatment prescribed in the scheme. However, the Companies Act as well as the Announcement of the ICAI require certain disclosures in case the accounting treatment prescribed by the scheme is not in compliance with the Accounting Standards/Indian GAAP.

(ii) It may be noted that the relevant Announcement of the ICAI requires the disclosure concerning the deviations from normal Indian GAAP and their impact to be "made in the financial statements of the year in which different treatment has been given". The reference is to 'the year' rather than 'the year(s)'. This view is further strengthened from a reading of AS 14 which requires specified disclosures to be made in the first financial statements following the amalgamation.

(iii) A different position, however, seems to emerge from the following requirements of Standard on Auditing (SA) 700 (Revised), 'Forming an Opinion and Reporting on Financial Statements', issued by the ICAI, which has become effective for reporting periods commencing on or after 1st April, 2012:

"A32a. There can be situations where an entity or a class of entities obtains written permission from the Central Government of India or a regulator or by order of a court of law having jurisdiction to make such an order, to prepare its financial statements without meeting specific recognition, measurement, presentation or disclosure requirements of the applicable financial reporting framework. Such a change shall be treated as a modification of the financial reporting framework and not as inability of the auditor to obtain sufficient appropriate audit evidence. If the effect of this is material, the auditor shall describe in sufficient detail the resultant deviation from the financial reporting framework in an Emphasis of Matter paragraph in accordance with the SA 706."

The following requirements of Standard on Auditing (SA) 706, 'Emphasis of Matter Paragraph and Other Matter Paragraphs in the Independent Auditor's Report, issued by the ICAI (which also has become effective for reporting periods commencing on or after 1st April, 2012) may also be noted:

"6. If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements."

Reference may also be made to the following extracts from 'Implementation Guide on Reporting Standards (SA 700, SA 705 & SA 706), issued by the Auditing and Assurance Standards Board of the ICAI:

> **"Question 19: How should an auditor frame his opinion where a statute or court order or government directive/ permission allows an entity to prepare financial statements without meeting a GAAP requirement?**
>
> **Response 19:** Sometimes the Central Government or a court of law, say, at the request of the entity, permits it to follow a specific accounting treatment in respect of a particular transaction. For example, an entity may be permitted to account for a certain type of income or expenditure on cash basis or on a deferral basis that may not be permitted by the Accounting Standards. The question is whether a departure from the framework under such circumstances requires an auditor to qualify his report?
>
> The answer is "no". In such a situation, the departure is not a non-compliance with the framework but compliance with a modified framework. If the effect of doing this is material, the auditor should describe the resultant deviation from the framework in sufficient detail in an emphasis of matter paragraph."

From the above, there could be a view that "modification of the financial reporting framework" is not limited to the financial year in which the departure from the applicable financial reporting framework pursuant to permission/order of Government/Court/Tribunal is made. The financial reporting framework remains modified as long as the impact of the aforesaid departure remains material. It can be argued that so long as these departures have a continuing material effect on current period or previous period figures, they should continue to be reported, else a reader would not get a complete picture except in the first year in which the departure is made. Therefore, there can be a view that since the requirements of SA 700 (Revised) have also to be complied with, the relevant disclosures and EoM paragraph should continue in the period commencing on 1st April, 2012, i.e., in the financial statements for the year ending 31st March, 2013 and subsequent years.

(iv) AS 14 requires specific disclosure in the financial statements if the scheme prescribes a different treatment to the reserves from that prescribed by AS 14 in the first financial statements post amalgamation. However, the ICAI Announcement, referred above requires such disclosures for all the deviations in the financial statements of the year in which different treatment has been given.

The objective of a financial statement is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. Notes are considered to be an integral part of the financial statements which would generally contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet.

Thus, on a combined reading of the above, it seems that the note and the emphasis of matter paragraph should continue to be given till the impact is material to the financial statements/ results.

(v) However, the above view could have an impact on the schemes sanctioned in the earlier years. In other words, in case there are deviations with the notified GAAP for transactions consummated prior to 31^{st} March, 2012, then as per the new Standard, these transactions, irrespective of the timing of their consummation and irrespective of their manner of reporting in the prior periods would be brought out as an Emphasis of Matter/modification in the subsequent years by the auditor, if material, to the financial statements. This would have a severe implication on all financials presented in the past involving accounting as per a Court approved scheme and would accordingly, require the management and auditors to revisit the accounting implications of such transactions for accounting period commencing on or after 1^{st} April, 2012. This would not be feasible for the auditor if the prior year financial statements have been audited by another auditor and a disclosure as per ICAI Announcement and an emphasis of matter paragraph as per pre-revised SA 700 was not included in the financial statements and auditor's report.

(vi) Therefore, in the above case, the EoM paragraph and note in the financial statements for Court schemes sanctioned prior to April

2012 should not be continued in the year ended 31st March, 2012 and subsequent years.

B. Query

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

(i) Whether a note stating the effect of the merger scheme and an emphasis of matter in the audit/review report will be given in the financial statements of the year in which different treatment has been given, i.e. in the previous year ended 31st March, 2013 and 31st March, 2014 (as comparative) or will it continue in subsequent financial years, till the time the amounts to which differential treatment is given, are material to the financial statements of the company?

(ii) Whether a similar disclosure in the notes to the financial statements and an emphasis of matter paragraph in the audit/review report will be given for the scheme sanctioned prior to the applicability date of the revised standards, i.e., SA 700, SA 705 and SA 706? For example, a company may have created a reserve and would debit impairment losses arising in future years directly against such reserves. Such direct debit to reserve would tantamount to non-compliance with the principles of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

C. Points considered by the Committee

5. The Committee, while answering, has examined only the issues raised in paragraph 4 above and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of accounting treatment made pursuant to Court Scheme, accounting treatment including disclosures in the financial statements for financial year 2011-12 for a scheme of amalgamation approved by the Court in March 2013, etc. Further, as the Scheme of amalgamation was approved in March 2013, the Committee has examined the issue in the context of the Companies Act, 1956.

6. With regard to the issue regarding disclosure in the notes to accounts stating the effect of the merger scheme in the financial statements of the year in which different treatment has been given and in the subsequent

financial years also, the Committee notes paragraph 23 of Accounting Standard (AS) 14, 'Accounting for Amalgamations', relevant extract from the Announcement of the Institute of Chartered Accountants of India (ICAI) on 'Disclosures in cases where a Court/Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard', as below:

> *AS 14*
>
> "23. The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserves of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed. In some cases, the scheme of amalgamation sanctioned under a statute may prescribe a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme. In such cases, the following disclosures are made in the first financial statements following the amalgamation:
>
> (a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Standard.
>
> (b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.
>
> (c) The financial effect, if any, arising due to such deviation."
>
> *Announcement on Disclosures in cases where a Court/Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard*
>
> "... if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

1. A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/Tribunal Order.

2. Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.

3. The financial impact, if any, arising due to such a difference.

…"

The Committee also notes that section 211 of Companies Act 1956, inter alia, states as below:

" …

(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:-

(a) the deviation from the accounting standards;

(b) the reasons for such deviation; and

(c) the financial effect, if any, arising due to such deviation."

…

(6) For the purposes of this section, except where the context otherwise requires, any reference to a balance sheet and profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by this Act, and allowed by this Act to be given in the form of such notes or documents."

From the above, the Committee notes that the Announcement of the ICAI and section 211 of the Companies Act, 1956 requires the above disclosures to be made in the financial statements of the year in which different treatment has been given. Therefore, the Committee is of the view that as long as treatment given in the financial statement(s) pursuant to Court Order is different from the treatment prescribed in the Accounting Standards, disclosure should be given in the notes to accounts in the year(s) in which such different treatment is given in the financial statement(s). In other words, if the effect of a deviation from the treatment prescribed by an Accounting Standard continues in the financial statements of the succeeding financial years also, the financial statement of those years should also comply with the requirements of the Announcement. With regard to disclosures in the notes to accounts for the above-mentioned deviation where such deviation or impact thereof is forming part in the figures of comparatives only, the Committee notes the requirements of Schedule VI (Revised) to the Companies Act, 1956, in the 'General Instructions for the Preparation of Balance Sheet and Statement of Profit and Loss of a Company' and paragraphs 25 and 42 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI as follows:

> *General Instructions for Preparation of Balance Sheet and Statement of Profit and Loss of a Company*
>
> "5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given."
>
> *Framework for the Preparation and Presentation of Financial Statements*
>
> "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."
>
> "42. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s)."

From the above, the Committee notes that one of the qualitative characteristics of financial statements is 'comparability' and that comparative figures including those appearing in the notes are an essential part of the current year's financial statements for understanding these statements. Accordingly, the Committee is of the view that if the disclosure of deviation in the accounting treatments of the previous year (as comparative) is necessary for understanding the financial statements of the current year, the company should disclose in the notes to accounts, such deviation, reason thereof and its financial effect on the financial statements as required by the above-reproduced ICAI's Announcement and the Companies Act, 1956.

7. With regard to Emphasis of Matter (EoM) in the audit/review report in respect of different accounting treatment given in the financial statements, the Committee notes that Standard on Auditing (SA) 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', issued by the ICAI defines 'Emphasis of Matter Paragraph' as "A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is *fundamental to users' understanding of the financial statements*". The Committee further notes paragraph A32a of Application and Other Explanatory Material to Standard on Auditing (SA) 700, Forming an Opinion and Reporting on Financial Statements and paragraph 6 of SA 706 as stated below:

> *Application and Other Explanatory Material to SA 700*
>
> "A32a. There can be situations where an entity or a class of entities obtains written permission from the Central Government of India or a regulator or by order of a court of law having jurisdiction to make such an order, to prepare its financial statements without meeting specific recognition, measurement, presentation or disclosure requirements of the applicable financial reporting framework. Such a change shall be treated as a modification of the financial reporting framework and not as inability of the auditor to obtain sufficient appropriate audit evidence. *If the effect of this is material*, the auditor shall describe in sufficient detail the resultant deviation from the financial reporting framework in an Emphasis of Matter paragraph in accordance with the SA 706."
>
> *SA 706*
>
> "6. If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements."

On a combined reading of the above paragraphs, the Committee notes that when treatment given in the financial statements of an enterprise is different from the treatment prescribed in the applicable Accounting Standards (viz., the financial reporting framework) due to Court's order, the impact of which is material and if in the auditor's judgement, it is fundamental for understanding the financial statements from users perspective, then the auditor should describe the resultant deviation from the reporting framework in sufficient detail in an emphasis of matter paragraph. Accordingly, the Committee is of the view that in the extant case, after SA 700 and SA 706 coming into effect w.e.f. 1st April, 2012, the auditor should assess the impact of the deviation in the accounting treatment followed by the company on the financial statements, including figures of the current reporting year and comparatives for previous year and if such impact is material, then the auditor should describe in sufficient detail the resultant deviation from the financial reporting framework in an Emphasis of Matter paragraph in accordance with the requirements of SA 706.

8. As regards the second issue on whether a similar disclosure in the notes to the financial statements and an emphasis of matter paragraph in the audit/review report for the scheme sanctioned prior to the applicability date of the revised standards, i.e., SA 700, SA 705 and SA 706 (i.e., April 1, 2012) is required, the Committee is of the view that this is a hypothetical issue as in the extant case, the scheme is sanctioned in March 2013, i.e., after the applicability date of these standards. Accordingly, this issue cannot be answered by the Committee as per the Rule 3 of the Advisory Service Rules of the Committee.

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 4 above:

(i) If the effect of a deviation from the treatment prescribed by an Accounting Standard continues in the financial statements of the succeeding financial years also, the financial statement of those years should also comply with the requirements of the Announcement and the Companies Act, 1956 and accordingly, the company should give disclosure in the notes to the financial statements of the year(s) in which different treatment has been given, i.e., in the first year of amalgamation as well as in subsequent years, as discussed in paragraph 6 above. Further, if the disclosure of deviation in the accounting treatments of the previous year (as comparative) is necessary for understanding the financial statements of the current year, the company should disclose in the notes to accounts, such deviation, reason thereof and its impact on the financial statements as required by the ICAI's Announcement and Companies Act, 1956. If there is any material impact of differential accounting treatment of the scheme, and if in the auditor's judgement, it is fundamental for understanding the financial statements from users perspective, the auditor should describe in sufficient detail the resultant deviation from the financial reporting framework in an Emphasis of Matter paragraph in accordance with the requirements of SA 706, as discussed in paragraph 7 above.

(ii) This issue is a hypothetical issue, as discussed in paragraph 8 above, and therefore, cannot be answered by the Committee in view of Rule 3 of the Advisory Service Rules of the Committee.

Query No. 31

Subject: (i) Accounting for short term bridge foreign currency loan taken to invest in an overseas joint venture entity.

(ii) Accounting treatment of investment in overseas company's shares.

(iii) Treatment of loans (advances) given to the overseas joint venture entity. [1]

A. Facts of the Case

1. A navaratna central public sector undertaking under the administrative control of the Ministry of Petroleum and Natural Gas, Government of India,

[1] Opinion finalised by the Committee on 7.11.2014.

is engaged in the exploration, development and production of oil and gas in various oil and gas fields and transportation of crude oil to refineries.

2. The company has acquired 40% shares in A Ltd., a company registered in British Virgin Islands. A Ltd. holds 10% participating interest in offshore block Rovuma 1 in Mozambique.

3. The Government of India had approved the above acquisition transaction with a stipulation that the entire foreign exchange required for the transaction be raised through external commercial borrowings (ECBs)/ other overseas funding and earnings abroad.

4. The company with the approval of the Reserve Bank of India (RBI), had arranged a short term bridge loan (upto one year) of US$ 1.3 billion from foreign banks for financing the acquisition of 40% stake in A Ltd. and had drawn US$ 1.03 billion on 6th January, 2014 for payment of initial acquisition cost of shares of A Ltd. Since the approval of RBI for short term bridge loan stipulated replacement of the same with long term ECB compliant with all the extant ECB guidelines, the company had issued Foreign Currency Bonds (FCBs) in the international market in two tranches of US$ 500 million each for tenors of 5 years and 10 years respectively in April, 2014. The proceeds of the issue have been utilised for part repayment of the short term bridge loan on 22.04.2014.

5. The querist has stated that the company through A Ltd., will also be required to invest additional US$ 1 billion in the project over a period of next 4–5 years as capital expenditure (capex). For this, the company will be raising additional foreign currency loans and extend the same to A Ltd. in the nature of equity or loans (advances) for meeting capex requirements. As of 31.03.2014, the company has already extended loans (advances) to A Ltd. for this purpose.

6. The company's accounting policies for the relevant areas are as follows:

1. *Foreign Currency Translation*

(i) Foreign currency transactions are initially recognised and accounted for at the exchange rates prevailing at the dates of transactions.

(ii) Foreign currency monetary assets and liabilities outstanding at the close of the year, are translated at the rates of exchange prevailing at the date of balance sheet. Resultant gain or loss is accounted for during the year.

(iii) Foreign currency transactions in relation to joint venture (overseas) are treated in the following manner:

(a) Foreign currency transactions are initially recognised and accounted for at the exchange rates prevailing at the dates of transactions. However, the average exchange rate of relevant month is taken for the transactions of that month, where actual rate of transaction is not available or at the rate as agreed otherwise.

(b) Foreign currency monetary assets and liabilities outstanding at the close of the year, are translated at the rates of exchange prevailing at the date of balance sheet. Resultant gain or loss is accounted for during the year.

2. *Investments*

(i) Non-current investments are valued at cost. However, provision for diminution in value is made to recognise a decline in the value, other than temporary.

(ii) Current investments are valued at lower of cost or fair value.

7. The querist has also stated that application of above accounting policies in the instant case is given below:

1. Standalone accounts

(i) Investment in equity shares of A Ltd. is accounted as under:

(a) as investment in joint venture in the nature of jointly controlled entity under paragraph 26 of Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures'.

(b) a non-current investment under Accounting Standard (AS) 13, 'Accounting for Investments'.

(ii) Advances to A Ltd. are accounted as under:

(a) as current monetary item under Non-integral Foreign Operation.

2. Consolidated accounts

(i) Investment in A Ltd.

(a) Using proportionate consolidation method under paragraph 28 of AS 27.

8. *Accounting treatment done by the company with regard to foreign currency translation prevailing at the balance sheet date:*

The accounting treatment in respect of the subject acquisition and loan transactions is as under:

(i) Investment in A Ltd. shares (standalone accounts):

(a) Initial recognition - Recognised and accounted for at the exchange rates prevailing at the date of acquisition of shares (paragraph 9 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates').

(b) Restatement at balance sheet date - Continuing at cost and not restated being a non-monetary item (paragraphs 11 and 12 of AS 11).

(ii) Short term bridge loan for financing acquisition (standalone accounts):

(a) Initial recognition - Recognised and accounted for at the exchange rates prevailing at the date of loan (paragraph 9 of AS 11).

(b) Restatement at balance sheet date - Restated at the closing rate being a monetary item and difference is taken to the profit and loss account. (paragraph 13 of AS 11).

(iii) Loans (advances) given to A Ltd. for future capex in the project (standalone accounts):

(a) Initial recognition - Recognised and accounted for at the exchange rates prevailing at the dates of loans (advances) given to A Ltd. (paragraph 9 of AS 11).

(b) Restatement at balance sheet date - Restated at the closing rate being a monetary item and difference credited to foreign currency translation reserve (FCTR) (paragraph 15 of AS 11).

(iv) Goodwill (Consolidated Accounts): Restated at closing rate in the consolidated accounts and resulting exchange variation taken to FCTR. (paragraphs 27 and 24 of AS 11)

9. The querist has also stated that for item 8(ii) as above on short term bridge loan, there was a substantial gain on foreign currency translation as on the balance sheet date (i.e., 31.03.2014) which was recorded through profit and loss account. However, the statutory auditors of the company had a reservation on the aforesaid accounting treatment due to the following reasons:

(i) Government of India approved the foreign asset acquisition with a stipulation that entire foreign exchange required for the transaction be raised through external commercial borrowings/ other overseas funding and earnings abroad;

(ii) Due to the above stipulation, (as per the statutory auditors) the company is not allowed to repay the borrowings from the Indian sources.

(iii) A part of the short term bridge loan was replaced by a long term foreign currency loan raised through issue of bonds of 5/10 years tenor after the balance sheet date. Accordingly, statutory auditors are of the view that for such loans, paragraph 11(a) of AS 11 will be applicable as there are restrictions on remittances and, therefore, the borrowings cannot be translated simply at the closing rate.

In view of the above, the statutory auditors are of the opinion that such gain/ loss on foreign exchange fluctuation on the short term borrowing cannot be taken through profit and loss statement and need to be accumulated in a foreign currency translation reserve until the disposal of the investment, at which time this should be recognised as income or expense.

10. *The company's view:*

(i) The Government stipulations are with reference to raising of funds only and there are no explicit stipulations on repayment of the loan raised in foreign currency.

(ii) The loan is on the company's account and for all practical purposes, at some point of time, such loan has to be repaid by the company, which is an Indian company, out of its own resources only.

(iii) The word 'restrictions' used in paragraph 11 of AS 11 actually refers to a situation where there is a general restriction on overseas remittances due to which a realistic closing rate of the foreign currency is not available. In such circumstances also, the relevant monetary items should be reported in the reporting currency at the amount which is likely to be realised/disbursed. The provisions in this paragraph 11 of AS 11 only specifies the rate at which the monetary items need to be converted at the balance sheet date and does not restrict the treatment of gain/ loss on the foreign exchange fluctuations for monetary items through profit and loss statement.

(iv) The short term bridge loan for which foreign exchange fluctuation gain is being accounted for is a short term loan only. Accordingly, any loss/gain on this account cannot be carried forward as foreign currency translation reserve even after the expiry of the loan period. The requirement of raising 5/10 years bonds from abroad, to repay the short term bridge loan, is only a funding decision taken by the company keeping in view the approvals of Government of India and RBI .

(v) In the instant case, the closing rate is realistically available in the market.

In view of the above, the company has restated the short term bridge loan (being a monetary item) at the closing rate on the balance sheet date and has taken the restatement difference to the profit and loss account.

B. Query

11. In view of the above facts and the divergent stand of the querist and the auditors, the querist has sought the opinion of the Expert Advisory Committee to ascertain the correctness or otherwise of the accounting treatment done by the querist in respect of:

(i) Initial recognition and restatement of short term bridge loan in standalone accounts:

1. Initial recognition - Recognised and accounted for at the exchange rates prevailing at the date of loan.

2. Restatement at balance sheet date - Restated at the closing rate being a monetary item and difference is taken to profit and loss account.

(ii) Investment in the overseas company shares (standalone accounts):

3. Initial recognition - Recognised and accounted for at the exchange rates prevailing at the date of acquisition of shares.

4. Restatement at balance sheet date - Continuing at cost and not restated being a non-monetary item.

(iii) Loans (advances) given to the overseas company for future capex in the project (standalone accounts):

5. Initial recognition - Recognised and accounted for at the exchange rates prevailing at the dates of loans (advances) given to the overseas company.

6. Restatement at balance sheet date - Restated at the closing rate being a monetary item and difference credited to Foreign Currency Translation Reserve (FCTR).

(iv) Goodwill (consolidated accounts): Restated at closing rate in the consolidated accounts and resulting exchange variation taken to FCTR.

C. Points considered by the Committee

12. The Committee, while answering the query, has considered only the issues raised in paragraph 11 above, and has not considered any other issue that may arise from the Facts of the Case, such as, accounting treatment of foreign currency bonds, accounting in the books of A Ltd., accounting for advances in the nature of equity to A Ltd. by the company, correctness of treating the loans (advances) given to A Ltd. by the company for future capital expenditure as a monetary item under AS 11, legal interpretation of the approval of the Government/RBI allowing the transaction of acquisition of shares of A Ltd. through bridge loan/ECB and their

repayment, propriety of use of monthly average exchange rate for the transactions of that month as stated in paragraph 6 (iii) above, etc. The Committee has further presumed from the Facts of the Case that A Ltd. is a non-integral foreign operation for the company.

13. With regard to initial recognition and restatement of short-term bridge loan in standalone accounts of the company, the Committee notes the following paragraphs of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> ***"7.11 Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money."***
>
> ***"7.14 Non-monetary items are assets and liabilities other than monetary items."***
>
> ***"9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction."***
>
> **"Reporting at Subsequent Balance Sheet Dates**
>
> **11. At each balance sheet date:**
>
> ***(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;***
>
> ***(b) non-monetary items which are carried in terms of***

historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Standard. ..."

"Recognition of Exchange Differences

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."

"Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31."

From the above, the Committee is of the view that short-term bridge loan in foreign currency should be recognised initially by applying the rate of exchange as prevailing on the date of the loan. As regards reporting of short-term bridge loan at the subsequent balance sheet date, the Committee is of the view that the same will depend on whether the item is monetary or non-monetary. In the extant case, the Committee is of the view that the short-term bridge loan in foreign currency, being a monetary item, should be reported using the closing rate of foreign currency at subsequent balance sheet dates. With regard to the stipulations of the auditor regarding restrictions on remittances and that considering paragraph 11(a) of AS 11, the gain or loss arising on reporting at subsequent reporting date should be accumulated in foreign currency translation reserve account, the Committee notes that paragraph 11(a) deals with the situation where closing rate may not reflect with reasonable accuracy the amount in the reporting currency that is likely to be realised from or required to disburse a foreign currency monetary item at the balance sheet date, for example, in certain situations where there are restrictions on remittances and it is not possible to effect an exchange of currencies. In those situations, paragraph 11 of AS 11 prescribes to report the monetary item at the amount which is likely to be realised from or required to disburse that item at the balance sheet date. Without commenting on the issue whether there are any restrictions on remittances of the foreign currency in the extant case or not, the Committee is of the view that AS 11 does not cover such type of restrictions on remittances and covers only those restrictions where the closing rate of foreign currency will not reflect realistic exchange rate. Further, paragraph 11 of AS 11 nowhere states to accumulate the gains or losses arising on reporting the monetary items at subsequent reporting date in foreign currency translation reserve account. Accordingly, the Committee is of the view that the short-term bridge loan should be reported using the closing rate of foreign currency at subsequent balance sheet date in the standalone accounts of the company and exchange differences arising, if any, should be recognised in the statement of profit and loss of the company.

14. As regards recognition of investment in the shares of joint venture entity and subsequent reporting at the balance sheet date in the standalone financial statements of the company, the Committee notes the following paragraphs of Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures' and Accounting Standard (AS) 13, 'Accounting for Investments', notified under the Rules:

AS 27

"***26. In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.***

27. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.

AS 13

"3.2 A <u>current investment</u> is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

3.3 A <u>long term investment</u> is an investment other than a current investment."

"17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment."

"19. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist."

On the basis of the above, presuming the investment in the shares of A Ltd., a jointly controlled entity, as a long-term investment and considering paragraphs 11 (b) and 12 of AS 11, the Committee is of the view that the same is a non-monetary item and, therefore, should be initially recognised at the exchange rates prevailing at the date of acquisition of shares and should be carried at historical cost at the subsequent balance sheet date, subject to provisions contained in paragraphs 17 and 19 of AS 13.

15. With regard to loans (advances) given to A Ltd. for future capital expenditure in the project in the standalone accounts of the company, the Committee is of the view that as per paragraph 9 of AS 11 reproduced above, same should be initially recognised at the exchange rate prevailing on the date of loans and advances. Further, with regard to subsequent reporting at the balance sheet date, the Committee notes paragraphs 13 and 15 of AS 11 as reproduced above and paragraph 16 of AS 11, notified under the Rules, as stated below:

> "16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables."

The Committee notes from the above that in order to determine accounting treatment of exchange differences on a monetary item on subsequent reporting, there is a need to determine whether the loans advanced to the joint venture, in substance, form part of the company's net investment in the non-integral foreign operation. In this regard, the Committee notes from 'Note No. 21 – short-term loans and advances' under 'current assets' to the financial statements of the company for the financial year 2013-14 that the loan to A Ltd. is disclosed under 'Unsecured, considered good' category of short-term loans and advances. From this, it can be inferred that the advances given to A Ltd. are short-term loans and advances, which will be repaid within short period of time. Accordingly, it can be said that the repayment of loans is planned and is foreseeable. Thus, such loans are not of the nature of net investment in foreign operation (joint venture). Temporary advances in any case are not of the nature of net investment in foreign operation. The Committee is, thus, of the view that the loan advanced is not covered by the treatment prescribed in paragraph 15 of AS 11. Accordingly, exchange differences arising on the loan advanced should be recognised as income or as expense as per paragraph 13 of AS 11. Therefore, the accounting treatment of the company to recognise the exchange difference on reporting the advances at subsequent reporting date in foreign currency translation reserve as per the paragraph 15 of AS 11 is not correct.

16. With regard to treatment of goodwill in consolidated accounts of the company, the Committee notes the following paragraphs of AS 11, notified under the Rules:

> **"Non-integral Foreign Operations**
>
> ***24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:***
>
> ***(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;***
>
> ***(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and***
>
> ***(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment."***
>
> "27. Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate in accordance with paragraph 24."

From the above, the Committee is of the view that the goodwill arising on the acquisition of shares in A Ltd. in the consolidated accounts of the company should be translated using closing rate prevailing on the balance sheet date and the exchange differences should be transferred to foreign currency translation reserve.

D. Opinion

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

(i) Initial recognition and restatement of short term bridge loan in standalone accounts: The accounting treatment made by the company in this regard is correct, as discussed in paragraph 13 above.

(ii) Investment in the overseas company's shares in standalone accounts: The accounting treatment made by the company for its initial recognition as well as restatement at the balance sheet date is correct, as discussed in paragraph 14 above.

(iii) Loans (advances) given to the overseas company for future capex in the project in standalone accounts:

(a) Initial Recognition: It should be recognised at the exchange rates prevailing at the dates of loans (advances) and therefore, the treatment made by the company is correct as discussed in paragraph 15 above.

(b) Restatement at balance sheet date: The loans (advances), being a monetary item but not of the nature of net investment in non-integral foreign operation (joint venture), should be restated at the closing rate and the exchange differences arising should be recognised as income or as expense as per paragraph 13 of AS 11. Therefore, the treatment made by the company to recognise the exchange difference on reporting the advances at subsequent reporting date in foreign currency translation reserve is not correct, as discussed in paragraph 15 above,

(iv) Goodwill in consolidated accounts: The treatment made by the company to restate the goodwill at closing rate in the consolidated accounts and resulting exchange variation being taken to FCTR is correct, as discussed in paragraph 16 above.

Query No. 32

Subject: Disclosure of Trade Payables.[1]

A. Facts of the Case

1. A Government of India company (hereinafter referred to as the 'company') is engaged in the construction and operation of thermal power plants in the country. The company has also diversified into hydro power generation, coal mining and oil & gas exploration etc. The company is registered under the Companies Act, 1956 and being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956. The company is also listed with the Bombay Stock Exchange and the National Stock Exchange.

2. The querist has stated that as per paragraph 8.4.1 of the Guidance Note on Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI), "A payable shall be classified as a 'trade payable' if it is in respect of amount due on account of goods purchased or services received in the normal course of business. As per the old Schedule VI, the term 'sundry creditors' included amounts due in respect of goods purchased or services received or in respect of other contractual obligations as well. Hence, amounts due under contractual obligations can no longer be included within trade payables. Such items may include dues payables in respect of statutory obligations like contribution to provident fund, purchase of fixed assets, contractually reimbursable expenses, interest accrued on trade payables, etc. Such payables should be classified as "others" and each such item should be disclosed nature-wise. ..." Considering the above, the company, inter-alia, disclosed the amounts payable towards following services received from vendors/agencies as 'trade payables' in its financial statements:

(a) Security expenses payable.

(b) Electricity/power charges payable.

(c) Water charges payable (for water drawn for its plant operations as well as for offices/townships).

[1] Opinion finalised by the Committee on 7.11.2014.

(d) Communication expenses payable.

(e) Medical expenses payable to empanelled hospitals.

(f) Legal expenses payable.

(g) Amounts payable to travel agents.

(h) Other accrued expenses for services received in the ordinary course of business.

The querist has separately explained the nature of above expenses and the purpose for which these expenses are incurred in the following table:

Sl. No.	Nature of expense	Purpose of expense
1.	Security expenses payable to Central Industrial Security Force (CISF) and private agencies.	The company is in the business of generating electricity through its power plants at various locations in the country. The security service to the plants is provided by CISF. Private security agencies provide security services for townships, office complexes, schools, hospitals, etc. owned by the company at its power plants.The amount payable to the CISF/private security agencies for the security services provided as per agreements entered with them is categorised as security expenses payable.
2.	Legal expenses payable	Litigations normally arise due to disputes in respect of execution of work/supply of materials to the company, land acquisition by the company for construction of power plants, tariff fixation etc. which are contested in various courts and tribunals. Fee payable to the advocates engaged by the company in respect of legal cases is categorised as legal expenses payable.

3.	Communication expenses payable	The company obtains communication services from various telecom operators for its day to day operations. This includes telephone/mobile, internet services etc. Expenses payable to the telecom operators are categorised as communication expenses payable.
4.	Operating expenses of schools, hospitals, transit hostels etc. at the project township	The company provides infrastructure facilities, viz., schools, hospitals, etc. to its employees at projects of the company which are at remote locations. Similarly, transit hostels are also provided for the temporary stay of employees on official work. Day to day operations and repair & maintenance of these facilities are carried out by vendors/ agencies. Amounts payable for these expenses are categorised as operating expenses of schools, hospitals and transit hostels.
5.	Electricity/power charges payable	The company purchases electricity/power from electricity distribution companies for the following purposes: (i) For use in construction activities of new power plants; and (ii) For use in administrative/other offices, premises of the company not attached to power plants of the company. Expenses payable to the electricity distribution companies are categorised as electricity/power charges payable.
6.	Water charges payable	The company purchases water from the concerned state authorities for the following purposes: (i) For use in generation of electricity; and

		(ii) For use in administrative offices, township and other residential facilities owned by the company. Amounts payable to the state authorities are categorised as water charges payable.
7.	Medical expenses payable to empanelled hospitals	The employees of the company are entitled for medical treatment in the empanelled hospitals and the company pays directly to the empanelled hospitals towards the medical services received by its employees. Such expenses payable are categorised as medical expenses payable to empanelled hospitals.
8.	Amounts payable to travel agents	The air/railway tickets for the official travel of employees of the company are arranged through empanelled travel agents. The charges for tickets arranged payable to the travel agencies are categorised as amounts payable to travel agents.

Depending upon the date on which such amounts are due, the trade payables were classified under non-current liabilities or under current liabilities, as per the requirement of the revised Schedule VI to the Companies Act, 1956.

3. During supplementary audit of accounts of the company for the year 2013-14, the office of the Comptroller and Auditor General of India (C&AG) observed that the disclosure of accrued expenses towards security services to CISF and other private security agencies, legal services, telephone services and operating expenses of schools and transit hostels at the project township as 'trade payables' is not correct and such payables should have been classified under 'Other Current Liabilities'. During discussions, audit was of the view that amounts payable for administrative services received by the company such as security, communication, legal services etc. do not qualify to be classified as 'Trade Payables'. The company invited reference of audit to paragraph 8.4.1 of the 'Guidance Note on the Revised Schedule VI to the Companies Act, 1956' which defines 'trade payable' as under:

> "A payable shall be classified as 'trade payable' if it is in respect of amount due on account of goods purchased or services received in the normal course of business."

Accordingly, it was explained that the accrued expenses referred by audit relate to services received by the company for its operations carried out in the ordinary course of business and meet the criteria for disclosure as trade payables in the financial statements. It was agreed with the Government audit that the existing practice of the company for classification of above-mentioned amounts as trade payables shall be referred to the Expert Advisory Committee (EAC) of the ICAI for opinion.

B. Query

4. In the above background, the querist has sought the opinion of the EAC as to whether classification of the amounts payable for various services referred in paragraph 2 above as 'trade payable' by the company is in order.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised by the querist relates to classification and disclosure of amounts payable for various services under the head 'trade payables'. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. Further, the opinion being expressed hereinafter is purely from the perspective of disclosures in the financial statements and not from any other perspective.

6. In order to determine whether amount payable for various services should be classified under the head 'trade payable', the Committee notes Note 5 of the 'General Instructions for Preparation of Balance Sheet' of Schedule III to the Companies Act, 2013, which states as below:

> "A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business."

From the above, the Committee is of the view that only those amounts which are due in respect of goods purchased or *services received in the normal course of business,* can be classified under 'trade payable' in the balance sheet. In this context, the Committee also notes the definition of the term 'sundry creditor' as defined in the Guidance Note on Terms Used in Financial Statements as follows:

> **15.19 Sundry Creditor**
>
> Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditor** or **account payable**.

The Committee notes from the above that under Revised Schedule VI to the Companies Act, 1956 and under Schedule III to the Companies Act, 2013, the amounts due under contractual obligations are not included within 'trade payables'. In this regard, the Committee notes that as per paragraph 8.4.1 of the Guidance Note on Revised Schedule VI to the Companies Act, 1956 (hereinafter referred to as 'the Guidance Note'), amounts due under contractual obligations may include dues payable in respect of statutory obligations like contribution to provident fund, purchase of fixed assets, contractually reimbursable expenses, interest accrued on trade payables, etc. The Committee further notes that the term 'normal course of business' is no where defined or explained in the Companies Act, 2013 or in the accounting pronouncements issued by the ICAI. Accordingly, the same should be construed in common parlance. The Committee is of the view that in common parlance, 'normal course of business' may be understood as the activities which are required for running the business. The Committee is further of the view that which payables arise in the normal course of business, would also depend on the type of business/industry and nature of expenses incurred. Hence, it is a judgemental issue to classify the amounts due in respect of various services received under 'trade payables'.

7. On the basis of above, considering the nature of business of the company and the nature of expenses being incurred, the Committee is of the view that security expenses payable to Central Industrial Security Force (CISF) and private agencies, legal expenses payable, communication expenses payable, operating expenses of schools, hospitals and transit hostels at the project township, electricity/power charges payable, water charges payable, medical expenses payable to empanelled hospitals towards the medical services received by its employees, and amounts payable to travel agents, as explained in paragraph 2 above, appear to be the payables arising in the normal course of business of the company in the extant case, as discussed in paragraph 6 above and therefore, these should be classified and disclosed as 'trade payables'.

D. Opinion

8. On the basis of the above, the Committee is of the opinion that the amounts payable to various parties referred to in paragraph 2 (table) above, such as, security expenses payable to Central Industrial Security Force (CISF) and private agencies, legal expenses payable, communication expenses payable, operating expenses of schools, hospitals and transit hostels at the project township, electricity/power charges payable, water charges payable, medical expenses payable to empanelled hospitals towards the medical services received by its employees, and amounts payable to travel agents, appear to be the payables arising in the normal course of business of the company in the extant case, as discussed in paragraph 6 above and therefore, their classification and disclosure as 'trade payables' would be in order, as discussed in paragraph 7 above.

Query No. 33

Subject: Accounting treatment of price reduction due to delay in mechanical completion of capital projects. [1]

A. Facts of the Case

1. A company, a Government of India (GOI) undertaking working under the Department of Fertilizers (DOF) was incorporated on 23rd August, 1974 with two manufacturing units at Bathinda and Panipat in the state of Punjab and Haryana, respectively, having an installed capacity of 5.115 lakh MT urea each. Subsequently, on the reorganisation of fertilizer group of companies in 1978, the Nangal Unit of Fertilizer Corporation of India with an installed capacity of 4.785 lakh MT urea came under the company's fold. The company expanded its installed capacity in 1988 by 7.26 lakh MT urea after installing and commissioning of its Vijaipur gas based Plant in Madhya Pradesh. Subsequently, Vijaipur plant doubled its capacity by commissioning

[1] Opinion finalised by the Committee on 7.11.2014.

Vijaipur Expansion Unit i.e., Vijaipur-II in 1997. The company also implemented capacity enhancement projects at Vijaipur I and II. Consequently, at present, the company has an installed capacity of 35.68 lakh MT of urea. The plants at Nangal, Panipat and Bhatinda were based on feed stock of Fuel Oil (FO) and Low Sulphur Heavy Stock (LSHS) whereas plant at Vijaipur Unit was set up with feed stock as natural gas (NG). Urea (Fertilizer) is a controlled product and its price is controlled by the Government under its subsidy scheme.

2. The GOI, Ministry of Chemicals and Fertilizers, vide its letter dated 6.03.2009 notified policy for conversion of FO/LSHS urea units to natural gas. The salient features of the policy are given as under:

- Government has approved to recognise cost of conversion through reimbursement of fixed cost for five years after conversion.
- Only FO/LSHS units viz., Bhatinda, Panipat, Nangal and Gujrat Narmada Valley Fertilizers & Chemicals Ltd. (GNVFC) Bharuch covered under the policy.
- Project Development India Limited (PDIL) will evaluate the project report by conducting techno-economic feasibility study.
- The actual project cost for conversion would be admitted after scrutiny by a team comprising representatives of PDIL, DOF, Fertilizers Industry Coordination Committee (FICC) and respective units and will be in accordance with the final PIB approval alongwith exchange rate variation and variation in statutory levies.
- The pre-set energy would be allowed for 5 years and saving in energy with respect to the same would be considered on designed/ guaranteed basis and then same would be available to the unit for partially meeting the project cost. Keeping in view the above, the percentage of project cost to be considered for determining special fixed cost will be decided by the PIB while approving the project cost.
- The special fixed cost will be paid only for production till 100% of reassessed capacity.

3. *GOI approval of the company's proposal for Ammonia Feed Stock Conversion Project* (*AFCP Project) at Bhatinda, Panipat and Nangal Unit:* In

terms of aforesaid GOI policy, techno-economic feasibility study of the proposals for AFCP Project through contractors A Ltd. (Bhatinda and Panipat) and B Ltd. (Nangal) was carried out by Project Development India Limited. The company finalised award of lumpsum turnkey contracts (LSTK) in respect of Bhatinda, Panipat, Nangal Unit and after approval of the company's Board of Directors, proposals for investment were sent by the company to the Department of Fertilizers for the approval of PIB and Cabinet Committee on Economic Affairs (CCEA).

3.1 PIB considered the proposals and recommended for approval of CCEA, the estimated project cost of Rs. 1294.19 crore for Bhatinda, Rs. 1292.48 crore for Panipat and Rs. 1478.63 crore for Nangal (Rs. 1346.20 crore for urea covered by Government grant and Rs. 132.43 crore for industrial products to be financed by the company out of its own resources).

3.2 As the company has made reference to the Institute of Chartered Accountants of India (ICAI) for its opinion on accounting treatment of price reduction (liquidated damage (LD)) in respect of LSTK contracts pertaining to Nangal and Panipat units only, the brief facts in the matter excluding facts of Bhatinda Unit are mentioned in the following paragraphs.

3.3 GOI conveyed its approval to the investment proposal of Panipat and Nangal units for AFCP Projects to be implemented on lumpsum turnkey basis (LSTK) as per following details:

Name of unit	***Date of GOI approval (copies enclosed)***	***Total estimated cost (Rs./crore)***	***Zero Date***
Panipat	8.02.2010	1292.84	29.01.2010
Nangal	8.02.2010	1478.63*	29.01.2010

*Rs. 1346.20 crore for urea and Rs. 132.43 crore for industrial products.

4. DOF conveyed specific approval for Panipat and Nangal units vide its letter dated 8.02.2010 for undertaking conversion projects from FO/LSHS to gas based unit through LSTK contractor i.e., A Ltd. for Panipat unit and B Ltd. for Nangal unit. As per approval, the project cost shall be reimbursed subject to cost ceiling of Rs. 1292.84 crore for Panipat unit and Rs. 1346.20

crore for Nangal unit (subject to exchange rate variation, changes in statutory levies and also escalation/de-escalation on account of nickel price till the issuance of letter of intent on the quoted quantity of nickel). The project cost shall be further adjusted after completion of conversion project for any savings during execution, lower interest rate on loans with reference to SBI's PLR and sales realisation of redundant front end of existing plant after conversion. The reimbursement of project cost shall be based on the following parameters:

- The actual project cost shall be admitted after scrutiny by a team comprising representatives of PDIL, DOF, FICC and the company and will be in accordance with the CCEA approval.
- NPS III pre-set energy norm would be allowed for five years and saving in energy with respect to the same would be considered on designed/guaranteed basis and shall be available to unit for partially meeting the project cost.
- Balance project cost shall be paid through special fixed cost component and will be covering (i) interest on borrowed capital (ii) own funds (iii) 12% post tax return on own funds as a part of balance project cost.
- The special fixed cost would be fixed for five years period and would be paid from the date of commercial production after conversion upto the end of five years and shall be withdrawn at the end of five years.
- The special fixed cost shall be paid only for production till 100% of the re-assessed capacity.
- The project cost considered as special additional fixed cost would not be considered/recognised as a capital addition for the purpose of net fixed assets as well as for depreciation during current pricing and future pricing, if any.
- Special fixed cost component and the energy savings to be paid for first five years post conversion based on the production upto 100% of the reassessed capacity is towards reimbursement of capital cost of the project and is a subsidy in the nature covered under explanation 10 to section 43 (1) of Income-tax Act, 1961.

LSTK Contract for Nangal Unit:

5. Pursuant to the Government's approval, contract was awarded on 29.01.2010 to B Ltd. on LSTK basis for AFCP Project of Nangal Unit. Under the contract, mechanical completion of the project was to be completed by 29.10.2012. The mechanical completion of the project was achieved by the contractor on 15.02.2013. There is delay of 108 days on the part of contractor in achieving mechanical completion. Clause No. 11.0 on Price Reduction and Clause No. 11.1.1 on amount of Price Reduction as contained in the contract are as under:

> **"11.0 Price Reduction Clause**
>
> If for reasons not attributable to the Owner or due to conditions not constituting Force Majeure as defined in this Contract, the Work is not completed in accordance with the provisions hereof, within and in accordance with the Time Schedule/time for Completion as indicated in the terms and conditions of the Contract, it is agreed that the Owner shall be entitled to recover and/or the Contractor shall pay to the Owner, without prejudice to any other rights or remedy available to the Owner, the following amount as mutually agreed compensation.
>
> 11.1.1 A sum equivalent to 0.5% of the Contract price for every complete week or part thereof, for delay in completion of milestone activities separately for 'Mechanical Completion' and 'Hooking up & Commissioning' of Plant by the Contractor, subject to a maximum 5% of total Contract Price inclusive of escalation and contingencies, if any."

In terms of aforesaid provision of the contract, price reduction of Rs. 64.22 crore which is 5% of the contract value is leviable. The amount of price reduction (LD) of Rs. 64.42 crore is clearly identified with the AFCP Project and the same is directly attributable to the delay in achieving mechanical completion of the project. After commissioning on 9.04.2013, commercial production was declared on 18.07.2013. The assets of AFCP project were capitalised with project cost amounting to Rs. 1401.88 crore after reduction of Rs. 64.22 crore towards price reduction as per contract, in the accounts during F.Y. 2013-14.

LSTK Contract for Panipat Unit:

6. In respect of Panipat Plant, the contract was awarded on 29.01.2010 to A Ltd. As per the provisions of contract, mechanical completion of the project was to be completed by 28.10.2012. The mechanical completion of the project was achieved by the contractor on 9.11.2012. There is a delay of 12 days on the part of the contractor in achieving mechanical completion in respect of Panipat Unit. Clause No 11.1 on Price Reduction and Clause No. 11.1.1 on amount of Price Reduction as contained in the contracts for Panipat are as under:

> **"11.0 Price Reduction**
>
> "11.1 If for reasons not attributable to the Owner or due to conditions not constituting Force Majeure as defined in this Contract, the Work is not completed in accordance with the provisions hereof, within and in accordance with the Time Schedule/ time for Completion as indicated in the terms and conditions of the Contract, it is agreed that the Owner shall be entitled to recover and/or the Contractor shall pay to the Owner, without prejudice to any other rights or remedy available to the Owner, the following amount as mutually agreed compensation."
>
> "11.1.1 A sum equivalent to 0.5% of the Contract price for every complete week or part thereof, for delay in completion of milestone activities separately for "Mechanical Completion" and "Hooking up & commissioning" of Plant by the Contractor, subject to a maximum 5% of total contract Price inclusive of escalation and contingencies, if any."

In terms of aforesaid provision of the contract, price reduction of Rs. 10.99 crore is leviable on A Ltd. The amount of price reduction (LD) of Rs. 10.99 crore is clearly identified with the AFCP Project and the same is directly attributable to the delay in achieving mechanical completion of the project. After commissioning on 24.01.2013, commercial production was declared on 28.03.2013. The assets of AFCP project were capitalised with project cost amounting to Rs. 1232.32 crore after reduction of Rs. 10.99 crore towards price reduction as per contract in the books of account during F.Y. 2012-13.

7. Accounting treatment of Government grant in the annual accounts of the company for F.Y. 2012-13 and 2013-14

7.1 The company has adopted 'Income Approach' as per Accounting Standard (AS) 12, 'Accounting for Government Grants', for accounting treatment of government grant for the purpose of capitalisation of assets of AFCP Project of Nangal and Panipat Unit. Accordingly, assets of AFCP projects have been shown at their historical cost and government grant relating to assets of AFCP Project is being treated as deferred income (receivable from the Government over a period of 5 years) which is being recognised in the statement of profit and loss and being allocated to income over the periods and in the proportions in which depreciation on AFCP assets is being charged.

7.2 It may be mentioned that actual project cost of Nangal/Panipat Unit shall be admitted by the Government after scrutiny by a Government appointed team and will be in accordance with the Government's approval of these projects as per approval letters dated 8.02.2010. The Government will consider the actual executed cost under the contract. Therefore, in the executed cost of the project, the amount of price reduction of Rs. 64.42 crore and Rs. 10.99 crore is required to be adjusted by the company in terms of aforesaid contract.

7.3 As on date, the closure of AFCP contract for Nangal and Panipat is pending. The settlement of matter with LSTK contractor including the issue relating to recovery of price reduction shall be settled at the time of closure of contract.

Government audit observation on the annual accounts for F.Y. 2013-14:

8. During the course of audit of annual accounts of the company for F.Y. 2013-14, Government audit issued the following half margin (HM) on the accounting treatment of adjustment of price reduction in the capital cost of AFCP project of Nangal and Panipat Unit:

> "As per the Opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) dated February 7, 1992, liquidated damages are not directly attributable to the acquisition of capital equipment like trade discounts and rebates. They are also not adjustments in the price of the equipment. The damages result from inefficiency on the part of the supplier, i.e., delay in the supply of the

equipment. In view of this, the liquidated damages received from the supplier cannot be adjusted in the cost of purchase. Thus the amount of liquidated damages should be shown as income separately, in the profit and loss account, and not adjusted against the cost of the relevant asset acquired.

During the current year the company made recoveries on account of liquidated damages from the lumpsum turnkey (LSTK) contractors (of Ammonia Feed Stock Conversion Project at Nangal and Panipat units) M/s B Ltd. and M/s A Ltd. of Rs. 64.31 crore and Rs. 10.99 crore respectively on account of delay for mechanical completion of projects at Nangal and Panipat units as per terms of contract. In case of Nangal Unit, the LD charges were adjusted from the expenditure during construction period (included in capital work in progress) that were finally capitalised on commissioning of plant during the year. In case of Panipat Unit, the LD charges were adjusted from the capitalised amount of plant and machinery. Thus, the capitalised project costs for Nangal and Panipat units were reduced by Rs. 75.30 crore.

In view of the above opinion, the company cannot adjust the LD charges to reduce its capitalised cost and since this income pertains to the Government, as the asset is being acquired through capital grant, it being a revenue receipt, should be credited to the Government against the current recoverable from the Government. The above accounting treatment has resulted in understatement of Deferred Government Grant and Tangible Asset (Gross Block) as on 31.03.2014 by Rs. 75.30 crore. Further, the depreciation on fixed assets against Government Grant was under charged by Rs. 2.98 crore.

While confirming facts and figures, the comment of the management may please be furnished within three days from issuance of the HM."

9. *Reply to Government Audit Half Margin*: The company submitted following reply to the aforesaid HM to the Government audit:

"During F.Y. 2010-11, the company has undertaken projects for changeover of Feed Stock from FO to gas based at three FO based units at Nangal, Bathinda and Panipat on Lump-Sum Turn key basis. In terms of Department of Fertilizer Letter No.14016/2/2007-FP (Vol-II) (2) and No.14016/2/2007-FP (Vol-II) (3) dated 8th Feb, 2010, capital cost of the Project shall be reimbursed by the Government of India in a span of 5 years post commercial production.

In respect of Nangal Plant the Ammonia Feedstock Conversion Project (AFCP) contract was awarded on 29.01.2010 to the consortium bid of M/s X Ltd., Italy & M/s Y Ltd., Mumbai on LSTK basis for the work of 'The Revamp of Ammonia Plant at Nangal for change over of feedstock from Fuel Oil/LSHS to NG/RG'.

As per the provisions of contract, mechanical completion of the project was to be completed by 28.10.2012. The mechanical completion of the project was achieved by the contractor on 15.2.2013. There is a delay of 108 days on the part of the contractor in achieving Mechanical Completion.

In respect of Panipat Plant the contract was awarded on 29-01-2010 to M/s A Ltd. for the work of 'The Revamp of Ammonia Plant at Panipat for change over of feedstock from Fuel Oil/LSHS to NG/RG'.

As per the provisions of contract, mechanical completion of the project was to be completed by 28.10.2012. The mechanical completion of the project was achieved by the contractor on 9.11.2012. There is a delay of 12 days on the part of the contractor in achieving Mechanical Completion in respect of Panipat.

Clause No 11.1 on Price Reduction and Clause No 11.1.1 on amount of Price Reduction as contained in the contracts for Nangal and Panipat are as under:

Price Reduction

"11.1 If for reasons not attributable to the Owner or due to conditions not constituting Force Majeure as defined in this Contract, the Work is not completed in accordance with the provisions hereof, within and in accordance with the Time Schedule/ time for Completion as indicated in the terms and conditions of the Contract, it is agreed that the Owner shall be entitled to recover and/or the Contractor shall pay to the Owner, without prejudice to any other rights or remedy available to the Owner, the following amount as mutually agreed compensation."

"11.1.1 A sum equivalent to 0.5% of the Contract price for every complete week or part thereof, for delay in completion of milestone activities separately for “Mechanical Completion” and “Hooking up & commissioning” of Plant by the Contractor, subject to a maximum 5% of total contract Price inclusive of escalation and contingencies, if any.”

In respect of delay in mechanical completion as stated above, price reduction of Rs. 64.31 crore is leviable as per the provisions of the contract in respect of Nangal Unit and Rs. 10.99 crore in respect of Panipat Unit. In terms of the contract, above amounts pertain to price reduction due to delay in achieving mechanical completion and are not in the nature of liquidated damages.

The total amount of price reduction of Rs. 75.30 crore has been deducted as a reduction in cost of the project and is clearly identified with the AFCP Project and the same is directly attributable to the delay in achieving mechanical completion of the project. Since said levy of price reduction is in accordance with the terms of the contract, price reduction of Rs. 64.31 crore in respect of Nangal and Rs. 10.99 crore in respect of Panipat has been deducted from the respective capital cost of the AFCP Project of unit for the purpose of capitalisation of assets of project in the annual accounts for F.Y. 2013-14. In terms of the GOI policy dated 8.02.2010 for Nangal and Panipat for conversion of FO based plants to gas based, net cost is to be reimbursed by the Department of Fertilizers.

Further with reference to liquidated damages subsequent to opinion of the Expert Advisory Committee of the ICAI dated February 07, 1992, there are two expert opinions of the EAC of the ICAI dated December 12, 1995 and December 31, 1996 which are as under:

> “The Committee is of the view whether or not liquidated damages should be adjusted against the project cost would depend upon whether the liquidated damages are directly identifiable with the project and whether, in fact, they are received in mitigation of the extra project costs incurred and capitalised by the enterprise on account of the same specific events which gave rise to liquidated damages. Where and to the extent the liquidated damages meet the aforesaid stipulations in affirmative, the same should be adjusted in the cost of the project.”

The opinion of Expert Advisory Committee of the ICAI dated December 31, 1996 has reiterated the above opinion and has given opinion in the matter as under:

> "If it can be established that the liquidated damages are in fact received in mitigation of the extra project costs incurred and capitalised by the company on account of the same specific events which give rise to liquidated damages and that the said damages can be identified with the project, the Committee is of the opinion that the liquidated damages can be adjusted in the cost of the project."

Therefore, in view of embedded terms of AFCP contract of Nangal and Panipat Unit and opinion of Expert Advisory Committee, the accounting treatment is correct and this HM may kindly be dropped by Government Audit."

Government Audit Supplementary Observation:

10. Government auditors after considering the above reply have further pursued their observation of HM during the course of supplementary audit of the company's annual accounts for F.Y. 2013-14 and vide their letter dated 28.08.2014 have requested the comapny for needful action in respect of observation made in the subject matter as under:

> "The Company made recoveries on account of delay in mechanical completion as per Price Reduction clause of agreement from the lump sum turnkey (LSTK) contractors M/s. B and M/s. A Ltd. of Rs. 64.31 crore and Rs. 10.99 crore respectively at Nangal and Panipat Units. In case of Nangal Unit, the price reduction charges were adjusted from the expenditure during construction period that were finally capitalised on commissioning of plant during the year and in case of Panipat Unit, the price reduction charges were adjusted from the capitalised amount of plant and machinery. Thus, the capitalised project costs for Nangal and Panipat units were reduced by Rs. 75.30 crore. The company may refer full facts of the case to the ICAI to seek the opinion for accounting treatment in case of decrease in project cost due to price reduction."

B. Query

11. In the above background, the opinion of the Expert Advisory Committee is requested for the following issues:

(i) Whether the accounting treatment of adjustment of price reduction of Rs. 64.42 crore at Nangal and Rs. 10.99 crore at Panipat in the capital cost is correct.

(ii) In the event the accounting treatment as at (i) above is not found correct, what accounting treatment is to be followed by the company considering the nature of project of reimbursement of capital cost by the GOI?

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to accounting treatment of price reduction claimed by the company in respect of a contract from the contractor. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting treatment of reimbursement of capital cost of the project and various other costs from the Government, accounting for grants/subsidy received from the Government, etc. The opinion, expressed hereinafter, is purely from accounting perspective and not from the perspective of interpretation of norms for reimbursements of various elements of fixed and other costs as the accounting considerations are different from the considerations of the Government allowing reimbursement/Government grant/subsidy in respect of the Project.

13. The Committee is of the view that the accounting for price reduction would depend upon the nature of such reduction. In this context, the Committee notes the following paragraphs from the contracts between the LSTK contractor and the company (a copy of which has been supplied by the querist for the perusal of the Committee):

"11.0 Price Reduction Clause

11.1 If for reasons not attributable to the Owner or due to conditions not constituting Force Majeure as defined in this Contract, the Work is not completed in accordance with the provisions hereof, within and in accordance with the Time Schedule/ time for Completion as indicated in the terms and conditions of the Contract, it is agreed that the Owner shall be entitled to recover and/or the Contractor shall pay to the Owner, without prejudice to any other rights or remedy available to the Owner, the following amount as mutually agreed compensation.

> 11.1.1 A sum equivalent to 0.5% of the Contract price for every complete week or part thereof, for delay in completion of milestone activities separately for "Mechanical Completion" and "Hooking up & commissioning" of Plant by the Contractor, subject to a maximum 5% of total contract Price inclusive of escalation and contingencies, if any."
>
> "11.3 The amounts, as set in clause 11.1 is agreed upon and fixed by the parties due to difficulties in ascertaining, on the date hereof, the exact amount that will be actually incurred by the Owner in such event, and parties hereby agreed that amount specified herein are a genuine pre-estimate made by the parties of the loss and damage which the Owner would have suffered and as by way of mutually determined reasonable compensation payable to the Owner and without the Owner required to establish and prove the actual loss/damage suffered by the Owner, not in the nature of penalty and shall be applicable regardless of the amount of such deduction in value actually sustained by the Owner.
>
> 11.4 The parties agree and acknowledge that the amount set of in clause 11.1 above may be recovered by the Owner from the amount to be paid to the Contractor and the Contract Price shall stand reduced by such amount."

From the above, the Committee notes that the price reduction/compensation in the extant case is towards recovery of estimated loss and damages that would be incurred by the company. Further, the Committee notes that the terms of the agreement with the contractors themselves describe the amount to be recovered on account of delay in completion of the Project as 'Price Reduction', which indicate that this is merely an adjustment of price in case of delay in the completion of project. The Committee also notes that the amount of compensation would be recovered by the company from the amount to be paid to the contractor and the contract price shall stand reduced by such amount. Accordingly, the Committee is of the view that since the contract price itself would be reduced by the amount of compensation, the price reduction in the extant case is a reduction from the contract price and therefore, is a part of the process for determination of contract price of LSTK contract and, in substance, should be considered as a component of acquisition price of the relevant fixed asset under the LSTK contract. Accordingly, the price reduction in the extant case should be reduced from the cost of the asset/LSTK project concerned and should not be recognised in the statement of profit and loss.

14. With reference to the earlier opinion of the Committee referred to by the Government auditor in support of his contention, the Committee notes that the facts of the earlier opinion in respect of liquidated damages were different from the facts of the extant case and therefore, the opinion expressed in that case, that the liquidated damages cannot be adjusted in the cost of purchase, cannot be applied in the extant case.

D. Opinion

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

(i) The accounting treatment of adjustment of price reduction of Rs. 64.42 crore at Nangal and Rs. 10.99 crore at Panipat in the capital cost is correct, as discussed in paragraph 13 above.

(ii) In view of (i) above, answer to this question does not arise.

Query No. 34

Subject: Accounting for payments made by the company for Prospective Multirole Fighter (PMF) Project.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a navratna public sector undertaking (PSU) under the Department of Defence Production, Ministry of Defence (MoD). It is a Government company as per section *617* of the Companies Act, 1956. State-of-the-art design and production infrastructure for Aircraft, Helicopters, Engines, Accessories and Support Systems have been established by the company. The company is currently

[1] Opinion finalised by the Committee on 11.12.2014.

handling the design and development of Light Combat Aircraft (LCA), Intermediate Jet Trainer (IJT), Prospective Multirole Fighter (PMF), Multi-role Transport Aircraft (MTA), Hindustan Turbo Trainer (HTT-40), Light Combat Helicopter (LCH), Light Utility Helicopter (LUH), etc.

2. The querist has stated that design and development activities of aircraft / helicopters are in general carried out in the following stages considering the customer requirements/ specifications:

- Finalisation of technical specifications
- Preliminary design
- Detail design
- Manufacture of prototypes & test articles
- Ground testing
- Flight testing
- Development of technical training aids including simulators
- Technical publications and manuals
- Certification and release for service use

3. Prospective Multirole Fighter (PMF) project is a collaborative design and development (D&D) effort being undertaken by the company and Russian partner pursuant to an Inter-Government Agreement (IGA) signed on 18th October, 2007 between the Governments of the Republic of India and the Russian Federation. As per the IGA, the company is designated as the implementation agency from the Indian side and M/s XYZ has been designated as the implementation agency from the Russian side. The IGA for the PMF project lays down the broad agreements between the Indian and Russian Governments on all matters connected with the project and defines the representatives of the two Governments who will administer the IGA. It also defines the organizations in both the countries who are tasked with the actual implementation of the project underlying the IGA. All further contracts under the aegis of the IGA are signed between the two implementation organizations. For PMF project, the Government of India nominated the company as the implementation organisation from the Indian side owing to the company's past experience and its prominent position in

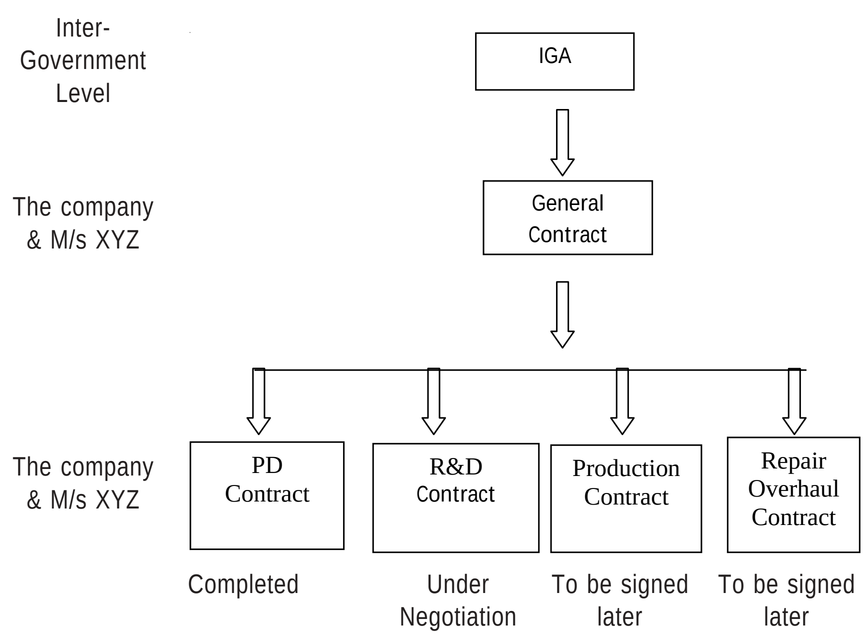
the field of aeronautics in India. The company and M/s XYZ have further signed a General Contract that governs the broad principles of cooperation, general terms and conditions and execution stages. The D&D of the PMF is implemented in the following two main stages:

(a) Preliminary Design (PD) stage for which a contract was signed between the company and M/s XYZ in December 2010 after obtaining the approval of Cabinet Committee on Security (CCS). The work execution under this stage has been completed by June 2013.

(b) R&D stage for which a contract is presently under negotiation by a Commercial Negotiation Committee of the Ministry of Defence (MoD).

For better understanding of the facts, the querist has provided the hierarchy of contracts for PMF project as follows:

Hierarchy of Contracts for PMF project



4. During the PD stage, as per the milestones defined in the PD Contract, the company received various deliverables (goods and services) from M/s XYZ in the financial year (F.Y.) 2011-12 and F.Y. 2012-13. For F.Y. 2012-

13, the aggregate value of such deliverables amounted to Rs. 1136.74 crores for which payment was made to M/s XYZ as per the provisions of the PD Contract. The company, as per its accounting policy 9.2, accounted the payment to M/s XYZ as D&D expenditure and D&D sales during F.Y. 2012-13.

5. Audit, vide their enquiry, commented upon the company's accounting for payments to M/s XYZ as D&D expenditure/ sales in F.Y. 2012-13 that:

- Revenue recognition by the company was not in accordance with Accounting Standard (AS) 9, 'Revenue Recognition'.
- The payment to M/s XYZ should have been treated as an intangible asset as per Accounting Standard (AS) 26, 'Intangible Assets'.

6. After the factual position was explained by the company in its written response, a provisional comment was issued by the audit stating that payments made by the company to M/s XYZ cannot be considered as part of the company's development expenditure and sales. However, the references to AS 9 and AS 26 in the earlier enquiry were not present in the provisional comments.

7. After submission by the company of explanations to the provisional comments, the comments were ultimately dropped. However, in view of the issues raised by audit, the company gave an assurance that the matter will be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) for an opinion and that necessary accounting action, if any, following the opinion will be undertaken during F.Y. 2013-14.

Background of D&D of PMF

8. PMF Project involves design and development in collaboration with Russian partner of an advanced fighter aircraft that will have state-of-the-art technological features. D&D of PMF will lead to certification of this aircraft for use primarily by the Russian and Indian Air Forces.

9. Based on the IGA signed between the two Governments on co-operation in development and production of the aircraft, a General Contract was signed on 22.12.2008 between M/s XYZ and the company. The General Contract outlines the broad principles of co-operation, general terms and conditions and execution stages of the project. As per bilateral understanding, funding

for the project will be equally shared between the Indian and the Russian Governments.

10. The design of PMF is based on the basic structural and system design of a similar Russian aircraft, the development of which is under a separate Russian Government project. To this baseline design, which is adopted for PMF, suitable modifications to meet the specifications as per the joint technical requirements have to be incorporated by the company and M/s XYZ as per mutually agreed work share to create the aircraft. Although the scope of activities in the PMF project includes many activities towards development of new technologies that can be classified as research. However, as per the querist, the share of such activities as a proportion of the overall cost of the PD stage is not very significant. Hence, it is safe to state that the scope of work in the PMF project will more appropriately meet the definition of development as per AS 9. Moreover, there are no significant uncertainties regarding the technical feasibility of the product. In view of all these aspects, the scope of work of PMF cannot be classified meaningfully as 'research' as per AS 26.

11. The PD Contract between the company and M/s XYZ was signed on 21.12.2010 after the MoD completed the contract and price negotiations and obtained clearance from the Cabinet Committee on Security (CCS). The Government of India formally accorded sanction to the company for the PD phase of PMF project in January, 2011 and an amendment dated March, 2011. The Indian portion of expenditure on PMF Project is met from the capital budget of the Indian Air Force.

12. The total sanction for the PD phase was 315.2 million USD with the following breakup.

(a) 295.2 million USD as cost of PD phase which is covered by the PD Contract, out of which;

    (i) 52 million USD for Indian work share to be expended by the company.

    (ii) 243.2 million USD to be paid to Russian side for delivery of goods and services to the company as per PD Contract.

(b) 20 million USD for infrastructure build-up within India for PD phase.

13. The deliverables to the company from the Russian side as per PD contract are broadly summarised below:

Stage-1 (T_0+3 months)

- Initial data pertaining to the general design of the aircraft
- Detailed technical specifications of equipment, structures and systems to be designed by the Indian side
- Supply of special software to the company for enabling joint design work
- Training of Indian designers in use of this special software
- Delivery of training materials (hand-outs for the trainees)

Stage-2 (Progressively from T_0+10 months to T_0+18 months)

- PD Books describing design of the aircraft in detail.
- System design details, schematics, diagrams, etc.
- Details on various computations.
- Programmes of ground testing and flight testing.
- Details of flying test beds.
- Plan for production of prototypes and technologies involved.
- Reports and results of scientific research on materials, technologies and other design elements.

14. Indian and Russian sides commenced their works relating to Preliminary Design (PD) of the PMF in February, 2011 (T_0 as per the PD Contract). The company along with other Indian co-executers progressed with the Indian work share. Russian side progressed with their work share responsibilities as per the PD contract and completed various milestones. With completion of both Indian and Russian deliverables and activities, the PD Contract has been closed by June, 2013.

Accounting treatment of D&D sales in general by the company:

15. During D&D, a product required by the customer is designed and developed by the company and certified for service usage. Based on successful D&D, the customer will order production and delivery of the product on a large scale. This latter stage is usually termed as Series Production.

16. The cost of the D&D is fully funded by the customer (IAF, Navy, Army, etc.). During D&D, expenditures are incurred by the company on the following major items:

- Design drawings, production documentation, manuals and other technical publications
- Prototypes built for ground and flight testing
- Rigs and test articles required for ground testing
- Ground & flight testing
- Technical training aids including simulators
- Ground support equipment/ ground handling equipment
- Development of software for the aircraft, rigs, simulator, etc.

17. The unique feature of the D&D stage is that although various goods and services as above are generated in the process of D&D, these are not deliverable to the customer. Rather, these goods and services can be construed as consumed by the D&D process itself. Production and consumption of these goods and services are evidenced to the customer by completion of various milestones and activities of the D&D project.

18. During D&D, customer normally releases funds to the company based on a set of project milestones which are reflected in the sanction letters or contracts as applicable. D&D expenses accrue progressively as each stage of D&D is being completed. The recognition of revenues for D&D projects is normally based on such defined milestones and activities.

19. D&D projects are normally taken up by the R&D centres of the company which are dedicated to design and development of products and services and the related development of technologies. The R&D centres of the

company are approved by the Department of Scientific and Industrial Research (DSIR) and the approvals are periodically renewed. For these R&D centres, all expenditures related to D&D projects can be assumed to be incurred in the ordinary course of business.

20. The expenditure incurred on design and development projects can be broadly classified under three categories.

(a) Labour: The man-hours booked against projects are accounted under respective work orders and converted into labour cost by multiplication with the man-hour rate which captures the wages and salaries and all other overhead expenditure as per absorption costing method.

(b) Material: Costs of raw materials, bought-out items, equipment, non-recurring costs for development of airborne equipment and ground-based test equipment, outsourced items, etc. expended during the D&D stage are accounted for as material cost.

(c) Sundry Direct Charges (SDC): All costs other than labour and material but directly chargeable to projects are accounted as SDC. Examples include technical assistance, training, deputation, testing charges, consultancy, insurance, etc. Stage payments made to sub-contractors, partners, collaborators, etc. as per contracts signed by the company with such parties are also normally accounted for as SDC. The querist has stated that the payments to Russian side which are the subject of this referral were also accounted for by the company as SDC.

21. As per accounting policy 9.2 of the company, development sales are set up on incurrence of expenditure identifiable to work orders and milestones achieved as per contract. Where milestones have not been defined, sales will be as per actual incurrence of expenditure.

22. Expenditure and sales in respect of all customer-funded D&D projects of the company are being accounted for as per the above accounting policy in a consistent manner over the years.

Accounting treatment of D&D cost of PMF and analysis of the Audit Comments:

23. The D&D of the aircraft under PMF project is undertaken by the Aircraft Research & Design Centre (ARDC) of the company as the prime agency supported by other R&D centres of the company, divisions of the company and external agencies such as the Defence Research & Development Organisation (DRDO)/ Council of Scientific & Industrial Research (CSIR) laboratories.

24. The deliverables from M/s XYZ to the company during the PD stage as per the PD Contract and the development expenditure/ sales accounted for by the company in the relevant financial years based on these deliverables are summarised below in the Table:

Stage/ Milestone	**Amount Million USD**
Stage 1 of PD:	
Elaboration and transfer to the company of design documentation	15.2691
Delivery of special software	9.0500
Delivery of training materials	1.2700
Training of the company specialists in special software	1.8800
Sub-total for F.Y. 2011-12 (sales booked in F.Y. 2011-12 = Rs. 125.93 crore)	**27.4691**
Stage 2 of PD:	
Elaboration of Preliminary Design and its preliminary acceptance by the company.	188.3805
Improvement of PD and its final acceptance by the company and delivery of PD documentation to the company.	27.3504
Sub-total for F.Y. 2012-13 (sales booked in F.Y. 2012-13 = Rs. 1136.74 crore)	**215.7309**
Total	**243.2000**

25. In addition to the above, expenditures incurred by the company on its own and expenditures of its Indian partners have also been accounted for as per accounting policy 9.2 in both the above financial years. There have been no audit observations in respect of the sales of Rs. 125.93 crore booked in F.Y. 2011-12 as per the Table above. However, audit made observations on the sales of Rs. 1,136.74 crore booked in F.Y. 2012-13, which is the subject of the present referral.

26. The Note included in the company's accounts for the year 2012-13 reads as follows:

"Development Sales in Note 22 of the Accounts includes Rs. 1,13,674.01 lakh being expenses incurred on Indian Prospective Multi-Role Fighter (PMF) towards training to Indian Specialists, training materials, supply of Design documents and special Software/ Database etc. for which payment was made to Russian side as project expenditure and accounted in the books as Direct Expenses under Note - 30. These Project Expenses have been accounted as Development Sales as per Accounting Policy 9.2." (Emphasis supplied by the querist.) On this Note, audit had remarked in the Provisional Comments that:

- Work performed by each party under the separate contract (meaning PD Contract) will be evaluated and accounted as that party's contribution to the programme.

- The joint 50:50 funding inspite of lower work share (<50%) for the Indian side (in physical terms) is the compensation mechanism which enables sharing of the know-how and IPR which would have otherwise remained exclusive property of the Russian side. The payments to M/s XYZ is also a part of the compensation mechanism for sharing of the know-how and IPR.

- There was no transfer of IPR involved, and whatever documents made available were supposed to be used by the company for fulfilment of Indian work share.

- The responsibility of the company was to draw the amount (from MoD/IAF) and pass on to M/s XYZ for its share of work based on achievement of milestones.

- The payments made by the company to M/s XYZ cannot be considered as part of the company's development expenditure.

- However, the company accounted the payments made to M/s XYZ as sundry direct charges treating it as the company's development expenditure and sales as per its accounting policy no. 9.2. This has resulted in overstatement of development sales and development expenditure by Rs. 1136.74 crore.

The audit observations and the point-wise responses have been provided by the querist for the perusal of the Committee.

27. The querist has stated that in order to gain a comprehensive understanding of the linkage between the work share and joint funding of the PMF project and thereby understand the basic issues which are at the root of the objections raised by the Government audit, it is necessary to analyse certain specific provisions of the IGA, General Contract and the PD contract and to derive logical conclusions therefrom. Accordingly, relevant extracts of various contracts and accounting policy of the company have also been provided by the querist for the perusal of the Committee.

28. Work share of PMF project for the total R&D stage can be divided into two categories based on the mode of execution.

(a) Work share of Russian side which is executed by the Russian side and funded by the Russian Government. (*This accounts for 50% of the cost of the PMF project. There are no cross border payments to Russia from India for this part*).

(b) Work share of the company, which accounts for the balance 50% of the cost of PMF project, is funded by the Government of India. This work can in turn be executed in either of the following two modes:

(i) Executed by (1) the company itself or (2) other Indian agencies or (3) vendors from third countries selected by the company and M/s XYZ by mutual agreement. (*There are no cross border payments from India to Russia for this portion of work*).

(ii) Executed by the Russian side for and on behalf of the company. (The company *receives goods and services from M/s XYZ as per milestones and payments defined in the contract. All cross border payments from India to Russia arise on account of this portion of work. As per the General*

> *Contract, if the company has to outsource any of its work to third parties, the Russian side has the first right of refusal. This essentially means that, as far as execution of the company's work share by any third entity is concerned, the status of M/s XYZ is equivalent to that of any other vendor of the company except for the preferential treatment to M/s XYZ as partner of the company in the project*).

(Emphasis supplied by the querist.)

29. The payments to M/s XYZ under the PD Contract amounting to a total of 243.2 Million USD are under category b(ii) above. The Indian share of 52 Million USD is under b(i) above. Both these expenditures are thus pursuant to Indian work share execution and derived from the overall 50% Indian funding for PMF project. These are thus, as per the querist, legitimate development expenditures of the company as the sole implementation agency from Indian side and as recipient of all Indian Government funding to PMF project.

30. Also, it can be observed that category (a) in paragraph 28 above represents 50% funding for the project by the Russian Government in which the company or the Government of India has no payment obligations. Therefore, according to the querist, the question of compensation for IPR or such other transfer payments to Russia does not arise in the case of PMF project. Further, with regard to creation of IPR for the company, the querist has separately clarified that in the case of PMF project, IGA is the uppermost contract from which all the other contracts derive their validity and strength. So, it is evident that no contract below the level of IGA can override the provisions in the IGA. As far as IPR is concerned, the IGA contains the following wordings:

> In the opening paragraph of the IGA, "The Government of the Republic of India and the Government of the Russian Federation, hereinafter referred to as the Parties…".
>
> In Article 1 of the IGA, "…The cooperation within the framework of this agreement shall be implemented to ensure equal rights of the Parties for Production of the fighter and availability of complete technology of its production..."

> In Article 9 of the IGA, "…All rights to the results of intellectual activity, created jointly in the course of implementation of the program shall belong to the Parties. … The results of intellectual activity jointly created in the course of implementation of the program, as well as the rights to their use shall be transferred to a third party by written consent of both Parties…".

In view of the above, it would be clear that the rights in respect of IP will get transferred to the Government of India as a party to the IGA. Additionally, the rights are shared between the Indian and the Russian Governments as 'Parties'. Coming to the specific issue of control, the company is not an agent, representative or delegate of the Government of India, but is only the organization nominated by the Government of India to implement the PMF programme from the Indian side. Therefore, it would be obvious that the company is in no position to exercise any control over the manner in which the rights under the PMF program are utilised by the Government of India in the future. Even though the General Contract and the PD contract have clauses regarding IP and mention the company as the Indian party, from the overriding nature of the IGA, it would be evident that the company will hold any such rights as a nominee of the Government of India. Also, at any stage during the project, Government of India would be free to alienate the rights of the company in this project and nominate any other entity in India to continue the implementation of the programme. In summary, the element of control which is an essential requirement of AS 26 is not met in the case of PMF project. Further, since the rights under the PMF programme, including the rights to produce the PMF aircraft after successful development, vest in the Government of India and Russia, there is no reasonable basis to expect that the future benefits from the project will definitely flow to the company. Form the foregoing, it would be apparent that the essential criteria as per AS 26 to recognise an intangible asset are not met in the case of PMF project. Consequently, as per paragraph 8 of AS 26, "if an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred".

31. As per the IGA, the rights for all the intellectual results created jointly in the course of PMF project belong to the parties. These rights can be used for production of the aircraft for the Armed Forces of both the countries and in general for the national defence of the State. Commercial exploitation by M/s XYZ or the company through sales to third countries is not permitted

and is subject to Inter-Governmental decisions. Even the production and sales of this aircraft by the company in the future for Indian Air Force will be based on quantities and funding to be decided by the Indian Government. The querist has further clarified that PMF project is of the category of 'R & D projects funded by the customers'. These projects cannot be classified as 'internal projects' due to obvious reasons. In these cases, the company considers the execution of the project as rendering of services to the customer and recognizes revenue as development sales.

32. The querist has further clarified that the company should not be considered as an agent of the Government. The querist is of the view that if this line of reasoning was taken, as per AS 9, the receipts on account of the PMF project should not be recognised as revenue and instead, only the commission payable to the company should be treated as revenue. In the case of PMF, as there is no such commission payable to the company, the revenue should be nil. In a general sense, for a company to be treated as an instrumentality or an agent of the 'State', it needs to be discharging functions or conducting business as a proxy of the 'State' and these functions should be sovereign in nature. In reality, this is not at all the case. According to the querist, if all PSUs in India were thus interpreted as agents of the India State, then none of them can recognise revenues as per AS 7 or AS 9. The querist has further stated that the Government of India, vide DPE O.M. No. 16(10)/90-GM dated 9th November, 1990 has instructed that when PSUs enter into commercial contracts, the following clause should mandatorily be incorporated.

> "It is expressly understood and agreed by and between (the corporation) and (the Indian PSU) that (the Indian PSU) is entering into the agreement solely on its own behalf and not on behalf of any other person or entity. In particular, it is expressly understood and agreed that the Government of India is not a party to this agreement and has no liabilities, obligations or rights hereunder. It is expressly understood and agreed that (the Indian PSU) is an independent legal entity with power and authority to enter into Contracts solely on its own behalf under the applicable Laws of India and general principles of Contract Law. The (company) expressly agrees, acknowledges and understands that (the Indian PSU) is not an agent, representative or delegate of the Government of India. ..."

According to the querist, one of the fundamental requirements of a principal-agent relationship is that the principal is answerable to third parties for the acts of the agent. The above mandatory clause in all commercial contracts by PSUs clearly negates this essential character of an agency relationship. This should be sufficient to dispel any fictional presumption that a PSU like the company in the extant case can be construed as an agent of the Government.

33. The querist has also clarified separately that the origin of the PMF project is the IAF's strategic requirement for a fifth generation fighter aircraft to meet its long term objectives of defence of the Indian nation. The acquisition mode chosen by the Government was the IGA route and the company was nominated (by the Government of India through the IGA) as the organization in India who will develop and produce the PMF aircraft in collaboration with Russian partners. Any product to be designed and developed should have a technical specification through which the customer defines the comprehensive set of requirements as applicable to the product. In the present case, the Technical Specification of the PMF aircraft are embodied in a joint Indo-Russian document called the Tactical Technical Assignment (TTA) which is signed by:

- IAF and the company from the Indian side, (IAF as the customer of the PMF aircraft and the company as IAF's vendor for design, development and production)
- Russian Air Force, another entity, M/s ABC and M/s XYZ from the Russian Federation. (Russian Air Force as customer of M/s ABC, M/s ABC in a role identical to that of the company, but with the additional role as Lead Designer of the PMF, M/s XYZ as the Russian Government agency through which all defence exports from Russia are regulated

The General Contract and the Preliminary Design Contract for PMF both mention that PMF will be designed and developed as per the TTA. Therefore, although there is no contract signed between the company and IAF in this case, the nature of IAF's position as the customer for PMF and the position of the company as the provider of services to IAF are both unmistakably inferable from the bilateral contracts mentioned above, the TTA and the role of MoD as mentioned earlier.

34. Unlike the case where a readymade equipment is procured off-the-shelf by IAF, the PMF aircraft has to be designed, developed and certified before it can be inducted into IAF (and Russian Air Force) during the production phase. This task of design & development has been assigned to the company on the Indian side through the IGA. Apart from funding, supervision, reviews, making its bases available for flight testing, etc., IAF does not undertake on its own any tasks of design and development. Therefore, as far as the underlying design engineering services involved in creation of PMF for IAF is concerned, according to the querist, the company is the service provider to IAF who is the company's customer for the PMF project. The funds provided to the company for PMF project under the PD contract as per the Government sanction are to be utilised by the company basically for the following types of expenditures:

- Expenditure related to activities directly undertaken by the company through its divisions
- Expenditure related to activities directly undertaken by other organisations in India including DRDO laboratories, CSIR laboratories, private vendors, etc.
- Payments to the Russian party (M/s XYZ) for goods delivered and services rendered by them to the company.
- Payments to vendors from third countries for goods delivered and services rendered by them to the company.

Funds required for all the above types of expenditures are claimed by the company from IAF through invoices raised by the company. The Government sanction specifies the stages of completion at which such invoices can be raised. Similarly, all payments made by the company to Russian party and to other organisations are based on invoices raised by such parties on the company.

35. According to the querist, there are two options available for revenue recognition in the extant case:

- Accounting Standard (AS) 7, 'Construction Contracts'
- Accounting Standard (AS) 9, 'Revenue Recognition'

Even a perfunctory reading of AS 7 would suggest that the application of the Accounting Standard is appropriate to contracts pertaining to construction of physical assets, such as, roads, dams, bridges, buildings, refineries etc. The creation of physical assets appears to be the main purpose and the services associated with such creation appear to be of a subsidiary significance. Also, in such contracts, it is rarely required to undertake research or development as defined in AS 26. On the other hand, AS 9 is the Standard that specifically deals with revenue recognition more comprehensively and is therefore, considered appropriate in the case of PMF project. As aforementioned, the company is the executor of the PMF project and IAF is its customer. All the activities undertaken during the creation of the PMF aircraft will meet the definition of development as per AS 26. Therefore, the revenues arising against rendering of design engineering services by the company to IAF for development of PMF aircraft will have to be treated as revenues from rendering of services under AS 9. As a corollary, once development is completed, delivery of aircraft in large numbers to IAF will result in revenues from sale of goods. Also, as the company is engaged routinely in design, development, production, overhaul, etc. of aircraft, the development of PMF is "in the course of the ordinary activities of the enterprise (the company)".

36. Further, paragraph 4.1 of AS 9 states that:

> ***"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration".***

All the requirements for measurement of revenue are met in the case of PMF project. It was also established earlier that the concept of agency relationship is not applicable in this case. Paragraph 7.1 of AS 9, inter alia, states "Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method". In the case of PMF project, the audit objection was related to recognition of expenditures and revenues on account of payments made by the company to the Russian party. Revenue was recognised based on proportionate completion method based on predefined milestones as per the PD contract. These milestones were also linked to various deliverables from the Russian side to the company. Therefore, when the milestones as per the PD Contract were completed and deliverables were received by the company, a well-defined and rational basis existed to recognise revenue by the proportionate completion method. Supply of goods and rendering of services by the Russian party is an essential ingredient for the company to fulfil its obligation as service provider to IAF who provided the funding and is the company's customer. Therefore, from the company's perspective, no special treatment needs to be adopted whether certain deliverables are procured from the Russian side or from any other supplier. All such expenditures which flow from valid commercial contracts signed by the company on its own capacity are inextricably connected with execution of the PMF project and are therefore, of the same character irrespective of the fact that the Russian party is also the company's partner in the project. Paragraph 9.1 of AS 9 states "Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection". In the instant case, revenue was exactly measureable as explained above. Also, as per the Government sanction to the company, for all payments due to the Russian side, the company was authorised to collect the funds from IAF in advance and remit to the Russian side based on completion of milestones as per the PD Contract. The exchange rate variation due to movements in Rupee/Dollar rate from the date of drawal of advance and the date of remittance to Russia was also fully protected as per the sanction. Therefore, collection was never under any uncertainty. In summary, the company maintains that the accounting for revenues of PMF project in respect of payments made to the Russian side fully complies with the provisions of AS 9.

B. Query

37. The querist has sought the opinion of the EAC as to whether the accounting treatment of the payments to the Russian side towards goods and services received by the company in accordance with the PD Contract for the PMF project as development expenditure and recognising as development sales during F.Y. 2012-13 as per accounting policy 9.2 of the company is in order.

C. Points considered by the Committee

38. The Committee notes that the issue raised by the querist relates to appropriateness of accounting treatment of the payments made to the Russian side towards goods and services received by the company pursuant to the PD contract for developing the preliminary design of the PMF (Project Multi Fighter) project as 'development expenditure' and also correspondingly recognising such payments as 'development sales'. 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, nomenclature of revenue and expenditure as 'development sales' and 'development expenditure', determination and measurement of project costs and revenues, recognition of revenue and expenditure relating to subsequent phases of the PMF project, accounting in the books of account (prepared, if any) of IAF, whether the activities carried out under the PMF project can be considered as 'research' activities as per AS 26, etc. Further, while considering the facts and forming its views on the aforesaid accounting treatment, the Committee has relied only on the extracts of the agreements furnished by the querist. The Committee has also presumed from the Facts of the Case that there is a principal to principal relationship, viz., no agency relationship, between the company and the Government or the IAF.

39. The Committee understands from the Facts of the Case that PMF project in the extant case is a design and development (D&D) activity, where the company considers IAF as its customer. Further, Preliminary Design (PD) stage is one of the stage of such D&D activity and for undertaking the activities of PD stage, a PD contract has been entered into by the company with M/s XYZ for its share of work under the PMF Project. The Committee also notes that according to the agreements (refer paragraph 28(b)(ii) of the Facts), with respect to the share of work to be performed by the company, the company has the option of either carrying out the work by itself, or sub-contracting the work to be carried out, with the first choice of refusal to be given to M/s XYZ from the Russian side. The company has opted for sub-contracting a part of the work to M/s XYZ, for which a separate agreement (PD contract) has been entered into between the company and M/s XYZ.

40. The Committee notes that as per PD contract, the scope of work to be performed by M/s XYZ includes preliminary designs, documentation, special software/ database and training for employees, etc. Accordingly, the issue

that arises from the above is whether the expenditure incurred towards these activities by the company results into creation of an asset or it results into an expense to be recognised in the statement of profit and loss. In this regard, the Committee notes the following paragraphs of AS 26, notified under the Companies (Accounting Standards) Rules, 2006 and the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

AS 26

"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."***

"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) ..."

Framework for the Preparation and Presentation of Financial Statements

"77. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities."

"96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

41. The Committee notes that in the extant case, there are specific clauses in the PD contract with respect to Intellectual Property Rights (IPRs). One of

the clauses states that "the company shall not copy or reproduce the documentation delivered in compliance with the present Contract and shall not use Russian inventions, "know-how" and other scientific and technical results contained in it for purposes other than the fulfilment of the Indian work share under this Contract without the prior written consent of M/s XYZ after receipt of the appropriate written request of the company. This Clause will apply reciprocally to M/s XYZ also". Further, the Committee notes from the Facts of the Case that the commercial exploitation by M/s XYZ or the company through sales to third countries is not permitted and is subject to Inter-Governmental decisions. Even the production and sales of this aircraft by the company in the future for Indian Air Force will be based on quantities and funding to be decided by the Indian Government. Moreover, due to overriding nature of the Inter-Government Agreement over any other contract, as stated by the querist in paragraph 30 above, any IPR generated out of the PD contract would belong to the Indian and Russian Governments and not to the company. Also, the company does not have the right to copy or reproduce any part of the documentation received for purposes other than the contract. Thus, although the PD contract may give rise to creation of IPR, know-how, etc., the company has no discretion with regard to their usage. In view of this, the Committee is of the view that since in the extant case, the company is holding any such rights only as a nominee of the Government for implementation of the PMF Project, no resource *controlled* by the company is arising out of the PD contract and therefore, the expenditure incurred on PD contract cannot be recognised as an asset and the same should be recognised as an expense in the statement of profit and loss as and when incurred.

42. The Committee further notes that since it is presumed in paragraph 38 above that there is a principal to principal relationship between the company and the Government or the IAF, for the company, IAF is its customer and the company is only an executor of the PMF project, who has been nominated by the Indian Government from Indian side for such project. Further, considering the activities involved in the PMF project (refer to paragraph 2 above), the Committee notes that the company is rendering design and development services to the IAF for development of PMF aircraft, which, as per the querist, meet the definition of development as per AS 26 (refer to paragraph 35 above). Accordingly, the Committee is of the view that although the PMF project would also involve creation of prototype of PMF aircraft and after its successful development would be consumed by the company itself for further manufacturing (viz., series production) by the company for IAF,

the PMF project is basically a contact for rendering design engineering services to the IAF and the creation of aircraft, which could be considered as a construction activity as per the principles of AS 7 is only an insignificant portion of such project. Accordingly, considering the economic substance of the contract from future series production by the company, the Committee is of the view that the principles of AS 9 would be applicable in the extant case. The Committee also notes the definition of revenue as per AS 9, Revenue Recognition, notified under the Companies (Accounting Standards) Rules, 2006, as below:

> ***"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them***. ..."

The Committee notes that the amount received by the company during the PD stage is towards preparation of preliminary designs, software, training materials and other documentation (refer to paragraph 24 above), which has been sub-contracted by the company under PD contract to the Russian agency. This indicates that the company is rendering the specified services to IAF, for which it is receiving consideration. Therefore, based on the definition of revenue as reproduced above, this amount should be recognised as revenue. Further, considering that the amount received is towards preliminary designs and training materials etc. which spans over a period of two years and the contract has specified milestones to be achieved at various points of time, the company should apply the principles of proportionate completion method for recognition of revenue over the contract period as envisaged in the following paragraphs of AS 9:

> ***"10. Revenue from sales or service transactions should be recognized when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed."***

"12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service."

"4.3 <u>Proportionate completion method</u> is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract."

"7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) ***Proportionate completion method-*** Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

..."

The Committee is of the view that the revenue should be recognised in accordance with the above paragraphs of AS 9 as per the proportionate completion method considering the degree of completion of services and achievement of various milestones as per the contract. Accordingly, the policy of the company to recognise 'development sales' would be correct provided it is in accordance with the principles of AS 9, as discussed above.

D. Opinion

43. On the basis of the above, the Committee is of the opinion that the accounting treatment of the payments to the Russian side towards goods

and services received by the company in accordance with the PD Contract for the PMF project as development expenditure and recognising as development sales during F.Y. 2012-13 as per accounting policy 9.2 of the company would be in order provided these are recognised as per the requirements of AS 9, as discussed in paragraph 42 above.

Query No. 35

Subject: ***Accounting treatment of unidentified receipts and unclaimed liability towards stale cheques to vendors and customers and de-recognition of income of the previous years on account of change in accounting policy in current financial year.*** [1]

A. Facts of the Case

1. A company is an unlisted, non-deposit accepting non-banking financial company registered with the Reserve Bank of India (RBI). The company is engaged in issuing credit cards to consumers in India.

2. Upto financial year (F.Y.) 2012-13, the following accounting policy was consistently followed and disclosed by the company:

> "Notes to Accounts 2C (iv) **-** Stale cheques including credit balance refund (CBR) credits, unidentified credits and other trade liabilities outstanding *for more than three years* are taken into income." (Emphasis supplied by the querist.)

Following are the details about these items:

Credit balance refund (CBR): Credit balance refunded to customer but cheque not presented by the customer.

[1] Opinion finalised by the Committee on 11.12.2014.

Unidentified credits: Any payment received by the company wherein either wrong credit card number is mentioned or no card number is mentioned is considered as unidentified credit. The origination of these payments can be classified under the following two categories:

(a) *Unidentified credit received from bank, i.e., Cash Management Partner (CMP)*:

These cheques are directly banked by CMP and money is received by the company. As these receipts cannot be credited into any customer account, hence, these are accounted for under 'Unidentified Credits Account (current liability account)' in general ledger. Remittances team follows a process for curing these payments by matching previous history, cheque series, partial match and various other means to identify the correct card number and subsequently, the payment is transferred from 'Unidentified Credits Account (current liability account)' to customers' account. This curing process by remittances team helps the curing of approximately 90% of such receipts. The remaining 10% lies in 'Unidentified Credits Account (current liability account)' and can be cured only when customer approaches the company.

(b) *Unidentified credit received from alternate payment modes (other than cheques)*:

Receipts from other sources like National Electronic Funds Transfer (NEFT), online payment options, over the counter (other than bank CMP as stated above) wherein customers' correct card number cannot be identified falls under this category. Such credits are also accounted in 'Unidentified Credits Account (current liability account)'. These kind of credits can also be cured only when customer approaches the company.

Other trade liabilities: This comprises any cheque issued to vendors but not presented for payment.

3. The querist has stated that upto F.Y. 2012-13, the above amounts were being kept in current liabilities for three years and then taken to income considering liability no more required. However, any claims afterwards by customers/vendors, which are very rare, are duly refunded by the company. Following were the key rationale to adopt the above policy upto F.Y. 2012-13:

(i) There is no specific Accounting Standard or law for the treatment of these types of transactions.

(ii) The company writes off all the recoverable from customers on 180 days past due and some of these payments may pertain to written off customers as well. The company does recovery follow ups through phone (if available) only for all the cases > Rs. 1,000 and physical visits for > Rs. 3,000. Hence, for the payments less than these threshold amounts or where customer is not contactable, the company will not be able to resolve these cases. Further, as the payment by customer could not be credited to his/her account due to lack of information provided by him/her, the debit balance in customer account may have got written off from books at 180 days past due. This is evident from the following data table that in F.Y. 2013-14, of the total unidentified credit cases resolved (when the customer approaches company), 38% of these cases were identified and credited to the written off customers' account.

Movement in these cases (aged > 3 months) during F.Y. 2013-14						
	Balance as on 31st March'14	**Total adjustment/ refunds in 2013-14**	**Adjustment against written off accounts**	**Adjustment against live accounts**	**Refunds < 3 year old cases**	**Refunds > 3 year old cases**
Numbers	**12,493**	**84**	32	50	1	1
Amount (Rs.)	**51,647,183**	**794,596**	251,323	535,905	5000	2,368

(iii) It is very unlikely that a customer will pay and forget to contact the company for three years.

(iv) No action on these liabilities after 3 years will result into piling up of non-movable transactions and balances in balance sheet which will weaken the overall control on these and are prone to fraud/ misappropriation/wrong adjustments.

(v) The policy does not deprive off the customer/vendor from their genuine claims even after three years though there are rarely such claims. In F.Y. 2013-14, only one such case came for and the company refunded the same.

(vi) The customers' base is more than 25 lacs and approximately 3.3 lacs payments are received every month. Out of this, approximately 200 payments per month form part these liabilities,

However, the Reserve Bank of India (RBI) and Comptroller and Auditor General of India (C&AG) have questioned the above policies in past (prior to F.Y. 2013-14) and in their view, the liability should not be taken to the income even after three years. Considering the views of these authorities, the company has changed the above accounting policy in F.Y. 2013-14 and discontinued recognising these liabilities in income even after 3 years. The policy was implemented prospectively for F.Y. 2013-14 onwards.

4. The auditors from C&AG office audited the financial statements for F.Y. 2013-14. Following are their observations and the corresponding management response to the same:

Observations	Management's response
As per AS 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.	The term 'prior period items', as defined in this AS 5, refers only to income or expenses which arise in the current period as *a result of errors or omissions* in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period.
Stale cheques issued by the company including those issued for credit balance refund (CBR), unidentified credits lying in the books of account and trade liabilities outstanding for more than three years were being considered as income by the company. On observations raised by RBI and C&AG of India in previous years that there should not be a policy to book	The company was following and disclosing the previous accounting policy consistently. However, the company reviewed its old policy and changed it accordingly in 2013-14. As in case of all policies, it was implemented prospectively. In case any refund is claimed by any party for any year, the Company refunds the money immediately.

these amounts as income, the company has stopped recognising this amount as income w.e.f F.Y. 2013-14. The amount of income recognised on this account in the previous years (March 2010 to March 2013) amounts to Rs. 12.21 crore. This income should be derecognized and the impact should be separately disclosed in profit and loss account as prior period item. The comments along with confirmation of facts may please be furnished in annotated form within three days from the date of issue of this observation.	Therefore, it is requested to drop this Audit Observation please.

However, C&AG office did not accept management's response and verbally advised the company to reverse all the incomes recognised in previous years (prior to F.Y. 2013-14) as well amounting to Rs. 12.21 crore.

B. Query

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

(i) In the light of the key rationale highlighted under paragraph 3 above, whether the company can adopt an accounting policy to write the liability back in the statement of profit and loss after a certain period (e.g., after 3 years) which will help the company to avoid piling up of non-movable transactions and balances in balance sheet which will weaken the overall control on these items and are prone to fraud/misappropriation/wrong adjustments.

(ii) As this was a policy change in F.Y. 2013-14, whether it will be appropriate to reverse all the previously recognised incomes considering that these were not an error or omission rather these were as per the accounting policy applicable in those years?

C. Points considered by the Committee

6. The Committee notes that the basic issues relate to correctness of the accounting treatment of writing back of the unclaimed liability towards credit balance refund, unidentified credits and other trade liabilities comprising cheques issued to vendors but not presented for payment, to the statement of profit and loss as 'income' after a period of 3 years, as mentioned in paragraph 2 above and since such treatment has been changed w.e.f. F.Y. 2013-14, whether such change should be considered as 'prior period item' or as 'change in accounting policy' as per the provisions of AS 5. 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, propriety of writing off all the recoverables from customers on 180 days past due, etc. Further, the Committee has opined purely from accounting perspective and not from any legal perspective in view of Rule 2 of the Advisory Service Rules. The Committee has also presumed in the extant case that the transactions and amounts in respect of the afore-mentioned accounting treatment are material.

7. At the outset, the Committee notes that the credit balances/liabilities being written off to the statement of profit and loss as income in the extant case can be broadly classified into two categories, first, unidentified credits from the customers for which adjustments against specific customers' dues are pending and second, unclaimed liability towards credit balance refund and other trade liabilities comprising cheques issued to vendors/customers but not presented for payment.

8. As far as the first issue relating to unidentified credits from customers for which adjustments against specific customers' dues are pending is concerned, the Committee is of the view that in order to determine the correctness of the accounting treatment, it is necessary to know the nature of the item, i.e., whether the unidentified credits can at all be considered as liabilities of the company or not. Therefore, the Committee notes the definition of the term 'liability' as per paragraphs 49(b), 59 and 61 from the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI as follows:

> "(b) A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

> "59. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities."

> "61. The settlement of a present obligation usually involves the enterprise giving of resources embodying economic benefits in order to satisfy the claim of the other party. ..."

The Committee notes from the above that a liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits for the satisfaction of the claim of the other party. The Committee notes that unidentified credit in the extant case represents the money received from the customers against their dues, which on account of certain problems, could not be identified with specific customers' dues (receivables) account and therefore, the settlement against the respective customers' accounts is pending. The Committee is of the view that such unidentified credits are merely recoveries against the receivable accounts that would not require any outflow of resources to satisfy the claims of any party and, therefore, cannot be considered as a liability of the company. The Committee further notes from the Facts of the Case that the company has a policy of writing off all the recoverables from customers that are 180 days past due. Therefore, it is possible that unidentified credits also relate to the written off recoverables as on the reporting date. Accordingly, the Committee is of the view that at the reporting date, the company should make an estimate as to whether the unidentified credits as on the reporting date relate to the recoverables written off during the reporting period, considering various factors, such as, outstanding date and period of the recoverables, date and amount of credit unidentified, etc. Accordingly, the Committee is of the view that on the basis of such estimate of the management, unidentified credits relating to the recoverables written off should be recognised as 'income' in the statement of profit and loss. Further, the Committee is of the view that in case the total amount of unidentified credit exceeds written off recoverables, income should be recognised only to the extent of written off recoverables.

9. With respect to unclaimed liability towards credit balance refund and other trade liabilities comprising cheques issued to vendors/customers but not presented for payment, the Committee is of view that these represent obligations of the company towards the vendors/customers involving outflow of resources embodying economic benefits and are therefore, these are to be treated as a liability. In this connection, with regard to the issue relating to accounting treatment to write back the unclaimed liability to the statement of profit and loss as 'income' after a period of 3 years, the Committee notes paragraphs 91-92 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, as reproduced below:

> **"Recognition of Income**
>
> 91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).
>
> 92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty."

From the above, the Committee notes that an income can be recognised due to decrease in liability, i.e., when a liability is no longer payable, for example, decrease in liability arising from the waiver of a debt payable or from the extinguishment/settlement of liability. The Committee also notes from paragraph 92 above that income can be recognised only in respect of those items that can be measured reliably and have a sufficient degree of certainty. The Committee is of the view that in case of an item of income resulting from decrease in liability, sufficient degree of certainty would normally arise only on extinguishment/settlement of liability. The Committee notes that in the extant case, the extinguishment/settlement through actual discharge or cancellation by the parties does not take place even after three years. Therefore, the Committee is of the view that assessment of liability as no longer payable should be made keeping in mind the relevant legal provisions, past experience, management estimates, etc. In this context, the Committee wishes to point out that if the requirements of the law are such that a debt does not expire/become time barred if the debtor continues to recognize the liability in respect of such debt in its books of account, then, the liability in such a situation can be written-off when the liability is considered to be no longer payable. Accordingly, the Committee is of the view that the accounting treatment of the company to write back a liability to the statement of profit and loss as its income automatically after three years would be correct only if it is done keeping in mind various factors, as explained above.

10. On the basis of the above, the Committee is of the view that the company should have followed the accounting treatment in respect of unidentified claims/unclaimed liability, as suggested above and if the company has not followed the same, it would be an incorrect accounting treatment followed by the company and the company should rectify the same treating it as 'Prior Period Item' in accordance with the following provisions of AS 5, notified under the 'Rules':

> ***"4.3 Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."***
>
> ***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***

11. With regard to the argument of treating the change in the accounting treatment for the unidentified credit/ unclaimed liability as change in accounting policy, the Committee notes the definition of 'accounting policies' as per AS 5 as follows:

> ***4.4 Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements."***

The Committee is of the view that in the extant case, it is a matter of accounting treatment in respect of the timing of derecognition of unidentified credit and extinguishment of unclaimed liability which is application of an accounting principle and not in itself a principle or method of application of principle, Therefore, there is no change in accounting policy.

D. Opinion

12. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

(i) The company should follow the accounting policy in respect of unidentified credit, as suggested in paragraph 8 above and in respect of unclaimed liability, as suggested in paragraph 9 above.

(ii) If the company has not followed the accounting treatment in respect of unidentified credit/unclaimed liability, as suggested in paragraphs 8 and 9 above, it would be an incorrect accounting treatment followed by the company. Accordingly, the company should rectify the same treating it as ‘Prior Period Item’ in accordance with the provisions of AS 5, notified under the ‘Rules’, as discussed in paragraph 10 above and not as a change in accounting policy, as discussed in paragraph 11 above.

Query no. 36

Subject: Accounting treatment of finished goods produced which are used for internal capital expansion.[1]

A. Facts of the Case

1. A Limited is an Indian multi-national in the manufacture of iron and steel products, such as, structural steel, plates & coils, wire rods etc. It has manufacturing units across India particularly in the central and eastern part

[1] Opinion finalised by the Committee on 11.12.2014.

of the country. It has subsidiaries, joint ventures and associates in India and abroad. The company is also into expansion mode and is establishing an integrated steel plant at a new location. For the construction of this plant, the company besides, external purchases, shall also be consuming its own manufactured products.

2. The querist has stated that the primary issue is whether finished products manufactured internally by a unit and consumed for capital consumption by another unit/ same unit can be regarded as 'revenue' in the statement of profit and loss. It may be noted that these manufactured finished products are also sold to external customers in the ordinary course of business in substantial volumes. Internal captive consumption is not material.

3. Secondary issues involve its (a) treatment when sold to related entities (b) cost of capitalisation in accordance with Accounting standard (AS) 10, 'Accounting for Fixed Assets' and (c) valuation when carried in inventories in accordance with Accounting Standard (AS) 2, 'Valuation of Inventories'.

4. The querist, while raising the issue has referred to the following literature:

- Accounting Standard – 1	Disclosure of Accounting Policies;
- Accounting Standard – 2	Valuation of Inventories;
- Accounting Standard – 9	Revenue Recognition;
- Accounting Standard – 10	Accounting for Fixed Assets;
- Accounting Standard – 21	Consolidated Financial Statements;
- Accounting Standard – 23	Accounting for Investments in Associates in Consolidated Financial Statements;
- Accounting Standard – 27	Financial Reporting of Interests in Joint Ventures;

- Announcement of the Institute of Chartered Accountants of India (ICAI) on 'Inter-divisional transfer' published in 'The Chartered Accountant', May 2005, pp 1531;

The following opinions of the Expert Advisory Committee of the ICAI:

Volume	Query No.	Subject matter
3	1.5	Whether materials produced by a company and used in an expansion project should be capitalized at the manufacturing cost or at selling price
5	1.17	Valuation of components manufactured for internal use as well as for sale to outsiders
7	1.31	Treatment of expenditure incurred on construction of godowns for self and on behalf of others
9	1.34	Accounting for internally manufactured spares
11	1.43	Disclosure of stocks of inter-unit transfers in the financial statements of a company
11	1.48	Capitalisation of the engineering overheads
15	1.7	Inclusion of internal transfers in turnover
22	20	Capitalisation of engineering overheads
27	8	Disclosure of internal consumption in the profit and loss account
29	34	Capitalisation of expenditures in respect of projects under construction
29	35	Capitalisation of expenditures in respect of projects under construction
29	36	Capitalisation of expenditures in respect of projects under construction

5. The querist has stated that in respect of the issue involved, three options could be considered:

Option 1: Goods capitalised are recognised as revenue with full disclosures in terms of quantity and value:

- This option is simple;

- The ratios could be analysed properly from a perusal of the published accounts which are general purpose financial statements;
- The company desires and is willing to disclose this treatment in the notes to the financial statements and to provide comprehensive quantitative details, such as, installed capacity, production of various products and products consumed internally for capital consumption in its published results even though not required by Schedule III to the Companies Act, 2013;
- It may be noted that the finished goods that are capitalized cannot be further processed by the company. There will be no value-add to these finished products.
- Had the company not consumed these goods for capital consumption, these would have been sold to external customers. Thus, by not following this method, the company would be understating its revenue;
- The market of these goods exists and the company is able to sell these goods without any problem. The objective is to ensure that the project cost is relatively lower. The material purchased from third parties will be more costlier than the internal cost. The goods are not specifically manufactured for capital consumption;
- Alternatively, the company can sell these goods to outsiders and then purchase from these outsiders these very goods for capital consumption. This methodology will give the same results as also given in option 1;
- Also, the opinions referred above and the ICAI announcement under 'Literature' above have been given in the perspective that:
    - o Goods are ultimately sold to external customers; and
    - o Due to inter-divisional transfer of goods, double recognition of revenue should be avoided;
- The Announcement and EAC opinions are not applicable to the present matter where goods are not ultimately sold to external customers but are consumed internally for capitalisation. Further,

the opinions are given in cases and are primarily applicable to 'intermediate' goods and not the 'finished' product;

- In this treatment:
  - o There is a change in the character of goods – from 'sale' to 'use';
  - o Thus, there is a change in the risk and reward profile of the goods;
  - o The ultimate collection is through 'use' embedded in the sale price of further goods manufactured through 'use' of capitalised products;
- It may be noted that the goods that are consumed are not a single item of a self-constructed asset. But it may also go in the construction of an asset that is being constructed by a third party. For example, in the cement industry, the cement manufacturer may be supplying cement to a building contractor constructing the office building for the cement manufacturer. The cement is either supplied free of cost or may be deducted from the running bill of the contractor.
- The company believes this treatment is in accordance with 'Substance over Form' as mentioned in paragraph 17 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies';
- That this option, as per the querist, is also supported by law (refer page 760 – 761 of Sampat Iyenger's Law of Income-tax, 10^{th} edition), which states that "In this context, the issue, as to the manner of taxation where stock in trade of the assessee is converted into capital asset or is merely withdrawn from the stock for personal use, would require a differential treatment as found in Sir Kikabhai Premchand v CIT (as held by Hon'ble SC in 1953 and reported in 24 ITR 506). It was held that if the stocks are valued at cost from year to year, the stocks that are withdrawn from the business *would be treated as having been sold* at cost for the purposes of computation from business and not at market value". (Emphasis supplied by the querist.)

- That paragraph 4.1 of Preface to the Statements of Accounting Standards, issued by the ICAI states, "Efforts will be made to issue Accounting Standards which are in conformity with the provisions of the applicable laws, customs, usages and business environment in India*. However, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law*". (Emphasis supplied by the querist.)

- This option facilitates the reconciliation of published data with various returns filed under various Acts such as excise, sales-tax and VAT;

- The querist has also observed that certain listed enterprises are following this practice.

Option 2: The value of goods capitalised is deducted from the cost of raw materials consumed and adequate disclosures are made:

- This follows the approach enunciated in the ICAI's Announcement and other literature referred above;

- But this option needs to appreciate that:

    - o There could be distortion of ratios over years within the enterprise and when compared with other entities, as 'revenue' is one of the indicators of enterprise growth;

    - o The value of goods capitalised consists of various components of costs, reducing only from cost of raw materials consumed will lead to understatement of 'cost of raw materials consumed' and overstatement of other expenses such as salaries, production and other overheads, interest, depreciation etc.;

    - o Schedule III to the Companies Act, 2013 requires total recognition and presentation of various items of cost;

    - o Enterprises are required to disclose 'indirect expenditure treated as part of capital work-in-progress' in the notes to the financial statements. Thus, to understand, for example, how much an enterprise has spent on say 'salaries & wages', a reader would be required to add figures from 3 data sources (a) statement of profit and loss (b) statement of indirect expenditure treated as capital work in progress and (c) statement of components of indirect cost embedded in the finished goods capitalised but data related to all components may not be disclosed;

- o Also, this presentation will not lead to complete recognition of all expenses of similar nature as a single item (It may be noted that the statement of profit and loss is now based on 'nature of expense' approach method);

- An alternative to this option is not to make any disclosures. Is this alternative view acceptable?

Option 3: As the goods consist of various components of cost, deduction is made from each component of cost and adequate disclosures are made:

- This option has a merit over option 2 as the costs are reduced from the correct head;

- However, generation of data for each component of cost could be a very complex, time consuming and expensive exercise and inconsistent with cost-benefit approach;

- But this approach will make the entire process of preparation and presentation of statement of profit and loss extremely complex and perhaps incomprehensible;

- An alternative to this option is not to make any disclosures, but this clearly is not advisable.

6. The querist has stated that the company presently measures the goods capitalised as a part of capital expansion project in accordance with Cost Accounting Standard 4 (CAS 4), 'Cost of Production for Captive Consumption' read with Rule 8 of the Central Excise Valuation Rules which, inter alia, provides that where the excisable goods are not sold but are used for consumption of the assessee or on his behalf in the production or manufacture of other articles, the value shall be 110% of the cost of

production or manufacture of such goods to be determined as per CAS 4, as required by circular dated 13th February, 2003, issued by Department of Revenue, Ministry of Finance and Company Affairs, Government of India. The querist pointed out that as per paragraph 4.1 of CAS 4, "cost of production shall consist of material consumed, direct wages and salaries, direct expenses, works overheads, quality control cost, research and development cost, packing cost, administrative overheads relating to production. To arrive at cost of production of goods dispatched for captive consumption, adjustment for stock of work-in-process, finished goods, recoveries for sales of scrap, wastage etc shall be made".

7. The querist drew the attention of the Committee to the requirements of paragraph 10 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which states that "In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5. Included in the gross book value are cost 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".

8. The querist also noted the requirements of paragraph 6 of Accounting Standard (AS) 2, 'Valuation of Inventories', which provides that "the cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition".

9. The querist pointed out that one of the costs that is included under AS 10 is borrowing cost, which is not included either under CAS 4 or AS 2.

B. Query

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

(a) Whether goods manufactured internally (which can also be sold to external customers) and capitalised as a part of capital work-in-progress or tangible fixed assets can be considered as 'revenue' in the statement of profit and loss. If yes, whether the treatment and disclosures proposed in option 1 (refer paragraph 5 above) shall be in conformity with the accounting principles and accounting standards. If not, what is the correct treatment and requisite disclosures?

(b) If answer to query (a) above is 'no', then, which of the options out of options 2 and 3 (refer paragraph 5 above) should be adopted and what should be the accounting and disclosures requirement? If neither option 2 nor option 3 is acceptable, what is the correct methodology for accounting and presentation in general purpose financial statements.

(c) The company will be selling the goods manufactured by it to its subsidiaries, step-down subsidiaries, joint ventures and associates and the transactions will be at 'arm's length'. Further, these enterprises shall be capitalising these goods as part of tangible fixed assets. In such a case, how should these transactions be recognised, measured, presented and disclosed in the consolidated financial statements prepared by the holding company so that these are in compliance with Accounting Standard (AS) 21, 'Consolidated Financial Statements', Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', and Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures'?

(d) When capitalising an internally manufactured finished product, whether the value of capitalised item to be adopted should be as per (a) Cost Accounting Standard 4, 'Cost of Production for Captive Consumption' read with relevant excise law circulars (refer paragraph 6 above), (b) AS 2, 'Valuation of Inventories' (refer paragraph 8 above), or (c) AS 10, 'Accounting for Fixed Assets' (refer paragraph 7 above). If neither of these alternatives are acceptable, suggest the correct valuation methodology.

(e) Presently, the company is valuing its inventory in accordance with AS 2, i.e., lower of cost or net realisable value. As per the querist, the issue is that the company may not be aware as on the reporting date whether the goods carried in inventory shall be used for capital consumption in subsequent years. In case the company is not aware whether the goods carried in inventory shall be used for capital consumption in subsequent years:

- Will it be appropriate to value the said goods in accordance with the present practice, i.e., lower of cost or net realisable value?

- If so, if such valuation differs from the valuation determined in accordance with paragraph 10 of AS 10, how should the differential in two values be recognised and disclosed in the annual results when these products are used for capital consumption in a subsequent year?

In case the company is aware that the goods, as identified, carried in inventory shall be used for capital consumption in subsequent years, what should be the basis of valuation of such goods?

C. Points considered by the Committee

11. The Committee has examined the issues raised in paragraph 10 above, purely from accounting point of view and has not evaluated the compliance or otherwise of this matter with the applicable laws and regulations including excise rules, requirements relating to cost accounting records etc. since as per Rule 2 of the Advisory Service Rules of the Committee, the Committee does not answer issues that involve purely interpretation of legal enactments. Similarly, the Committee has not evaluated any tax implications of the matters under consideration. Further, the opinion expressed below does not deal with the associated presentation and disclosure matters, such as segment reporting, related party disclosures, disclosures required by Schedule III of the Companies Act, 2013 etc., which should be carried out in accordance with the relevant requirements, as applicable.

12. The Committee notes that, as per the querist, internal captive consumption is not material (refer to paragraph 2 above). The Committee has examined the matter from the perspective of accounting principles. However, as per the 'Preface to the Statements of Accounting Standards, issued by the Council of the Institute of Chartered Accountants of India (ICAI), "the Accounting Standards are intended to apply only to items which are material". Further, the Committee notes that with regard to the amount at which the finished product should be capitalised, the querist has referred to Cost Accounting Standards. The Committee is of the view that these are not relevant for the measurement of an item for the purpose of preparation of general purpose financial statements since the objective and purpose of such standards are different.

13. The Committee notes the following definition of 'revenue' as per Accounting Standard (AS) 9, Revenue Recognition:

> ***"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."***

The Committee also notes the following paragraphs from the Announcement on Treatment of Inter-divisional Transfers, issued by the ICAI in May 2005 (referred to as the 'Announcement'):

> "The use of the word 'enterprise' in the definition of the term 'revenue' clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term 'revenue'. Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard (AS) 9, Revenue Recognition. ..."

> "Since in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers."

14. Considering the above, the Committee is of the view that goods manufactured internally, which are used for the purpose of capital expansion project of the company, cannot be considered as revenue of the company. The Committee notes that this view is also consistent with the EAC opinions referred to by the querist in paragraph 4 above.

15. The Committee also considers the querist's view that the earlier EAC opinions and the Announcement are not applicable to the present situation since ultimately goods are not sold to external customers but are consumed internally for capitalisation and hence, there is no double recognition of revenue, and also that the earlier opinions were primarily applicable to 'intermediate' goods and not to the 'finished' product. The Committee is of the view that these aspects do not have an impact on the matter under consideration since in both the cases, i.e., where the goods are transferred

to other divisions for onward processing and sale and, where the goods are transferred for capital expansion project within the company, no sale of goods to external customers is involved. Therefore, recognition of revenue is not appropriate.

16. The Committee notes that the cost of finished goods capitalised comprise various components, such as, raw materials, production and other overheads, depreciation etc. In view of this, it would not be appropriate to deduct the entire cost of goods capitalised from the cost of raw materials consumed, as suggested by the querist as Option 2 (refer paragraph 5 above). The various components of cost of finished goods should be reduced from the relevant heads. This position is similar to the situation where a company uses its internal department, say engineering department, for capitalisation activity, and the salary of the personnel of that department is capitalised as a part of the capital work-in-progress. The company should make suitable disclosures by way of a note to explain the above.

17. With regard to the situation where the goods manufactured by the company are sold to its subsidiary, joint venture and associate companies and these companies capitalise these goods as a part of capital work-in progress or tangible fixed assets, in the context of consolidated financial statements, the Committee is of the view that in such cases, the general principles laid down in AS 21, 'Consolidated Financial Statements', AS 23, 'Accounting for Investments in Associates in Consolidated Financial Statements' and AS 27, 'Financial Reporting of Interests in Joint Ventures', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') as reproduced below, should be applied:

> *AS 21, Consolidated Financial Statements:*
>
> "***16. Intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.***
>
> 17. Intragroup balances and intragroup transactions, including sales, expenses and dividends, are eliminated in full. Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealised losses resulting from intragroup transactions that

are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered."

In view of the above, while preparing the consolidated financial statements, the company would eliminate the intragroup transaction of sale of finished products and unrealised profit, if any, included in the carrying amount of tangible fixed assets. The overall impact from the perspective of the consolidated financial statements, would be the same as if the financial statements of a single enterprise are prepared considering the subsidiary as a division. Therefore, the accounting treatment explained in the above paragraphs would be equally relevant in the context of consolidated financial statements when the goods manufactured are sold to a subsidiary company.

AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

13. In using equity method for accounting for investment in an associate, unrealised profits and losses resulting from transactions between the investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor's interest in the associate. Unrealised losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.

Considering the above requirements of AS 23, the company, in its consolidated financial statements, in effect, should eliminate unrealised profits and losses to the extent of the company's interest in the associate entity (assuming that the cost of the transferred asset can be recovered).

AS 27, Financial Reporting of Interests in Joint Ventures:

"40. When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss."

> 44. In the separate financial statements of the venturer, the full amount of gain or loss on the transactions taking place between the venturer and the jointly controlled entity is recognised. However, while preparing the consolidated financial statements, the venturer's share of the unrealised gain or loss is eliminated. Unrealised losses are not eliminated, if and to the extent they represent a reduction in the net realisable value of current assets or an impairment loss. The venturer, in effect, recognises, in consolidated financial statements, only that portion of gain or loss which is attributable to the interests of other venturers."

Considering the above requirements of AS 27, the company, in its consolidated financial statements, in effect, should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers (assuming unrealised losses do not represent a reduction in the net realisable value of current assets or an impairment loss).

18. The Committee is of the view that till the change in intention of the company to transfer the inventory item (finished goods) to capital work-in progress or tangible fixed assets, the company needs to follow the measurement principles of AS 2, Valuation of Inventories, since till that time, the intention was to sell the inventory item in the ordinary course of business. Once there is a change in intention of the company from 'sale in the ordinary course of business' to 'use in internal capital project', the question arises with regard to the value at which the transfer should be made. In this regard, the Committee notes the requirements of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Rules, as follows:

> "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.

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."

"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 the above, the Committee notes that the cost of an item of fixed assets comprises the cost of various items/elements that are directly attributable to bringing the asset to its working condition for its intended use. Accordingly, the Committee is of the view that the transfer should be made at cost. In case, such items of inventories are being carried in the books at 'net realisable value' as per the principles of AS 2, the Committee is of the view that inventories should be brought back to their cost through the statement of profit and loss, as per the requirements of AS 2.

19. With regard to capitalisation of 'borrowing costs', the Committee is of the view that as per AS 16, borrowing costs should be capitalised (subject to fulfilment of other criteria prescribed therein) only if these are directly attributable to the acquisition, construction or production of a qualifying asset. In the present case, till the time, the finished goods are held by the company for sale in the ordinary course of business, it would not meet the definition of a qualifying asset and, hence, borrowing costs cannot be capitalised. Once these assets are classified as a part of capital work-in progress, the relevant costs would be considered for capitalisation of borrowing costs (provided the underlying capital expansion project meets the definition of 'qualifying asset' and other criteria laid down in AS 16 are met). The Committee is of the view that change in the expected usage of finished goods from 'sale in the ordinary course of business' to 'use in the internal capital project' is the trigger point for determining its classification and subsequent accounting thereof.

20. With regard to the accounting as at the reporting date, the Committee notes the difficulty expressed by the querist that the company may not be aware as on the reporting date whether the goods carried as inventory shall

be used for capital expansion in subsequent years. However, the Committee is of the view that such a situation may not arise due to reasons stated in paragraphs 18 and 19 above. Till the time, the finished goods are held by the company for sale in the ordinary course of business and not identified for use in the fixed asset, they would meet the definition of inventory and would continue to be classified as such. Change in the expected usage of finished goods from 'sale in the ordinary course of business' to 'use in the internal capital project' should be the trigger point for determining its classification and subsequent accounting thereof.

D. Opinion

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

(a) The goods manufactured internally and capitalised as a part of capital work-in-progress or tangible fixed assets, should not be considered as revenue.

(b) Various components of the cost of finished goods produced should be deducted from the respective heads. The company should make suitable disclosures by way of a note to explain the above as stated in paragraph 16 above.

(c) In case the finished products are sold to subsidiaries/ step subsidiaries, joint ventures and associates and are capitalised by these entities as a part of capital work-in progress or tangible fixed assets, the querist should apply the principles laid down in AS 21, AS 23 and AS 27, referred to in paragraph 17 above, for the purpose of preparing consolidated financial statements.

(d) Till the change in intention of the company to transfer the inventory item (finished goods) to capital work-in progress or tangible fixed assets, the company needs to follow the measurement principles of AS 2, Valuation of Inventories. The transfer from inventory to capital work-in-progress or tangible fixed asset should be made at its cost and, subsequent measurement should be in accordance with requirements of AS 10, Accounting for Fixed Assets, as discussed in paragraphs 18 to 20 above.

(e) Till the time, the finished goods are held by the company for sale in the ordinary course of business and not identified for use in the fixed asset, they would meet the definition of inventory and would continue to be classified as such. Change in the expected usage of finished goods from 'sale in the ordinary course of business' to 'use in the internal capital project' should be the trigger point for determining its classification and subsequent accounting thereof.

Query No. 37

Subject: Accounting treatment of exchange variation in respect of foreign operations of the company as per AS 11.[1]

A. Facts of the Case

1. A public limited company, which is a wholly owned subsidiary of a listed Government company (hereinafter referred to as the 'company'), is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. The company acquires oil and gas properties/blocks by way of acquisition of Participating Interest (PI) 100% or less therein either directly or through acquisition of shares of the legal entity owning the right in the oil and gas properties/blocks. The overseas oil and gas operations are generally conducted in joint ventures with other partners. The company has PI in these joint ventures either directly or acquisition of a company holding PI in the asset or through its wholly owned overseas subsidiary companies. Main consideration for holding PI through subsidiary companies is because of tax or host country's regulations or risk management point of view.

2. The company compiles its financial statements both on standalone and consolidated basis including the overseas subsidiaries in INR, following the requirements of Companies Act and Accounting Standards and Guidance

[1] Opinion finalised by the Committee on 11.12.2014.

Notes issued by the Institute of Chartered Accountants of India (ICAI). In respect of the overseas joint ventures directly held by the company, following procedure is followed for accounting for the company's share of expenditure:

- The company pays its estimated share of expenditure at the beginning of every month to the operator of the project termed as cash calls which is accounted as advance payment.
- The joint venture operator provides the periodic statement of expenditure which is considered for accounting for the company's share of expenditure in joint venture following Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures' on a line by line basis.
- The company receives its share of oil and gas production from the joint venture and markets the same either directly on its own or jointly through other consortium partners and the revenue is accounted for in the normal course of operation following the provisions of Accounting Standard (AS) 9, 'Revenue Recognition'.

Based on the above procedure, operations of such joint ventures are considered as 'Integral Foreign Operations' as per the criteria provided in Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'. Subsequent to the initial recording of the company's share of expenditure, income, assets and liabilities in the joint venture, the monetary items denominated in foreign currency are revalued at the end of the period and the exchange difference arising out of such revaluation is transferred to the statement of profit and loss.

3. In respect of joint ventures/projects held through overseas subsidiaries, following procedure is followed for accounting for the subsidiary company's share of expenditure, income, assets and liabilities in the joint venture:

- The overseas subsidiary operates with a substantial degree of autonomy over its operations and does not affect the day to day activities of the company. The management and control of the subsidiary is located in respective overseas jurisdiction.
- Periodically, the share of profit is received from the overseas subsidiary in the form of dividends which is accounted for as income in the books of the company.

- The financial statements of overseas subsidiaries are consolidated following the provisions of Accounting Standard (AS) 21 'Consolidated Financial Statements'. While compiling the consolidated financial statements of the company, the balance sheet items are converted at the period end exchange rate and the profit and loss items are converted at the average exchange rate for the period. The resulting exchange difference is transferred to the Foreign Currency Translation Reserve, which is part of 'Reserves and Surplus'.

Such overseas subsidiaries are considered as 'Non-integral Foreign Operations' as per the definition provided in AS 11.

4. The company is of the view that both types of foreign operations of the company are similar in substance but different in form, however for the same purpose. The only difference is the legal form of the operations, otherwise the operation through the subsidiary companies is essentially an extension of its direct operations. Thus, the accounting treatment as per AS 11 should not be different. As per the querist, there is separate accounting treatment for both types of foreign operations, which are in essence quite similar. The company is of view that both types of operations should be considered as 'integral foreign operations'.

5. As per paragraph 18 of AS 11, an integral foreign operation has been defined as the operation which carries on its business as if it were an extension to the reporting enterprise itself. The relevant paragraph of AS 11 has been reproduced below:

> *"18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation."*(Emphasis supplied by the querist.)

The Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, in paragraph 35 deals with 'substance over form' as one of the principles for reliability of financial statements. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. The principle of 'substance over form' is used "to ensure that financial statements give a complete, relevant, and accurate picture of transactions and events". If an entity practices the 'substance over form' concept, then the financial statements will show the overall financial reality of the entity (economic substance), rather than the legal form of transactions. In accounting for business transactions and other events, the measurement and reporting is for the economic impact of an event, instead of its legal form. Accordingly, as per the querist, considering 'substance over form' in the instant case, both types of operation should be treated as integral foreign operations as per the provisions of AS 11.

B. Query

6. In view of the above facts, the opinion of the Expert Advisory Committee of the ICAI is sought on the following issues:

(i) Whether the current accounting treatment of foreign operations of the company carried on through joint ventures held directly or through overseas subsidiary as per AS 11 is appropriate; or

(ii) Whether there is any other appropriate accounting treatment/ disclosure in respect of foreign operations of the company.

(iii) Whether the company can treat the operations conducted through overseas subsidiaries as integral foreign operations as per AS 11.

(iv) If the company has to treat the subsidiary companies as integral foreign operations as stated in point (iii) above, what will be the accounting treatment of the exchange variation in 'Foreign Currency Translation Reserve' till the date of switch over to 'Integral Foreign Operation'?

(v) Is there any need for revision of the relevant Accounting Standards to provide for the extant situation and to adhere to the basic accounting principle or substance over form?

C. Points considered by the Committee

7. The Committee notes that the basic issue relates to appropriateness of accounting treatment of the foreign operations of the company carried on through participating interest in joint operations with other partners, which is termed by the querist and hereinafter referred to as 'joint venture', held directly or through overseas subsidiary as per AS 11. 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, classification of joint operations with other partners as 'joint venture' and accounting for the company's share of expenditure, income, assets and liabilities in such joint venture as per AS 27, accounting for share of oil and gas production from joint venture, recognition of share of profit received in the form of dividend from the overseas subsidiary company, consolidation of financial statements of subsidiary companies as per AS 21, use of average exchange rate for the period for translating the items of statement of profit and loss of the foreign subsidiary companies, etc.

8. The Committee is of the view that the accounting treatment of foreign operations of the company carried on through joint ventures held directly or through overseas subsidiary as per AS 11 would depend upon whether the foreign operations are integral or non-integral to the operations of the company. In this regard, the Committee notes the definitions of 'integral foreign operation' and 'non-integral foreign operation', and paragraphs 18 to 20 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates,' notified under the Companies (Accounting Standards) Rules, 2006 as follows:

> ***"7.10 <u>Integral foreign operation</u> is a foreign operation, the activities of which are an integral part of those of the reporting enterprise."***
>
> ***"7.13 <u>Non-integral foreign operation</u> is a foreign operation that is not an integral foreign operation."***
>
> "18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit

the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification."

From the above, the Committee is of the view that classification of a foreign operation into integral or non-integral requires judgement in the specific facts and circumstances which takes into consideration the substance of the situation. Accordingly, if two foreign operations are similar in substance in the way these are financed or operate in relation to the reporting enterprise, these would be classified similarly (viz., integral or non-integral) as per the principles of AS 11. It is not the legal form, viz., subsidiary or joint venture that determines the classification under AS 11. If the operations of a subsidiary company are being carried out as if it were an extension of the company, the operations of even a subsidiary company would be classified as integral foreign operations. AS 11 nowhere states that the operations of a subsidiary company should essentially be classified as 'non-integral foreign operations' even when it is carrying operations as an extension of the holding company. This is also clear from the requirements of the Standard pertaining to 'change in the classification of a foreign operation' which states that a change in the way in which foreign operation is financed and operates in relation to the reporting enterprise (viz., substance) may lead to a change in the classification of foreign operation. Thus, it is possible that without a change in the legal form, an integral foreign operation may be reclassified as non-integral foreign operation and vice versa.

9. The Committee notes from the Facts of the Case that the querist has stated that the overseas subsidiary operates with a substantial degree of autonomy over its operations and does not affect the day to day activities of the company and that the management and control of the subsidiary is located in respective overseas jurisdiction. However, the Committee is of the view that this information is not sufficient to determine the classification of foreign operations as per the above-reproduced paragraphs of AS 11 and other factors as specified in AS 11 should also be considered. Determination of classification is a judgemental issue considering the facts and circumstances specific to the company in the light of the requirements of AS 11. The Committee is, therefore, of the view that the company should apply the criteria specified in the above paragraphs in its own facts and circumstances to determine whether the foreign operations of joint venture held directly or through overseas subsidiary are integral or non-integral.

10. After classification of foreign operation as discussed above, the Committee is of the view that accounting treatment should be followed accordingly, as per the provisions contained in the AS 11. In this regard, the Committee is of the view that after considering the above criteria, if it is determined that foreign operations of the company carried on through joint ventures held directly by the company, are integral foreign operations as per AS 11, then the accounting treatment as followed by the company is appropriate, otherwise it is not appropriate. Similarly, after considering the above criteria, if it is determined that foreign operations of the company carried on through a subsidiary of the company, are non-integral foreign operations as per AS 11, then the accounting treatment as followed by the company is appropriate, otherwise it is not appropriate.

11. With regard to the issue raised by the querist regarding the accounting treatment of the exchange variation in 'Foreign Currency Translation Reserve' till the date of switch over to integral foreign operation if the company has to treat the foreign operations conducted through the subsidiary companies as integral foreign operations, the Committee is of the view that if, facts and circumstances remaining the same, by considering the above criteria, it is determined that the foreign operations conducted through subsidiary company are integral foreign operations and not non-integral foreign operations, then it is an error in the preparation of the financial statements of earlier years and, therefore, it is a 'prior period item' as per Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in

Accounting Policies'. Accordingly, the company should rectify its error of prior accounting periods by making appropriate changes in the current reporting period by treating it as a 'prior period item' as per the provisions of AS 5.

D. Opinion

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

(i) and (ii) The appropriateness of accounting treatment of foreign operations of the company carried on through joint ventures held directly or through overseas subsidiary as per AS 11 would depend upon the classification of foreign operations as integral or non-integral foreign operations as per the provisions of AS 11, as discussed in paragraphs 8, 9 and 10 above.

(iii) The operations conducted through overseas subsidiaries can also be treated as integral foreign operations if the operations of a subsidiary company are being carried out as if it were an extension of the company as per the criteria of AS 11, as discussed in paragraph 8 above.

(iv) If after considering the above criteria as discussed in paragraphs 8 and 9 above, it is determined that the foreign operations conducted through subsidiary company are integral foreign operations and not non-integral foreign operations, then as discussed in paragraph 11 above, it is an error in the preparation of the financial statements of earlier years, and therefore, it is a prior period item as per AS 5.

(v) Since AS 11 adequately addresses the issue involved in the extant case, answer to this question does not arise.

Query No. 38

Subject: Accounting treatment of interest earned on surplus equity funds. [1]

A. Facts of the Case

1. A public sector undertaking is wholly owned by the Government of National Capital Territory of Delhi (GNCTD). The company is in the business of generation of power. The company has two power stations in operation, the tariff of which is regulated by the Delhi Electricity Regulatory Commission (DERC)/Central Electricity Regulatory Commission (CERC). The company had planned to set up a project of 750 megawatt (MW) gas based combined cycle power plant at Bamnauli (hereinafter referred to as the 'project'). The same was to be set up with debt/equity ratio of 30:70.

2. Equity for the project was to be invested by the GNCTD and debt portion was proposed to be availed equally from the GNCTD and Power Finance Corporation. The GNCTD had contributed towards equity amounting to Rs. 100 crore and Rs. 300 crore on 04.04.2011 and 30.11.2011, respectively. The company had initiated the pre-construction activity by awarding the contract to A Ltd. for diversion of 400 KV Bawana-Bamnauli D/C and 400 KV Ballabhgarh-Bamnauli transmission line. As per the contract with A Ltd. for pre-construction activity of the project, the company has been making payment out of the equity funds. The GNCTD had directed to the company that it should not incur any cost for construction of the project without any firm commitment of allotment of gas by the Central Electricity Authority/Government of India.

3. The querist has stated that the company on a regular basis has been investing the amount available in surplus out of the equity received for the project in the term deposits with the public sector banks as per the investment policy of the company. As per the conditions of sanction of equity contribution of the GNCTD, the interest income, if any, on the equity amount of the GNCTD shall be utilised as additional equity of the GNCTD and is to be utilised for the respective project. As the interest earned on equity funds is income of the company, no additional equity shares are being allotted to the GNCTD against such interest earned. The company has accounted for the interest as 'income' and has been re-investing the interest amount alongwith

[1] Opinion finalised by the Committee on 11.12.2014.

the balance equity available in the term deposits with public sector banks. The said amount of interest, being accounted for as income, is subject to income tax and is being retained in surplus profit and loss account on year-to-year basis. As on 31.03.2014, the company had outstanding equity amount of Rs. 301.20 crore and interest income as Rs. 45.64 crore, which has been invested in term deposits of public sector banks and shown under investments.

4. The Comptroller and Auditor General (CAG) of India, while conducting supplementary audit for the financial year (F.Y.) 2013-14, has issued the following Half-Margin:

> "Half Margin No. 4
>
> Cash and Cash equivalents - (Note-20)-Rs. 35,504.66 lakh
>
> Other income - Rs. 3,948.52 lakh
>
> Interest on Bank deposits –Rs. 3,571.02 lakh
>
> The cash and bank balance of Rs. 35,504.66 lakh includes Rs. 34,683.60 lakh received from GNCTD as equity contribution from GNCTD for the project at Bamnaulli. The equity contribution of Rs. 40,000 lakh was received in 2011-12 specially for Bamnaulli project with the condition that the expenditure will be incurred only for the purpose for which the equity has been sanctioned.
>
> The other income includes interest on bank deposit of Rs. 3,571.02 lakh received and accrued on bank deposit of the equity contribution from GNCTD for the project at Bamnaulli. Since the equity was sanctioned for a specific project of Bamnaulli, the interest earned on these funds should not be included in the income of the company and special reserve should be created and interest earned should be credited in the special reserve. Thus, crediting Rs. 3,571.02 lakh to other income resulted in overstatement of 'profit before tax' of Rs. 3,571.02 lakh and understatement of 'Special Reserve' under the head of reserves & surplus.
>
> The facts and figures mentioned above may kindly be confirmed and comments, if any, on the audit observation may be offered at the earliest. Documentary evidence in support of the contention made by the Company may kindly be furnished in support of the reply."

5. In reply to the half margin, the management has submitted the reply duly confirmed by statutory auditor, which is as below:

> "The interest earned on balance amount available out of the equity contribution from GNCTD for the project at Bamnauli has been reinvested in the term deposit with public sector banks as per the investment policy of the Company.
>
> The interest income earned by the Company on the above said investment is its income for the F.Y. 2013-14 as per the applicable accounting principles and also Income-tax Act, 1961. This had also been discussed and opinion obtained from two renowned Chartered Accountants' firms.
>
> As regards the suggestion in audit observation to transfer the applicable interest (net of tax), the same is an appropriation of profits which needs to be approved by Audit Committee, Board of Directors and finally confirmed by the AGM. As an additional measure, we are obtaining expert opinion of the Institute of Chartered Accountants of India (ICAI) on the issue and necessary action would be taken thereafter accordingly.
>
> In view of the above submission, it is requested that Audit may please drop this half margin."

The querist has also stated that there is no provision in the regulations of DERC/CERC for creation of any special reserve.

B. Query

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

(i) whether the company has to create the special reserve as pointed out by the CAG in respect of the interest earned on the surplus amount available out of the equity contribution by the GNCTD, when there is no provision in the regulations of DERC/CERC and other accounting principles for creation of any special reserve.

(ii) in case, EAC opines to create special reserve in line with the observations of CAG audit in respect of the interest earned (net of taxes) on the surplus amount available out of the equity contribution by the GNCTD, the accounting treatment of the same may be advised.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting for the interest earned from the investments of the surplus equity funds, where there is a restriction on utilisation of interest amount. 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 equity contribution by the GNCTD, treatment of debt contribution by the GNCTD and A Ltd., disclosure of term deposits by the company in its financial statements, etc. Further, it may be mentioned that the opinion expressed hereinafter is purely from the accounting perspective and not from the perspective of interpreting any legal enactments, such as, Income-tax Act, 1961.

8. The Committee notes that in order to determine the treatment of interest earned from the investments of surplus equity funds of the company, it is necessary to examine whether the interest earned by the company is an income to the company or not. In this regard, the Committee notes the following paragraph from the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, which reads as below:

"69. ...

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) ..."

From the above, the Committee is of the view that although there are restrictions on the utilisation of funds for the purpose of project only, interest earned by the company by investing the equity funds results into enhancement of assets for the company and accordingly, is an income to the company. The Committee further notes paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and

Changes in Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006, as reproduced below:

> **"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."***

On the basis of the above, the Committee is of the view that the interest earned on investments made out of the surplus equity funds should be credited to the statement of profit and loss as income of the company. However, in view of the specific requirement as per the conditions of sanction of equity contribution of the GNCTD that the interest income, if any, on the equity amount of GNCTD, shall be utilised as additional equity of GNCTD and is to be utilised for the respective project, as stated in paragraph 3 of the Facts of the Case, the Committee is of the view that the said interest after routing through the statement of profit and loss may be transferred to a specific reserve as an appropriation of profits with necessary disclosure in financial statements.

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) and (ii) The company should recognise the interest earned on the surplus funds available out of the equity contribution by the GNCTD as income by crediting the statement of profit and loss and thereafter, considering the specific requirements for utilisation of the said interest, it may be transferred to a specific reserve fund as an appropriation of profits with necessary disclosure in financial statements.

Query No. 39

Subject: Accounting treatment of contribution to Settlement Guarantee Fund by an Exchange.[1]

A. Facts of the Case

1. A public limited company, incorporated on April 23, 2003 under the Companies Act, 1956, is a professionally managed on-line multi commodity exchange (hereinafter referred to as the 'company' or the 'Exchange'). It is the only commodity exchange in the country promoted by national level institutions. This unique parentage enables it to offer a bouquet of benefits, which are currently in short supply in the commodity markets. The institutional promoters and shareholders of the company are prominent players in their respective fields and bring with them institutional building experience, trust, nation-wide reach, technology and risk management skills.

2. The company is regulated by the Forward Markets Commission (FMC), which is a regulatory authority overseen by the Ministry of Finance, Government of India. It is a statutory body set up in the year 1953 under the Forward Contracts (Regulation) Act, 1952.

3. The querist has stated that an exchange has an obligation for guarantee of settlement and therefore, there is a requirement to have a Settlement Guarantee Fund (SGF) which will be:

(i) a potent line of defense and fallback guarantee mechanism in case the multiple levels of safety are found inadequate to cover the settlement obligations.

(ii) a pool of funds which can be dipped into to make good the price risk on the amount under obligation of the defaulting member.

The Forward Markets Commission (FMC) has issued uniform guidelines to all national commodity exchanges, with respect to sources of funds for SGF and contribution by the exchanges to SGF, vide its letter No. 2/2/2008-MKT-II dated August 23, 2013 (hereinafter referred to as SGF Guidelines) (copy of which has been supplied by the querist for the perusal of the Committee).

[1] Opinion finalised by the Committee on 11.12.2014.

4. The extracts of the Guidelines are as under:

   (i) The components of SGF shall be:

   a. The initial contribution to SGF by the Exchange will be equivalent to 5% of the sum total of the gross revenues of the Exchange for the preceding financial years starting from financial year 2007-08 or from the date when the Exchange was set-up, till financial year 2012-13, subject to a minimum of Rs. 10 crore.

   b. Base Minimum Capital (BMC) of members (stipulated by the FMC as per letter No. 6/12/2012-MKT-I dated March 8, 2013).

   c. Interest accrued on Base Minimum Capital.

   d. Refundable deposits made by the members (other than margins) for trade, by whatever name called (i.e., the Base Capital collected by the Exchange).

   e. All settlement related penalties charged by Exchange from members with effect from September 1, 2013.

   f. The annual contribution by the Exchange will be 5% of its gross revenue of the previous year with effect from April 1, 2014.

   g. Interest amount and any other income accrued on investments of fund of SGF shall also be credited to SGF.

   (ii) The margin collected by the Exchange from the members shall not be part of SGF.

   (iii) The Exchange shall constitute a Committee for management of SGF, whose composition will be as under:

   - An independent director appointed by FMC
   - An independent director appointed with approval of FMC
   - A member of the Exchange appointed in consultation with the members or association of members

- MD/CEO of the Exchange shall be the ex-officio member secretary to the Committee

The FMC, vide clause 2 of the above stated guidelines has specified that "the status of SGF funds should be shown separately in the head of account of the Exchange". (Emphasis supplied by the querist.)

5. Subsequently, vide letter No. 2/2/2008-MKT-II dated 14th March, 2014 (copy of which has been supplied by the querist for the perusal of the Committee), the FMC has partially modified its earlier Guidelines dated 23rd August, 2013, as under:

a. The Settlement Guarantee Fund shall not include the refundable deposits made by members for trade. However, the Base Minimum Capital (BMC) of members and interest income on investment of BMC will continue to be part of SGF.

b. The Exchange shall on quarterly basis, make the risk assessment on SGF and shall make fresh contribution to SGF to meet the shortfall, if any, out of the revenue earned by them. The maximum contribution by an Exchange in the SGF in a year shall be up to 5% of the gross revenue (net of income tax to be paid by the Exchange). In cases where exchanges have sufficient funds available in the SGF to meet the contingent risk, then there is no need for exchanges to make any further contribution.

c. The income accruing on the funds belonging to SGF shall be credited to SGF by the Exchange, net of income tax paid on such income.

d. All settlement related penalties charged by the Exchange from members will continue to be part of SGF

6. As at March 31, 2014, the SGF corpus is presented in the financial statements as under:

(i) Refundable deposits from the members - Current/Non-current liability

(ii) Initial contribution by the Exchange - Reserves (Transferred from retained earnings)

As per the querist, there was no requirement for the annual contribution by the Exchange as at March 31, 2014 as per stress test stipulated in the Guidelines dated March 14, 2014. However, as per stress test done on June 30, 2014, the Exchange was required to make annual contribution of 5% of revenues of the *previous year (i.e., revenue of financial year 2013-14).*

Annual contribution by the Exchange to SGF – Whether liability or reserve?

7. The annual contribution to SGF is calculated as a percentage of revenues (and not of profits), i.e., the same will have to be made even in the absence of profits. Based on this, any contribution by the Exchange will be treated as a charge to profit and not appropriation. Therefore, one may consider SGF as a liability. However, going by the principle of 'substance over form', the objects and purpose of SGF indicate that the Exchange contribution to SGF is in nature of reserve due to following reasons:

(i) The obligation to guarantee settlement is with the Exchange and the Settlement Guarantee Fund is just an amount earmarked by the Exchange to meet this obligation, if and only if, the multiple layers of risk mitigation measures are found inadequate to cover settlement obligations. Therefore, SGF is a reserve created to meet any future unknown liability which is not crystallised or certain. Hence, any contribution by the Exchange to SGF should be treated as an appropriation and not as a charge to profits.

(ii) The amount contributed by the Exchange to SGF will remain with the Exchange as SGF is not with a separate entity.

(iii) As per clause (b) of the revised Guidelines dated March 14, 2014, the amount to be transferred to SGF is net of income tax to be paid by the Exchange. This reiterates that the contribution is an appropriation from retained earnings.

8. *Views of the company*

As stated above, the obligation to guarantee settlement is with the Exchange and the Settlement Guarantee Fund is an amount earmarked by the Exchange to meet this obligation, if and only if, the multiple layers of risk mitigation measures are found inadequate to cover settlement obligations. Therefore, in the view of the querist, SGF is a reserve and any contribution by the

Exchange to SGF should be treated as an appropriation and not as a charge to profits.

B. Query

9. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the treatment of annual contribution to SGF by the Exchange and other contributions, as stated below:

(i) Annual contribution by the Exchange:

As per the revised Guidelines of FMC dated March 14, 2014, "The exchange shall on quarterly basis, make the risk assessment on Settlement Guarantee Fund (SGF) and shall make fresh contribution to the Settlement Guarantee Fund to meet the shortfall, if any, out of the revenue earned by them. The maximum contribution by an exchange in the Settlement Guarantee Fund in a year shall be up to 5% of the gross revenue (net of Income Tax to be paid by the exchange). In cases where exchanges have sufficient funds available in the Settlement Guarantee Fund to meet the contingent risk, then there is no need for exchanges to make any further contribution".

Based on this, whether the annual contribution made by the Exchange to SGF should be charged to the statement of profit and loss or appropriated from profit after tax. Also, whether the same should be classified as a reserve or a liability in the balance sheet.

(ii) Income accruing on SGF:

As per revised Guidelines dated March 14, 2014, "The income accruing on the funds belonging to SGF shall be credited to SGF by the Exchange, net of income tax paid on such income." In view of this provision, whether the income earned out of the investments of SGF should be:

(a) credited to the statement of profit and loss and amount net of tax should be charged to the statement of profit and loss, or

(b) credited to the statement of profit and loss and amount net of tax should be appropriated from profit after tax, or

(c) directly transferred to SGF without the same being routed to the statement of profit and loss.

(iii) Settlement penalties collected by the Exchange from the members:

As per revised Guidelines dated March 14, 2014, “All settlement related penalties charged by the Exchange from members will continue to be part of SGF”. In view of this provision, whether the settlement related penalties collected by the Exchange should be:

(a) credited to the statement of profit and loss and the amount net of tax* to be transferred to SGF should be charged to the statement of profit and loss, or

(b) credited to the statement of profit and loss and the amount net of tax* to be transferred to SGF should be appropriated from profit after tax, or

(c) directly transferred to SGF without the same being routed to the statement of profit and loss.

* As per FMC Guidelines, it is not explicitly stated that settlement penalties are to be transferred to SGF net of tax. However, these penalties are subject to tax and therefore, it is assumed that transfer to SGF will be net of tax as in case of other contributions for which FMC has explicitly stated net of tax.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised in the query pertain to accounting for the contribution made to SGF in line with the SGF Guidelines revised upto March 14, 2014, accounting for income accruing on SGF and accounting for settlement penalties collected by the Exchange from members. 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, accounting for Base Minimum Capital/deposits received from the members, accounting for the company’s obligation of guarantee settlement in case of default by its members, determination of the amount to be contributed to SGF, legal interpretation and compliances of SGF Guidelines, etc.

11. The Committee notes that the Forward Markets Commission is the regulatory authority for the Exchange in the extant case and the Commission has prescribed SGF Guidelines for the Exchange, certain features of which are as follows:

(i) The Exchange shall on quarterly basis, make the risk assessment on SGF and shall make fresh contribution to the SGF to meet the shortfall, if any, out of the revenue earned by them. The maximum contribution by an Exchange in the SGF in a year shall be up to 5% of the gross revenue (net of income tax to be paid by the Exchange). In cases where exchanges have sufficient funds available in the SGF to meet *the contingent risk*, then there is no need for exchanges to make any further contribution.

(ii) All the monies *earmarked* to SGF need to be *maintained in a separate account* and any income earned on the SGF contribution needs to be retained in the same account and those should not be used for any purpose other than meeting the settlement obligations.

(iii) The income accruing on the funds belonging to SGF shall be credited to SGF by the Exchange, net of income tax paid on such income.

(iv) All settlement related penalties charged by the Exchange from members will continue to be part of SGF.

(v) The Exchange shall constitute a Committee for management of SGF.

(Emphasis supplied by the Committee)

From the above features of the Guidelines and the Facts of the Case provided by the querist, the Committee notes that SGF is a pool of funds maintained by the Exchange and which is managed by a committee constituted as per the SGF Guidelines, and will be used as a fallback guarantee mechanism to meet any contingency arising due to failure of member of the Exchange fulfilling his obligation of settlement. The Committee notes that as per the SGF Guidelines, at the time of making contribution, there is a mandate only for earmarking the funds by way of contribution to SGF as a percentage of revenue, which would be used in future for the settlement obligations of the Exchange. The Committee is of the view that this requirement of earmarking of funds cannot be considered as a mandate for incurrence of any expense during a period; rather, there is a mandate only for allocation and maintenance of funds so that there are sufficient funds available in case the contingency of settlement out of the funds arises. The Committee also notes that as per the provisions of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, a liability/provision should be recognised when there is a present obligation involving incurrence of expenditure, arising from a past event that leaves no realistic alternative apart from settling that obligation and also involving another party to whom the obligation is owed. The Committee notes that as per the SGF Guidelines, at the time of contribution to the Fund, there is no such obligation on the enterprise for incurrence of expenditure involving another party; rather the contribution is only an allocation to a pool of funds which can be used to meet any such obligation (if any) due to default on the part of members of the Exchange in future. Accordingly, the requirement in the SGF Guidelines for contribution to SGF may be met through creation of a reserve as an appropriation of profits rather than creating a liability by a charge to the statement of profit and loss. Accordingly, such contribution to SGF should be classified as a reserve in the balance sheet.

12. With regard to the accounting for income accruing on SGF and accounting for settlement penalties collected by the Exchange from members, the Committee notes the definition of 'income' as per paragraph 69(a) of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India and paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006, as follows:

Framework

"69. ...

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants."

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."

The Committee notes that in the extant case, the penalties collected from the members and income accruing on SGF are inflows for the company, which would be earmarked to the SGF and would be used to meet the settlement obligations of the company and, therefore, meet the definition of income as per the Framework. Accordingly, as per the above-reproduced paragraph 5 of AS 5, the gross amount of income accruing on SGF and the penalties collected should be credited to the statement of profit and loss. However, subsequently, considering the requirements of SGF Guidelines, the appropriation should be made from the net profit of an amount which is required to be earmarked to the SGF as per the SGF Guidelines.

D. Opinion

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

(i) The requirement in the SGF Guidelines for contribution to SGF may be met through creation of a reserve as an appropriation of profits rather than creating a liability as a charge to the statement of profit and loss. Accordingly, same should be classified as a reserve in the balance sheet, as discussed in paragraph 11 above.

(ii) and (iii) The gross amount of income accruing on SGF and the penalties collected should be credited to the statement of profit and loss. However, considering the requirements of SGF Guidelines, the amount required to be earmarked to the SGF as per the SGF Guidelines should be appropriated from the net profits, as discussed in paragraph 12 above.

Query No. 40

Subject: ***Recognition of Annuity Policy purchased from the Life Insurance Corporation of India under 'Return of Corpus Scheme' by a Pension Trust.*** [1]

A. Facts of the Case

1. A private sector bank (hereinafter referred to as the 'bank'), whose equity and debt securities are listed in two recognised stock exchanges, has, amongst other benefit schemes to its employees, a defined pension benefit plan on retirement of its employees. The pension liability of the bank is managed through a Pension Fund Trust, which is approved under the relevant Income-tax Rules, through purchase of an Annuity Policy for each of its employees from the Life Insurance Corporation of India (hereinafter referred to as the 'LIC'). The LIC is responsible for paying the pension/ family pension to the employees/legal heirs of the employees of the bank on their retirement/ death.

2. During the year 2011-12, the Pension Fund Trust, in discharge of the pension liability for 134 retired staff, purchased a 'specified' Annuity Policy from the LIC under the 'Return of Corpus' (hereinafter referred to as the 'ROC') Scheme by contributing approximately Rs. 36 crore out of the Trust funds. Under the said scheme, the LIC will be disbursing pension to the employees exclusively covered under the scheme consequent upon their retirement. This corpus is refunded to the Pension Fund Trust consequent upon death of the retired staff covered under this Policy, which, in turn, takes a separate Annuity for payment of family pension.

3. The querist has separately clarified the following:

(i) In the event of any failure on the part of the LIC, the obligation of the LIC for payment of pension /family pension to the employees/ legal heirs on their retirement/death rests with the Central Government by virtue of section 37 of the LIC Act, 1956.

(ii) The Pension Fund Trust maintains running account with the LIC for purchase of annuities and payment of pension. The refund of corpus will not reduce the need for the bank's contribution since the required contribution is already taken into account while

[1] Opinion finalised by the Committee on 16.1.2015.

estimating actuarial liabilities on pension duly taking into consideration family pension obligation also. Corpus amount received from the LIC on death of the pensioner under ROC method will be with the Pension Fund Trust and will not be returned to the bank.

(iii) The Pension Fund Trust is getting periodical contributions from the bank as per the actuarial valuation of obligation for pension including family pension. Actuarial valuation covers the bank's obligation towards service pension to the pension opted staff members on superannuation and also the family pension on the death of the pensioner. Hence, the returned corpus is not the source to purchase the Annuity towards family pension benefit payable to the legal heirs.

(iv) The amount payable for purchasing Annuity for family pension will be less than the amount of corpus returned. The entire amount received back will be with the Pension Fund Trust and will not be returned to the bank.

(v) The Annuity for payment of family pension is not purchased under 'ROC' scheme. Hence, after the death of the family pensioner, the amount already paid for purchase of the Annuity is not refundable to the Trust.

(vi) As per the Trust administration, balance sheet is prepared for the financial year duly certified by the Trust Auditor as per the Standards applicable to the Trusts.

4. The treatment followed by the Pension Fund Trust is as follows:

(a) As the entire purchase consideration will be returned by the LIC to the Pension Fund Trust, the Annuity purchased under the 'ROC' scheme is treated as an asset and classified under 'Long-Term Investments'.

(b) Considering the substance rather than the legal form of the transaction, the asset is classified as long-term investment.

(c) The Pension Fund Trust carries the investment at cost as it is held till maturity and no valuation is done till maturity.

(d) The cost of investment is reduced as and when the corpus is returned by the LIC on the death of a retired employee.

5. The querist has analysed the Accounting Standards issued by the Institute of Chartered Accountants of India covering 'Investments' and 'Employee Benefits' in detail as below to ascertain their applicability to the 'specified' Annuity Policy accounted for by the Pension Fund Trust as a long-term investment:

I. Accounting Standard (AS) 13, 'Accounting for Investments':

Paragraph 2 of AS 13 reads as follows:

"2. This Standard does not deal with:

(a) ...

(c) investments of retirement benefit plans and life insurance enterprises ; and

(d) ..."

From the above, it can be seen that AS 13 is not applicable to the investments of the Pension Fund Trust.

II. Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits':

The Pension Fund Trust adopts AS 15 (revised 2005).

Identifying the type of Post Employment Benefit:

(i) Paragraph 7.3 of AS 15 defines 'post-employment benefits' as **"*employee benefits (other than termination benefits) which are payable after the completion of employment*".** Accordingly, pension payments are post-employment benefits. Paragraph 7.4 of AS 15 defines 'post-employment benefit plans' as **"*formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees*"**. The above paragraphs of AS 15 are applicable to the formal arrangement between the bank and the employees for providing pension benefits through the Pension Fund Trust.

(ii) AS 15 requires post-employment benefit plans to be classified as either 'defined contribution plans' or 'defined benefit plans'.

(iii) Paragraph 7.5 of AS 15 defines 'defined contribution plans' as "***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***".

(iv) Paragraph 7.6 of AS 15 defines 'defined benefit plans' as "***post-***employment ***benefit plans other than defined contribution plans***".

(v) In order to meet the pension obligation to its retired employees, during the year 2011-12, the Pension Fund Trust had purchased 'specific' Annuity Policy from the LIC under the 'ROC' Scheme. As per the Policy terms, the LIC will be settling the pension obligations of the bank on an on-going basis till the happening of the event described in paragraph 2 above and the Pension Fund Trust will have no obligation to pay further contributions.

Insurance Policy – Whether a Plan Asset:

(i) Paragraph 7.16 of AS 15 defines a Qualifying Insurance Policy as below:

"7.16 A <u>qualifying insurance policy</u> is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:

(i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid."

In terms of the 'specified' Annuity Policy issued under the 'ROC' scheme, the LIC returns the entire contribution to the Pension Trust on the death of a retired employee. As per the querist, the payment does not satisfy the conditions mentioned above and the 'specified' Annuity Policy is not a 'qualifying insurance policy' in terms of AS 15.

(ii) Paragraph 104 of AS 15 is reproduced below:

> "Sometimes, an enterprise is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation. Qualifying insurance policies, as defined in paragraph 7, are plan assets. An enterprise accounts for qualifying insurance policies in the same way as for all other plan assets and paragraph 103 does not apply (see paragraphs 40-43 and 102)."

As per the querist, as elucidated above, the 'specified' Annuity Policy with the LIC is not a 'qualifying insurance policy' in terms of AS 15.

(iii) Thus, as per the querist, paragraph 43 of AS 15 becomes relevant.

First sentence of paragraph 43 of AS 15 reads as below:

> "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 'specified' Annuity Policy is in the name of the Pension Fund Trust. Beneficiaries under the policy are the retired employees. The Policy terms provide that neither the Pension Fund Trust nor the bank (the employer) carries any legal or constructive obligation to cover any loss on the policy since the policy is taken as per the terms of the LIC.

Second sentence of paragraph 43 of AS 15 reads as below:

> "The payment of fixed premiums under such contracts is, in substance, the settlement of employee benefit obligation, rather than an investment to meet the obligation. Consequently, the enterprise no longer has an asset or a liability."

The following points are to be noted with respect to the 'specified' Annuity Policy purchased under the 'ROC' scheme:

(a) The Pension Fund Trust makes an initial lump sum single premium, by way of a corpus. This is a capital contribution that is used by the LIC to settle the pension obligations.

(b) The quantum of single premium payable initially is determined by the LIC on the basis of, and by adopting, an appropriate valuation process including actuarial valuation process.

(c) Once this contribution is given, the LIC assumes the responsibility for settling the employee benefit obligations i.e., the pension due to the retired employee during his life time and issues a Policy.

(d) This corpus is refunded to the Pension Fund Trust consequent upon the death of the retired staff covered under this Policy, which in turn takes a separate Annuity for payment of family pension. Already, 4 pensioners deceased and the LIC refunded the entire premium paid by the Pension Fund Trust.

6. As per Rule 89 of the Income-tax Rules, 1962, public sector banks and other similar entities can manage their own Pension Funds through a Trust established for the purpose and approved under the said Rules. The investments are made by these Pension Funds as per the pattern of investments prescribed by the Ministry of Finance, Government of India. The investments are carried at cost and their market value is disclosed in the balance sheet for information only. No depreciation/ appreciation is required to be recognised *since the investments are to be held till maturity and no trading is normally permitted*. These investments are comparable to the investments categorised as 'Held-to Maturity' ('HTM') by the banks. The banks carry the HTM investments at cost only. (Emphasis supplied by the querist).

As per the querist, the investment made by the Pension Fund Trust is a long-term investment akin to 'HTM' investment and is carried at cost.

B. Query

7. Given the above background, the querist has sought the opinion of the Expert Advisory Committee as to whether the Pension Fund Trust can hold

the said long-term investment at cost, considering the nature of asset appearing in the balance sheet of the Trust.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to correctness of exhibition of amount paid for 'specified' Annuity Policy towards retirement pension as long-term investment at cost in the balance sheet of the Pension Fund Trust of the bank. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting treatment in the books of the bank, accounting treatment of Annuity in respect of family pension, implications of retired employees having no legal heirs and legal heirs predeceasing the retired employees, measurement of liabilities and assets, if any, other than the Policy of the Pension Fund Trust, detailed accounting aspects, disclosures, any statement other than balance sheet that might be required to be presented, etc. The Committee presumes that other than premium, there is no other cost, such as, brokerage, on acquisition of the above mentioned Policy. Throughout this opinion, the term 'retirement pension' excludes family pension payable to the legal heirs on death of the retired staff. The Committee expresses its opinion purely from the accounting perspective and not from any other perspective including income-tax perspective. The Committee wishes to point out that since the querist has made reference to Accounting Standards in paragraphs 3 and 5 above, without going into the question of mandatory applicability of Accounting Standards to the Pension Fund Trust, the Committee expresses its opinion in the context of Accounting Standards. To the extent a contrary treatment is prescribed specifically or implied by a regulatory requirement, that treatment should be followed by the Pension Fund Trust.

9. At the outset, the Committee wishes to point out that Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits', does not deal with accounting and reporting *by employee benefit plans* (see paragraph 2 of AS 15). It only deals with accounting *by an employer* for employee benefits (except employee share-based payments) (see paragraph 1 of AS 15). Hence, AS 15 is not applicable for accounting by the Pension Fund Trust. Further, the Committee also notes that rights arising under an insurance contract held by a policyholder has also been excluded from the scope of Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement', issued by the Institute of Chartered Accountants of India.

10. The Committee notes the scope exclusion mentioned in paragraph 2 of AS 13, pointed out by the querist in paragraph 5 above. Irrespective of the said scope exclusion, the Committee is of the view that an asset may be considered as an 'Investment' for accounting purposes, if it meets the definition given in paragraph 3.1 of AS 13, notified under the 'Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), as reproduced below and not within the scope of another Accounting Standard:

> ***"3.1 Investments are assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise. ..."***

The Committee notes that the Annuity Policy taken by the Trust gives two types of rights/benefits to the trust, first, annuity payment during the lifetime of the retired employee and secondly, the return of corpus on the death of the retired employee. Thus, considering the aforementioned definition of 'investment', the Committee is of the view that the Annuity Policy in the extant case is of the nature of 'investment'. Further, as regards nature of the investment, the Committee notes the following paragraphs of AS 13, notified under the 'Rules':

> ***"3.2 A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.***
>
> ***3.3 A long-term investment is an investment other than a current investment."***

The Committee is of the view that since the maturity of the policy is life-contingent, from a portfolio perspective, such investments are carried by the trust for a long-term objective. Further, since the querist has made reference to 'long-term investment' in paragraphs 4, 6 and 7 above, it appears that return of corpus is not expected to take place within one year from the date of taking out the 'Policy' under 'ROC' scheme and therefore, the Annuity Policy under the ROC scheme should be classified as a 'long term investment'. Accordingly, considering the requirements of paragraph 32 of AS 13 (reproduced below), the Committee is of the view that in the absence of a specific standard for such investment and in the context of historical cost concept of accounting, same should be carried in the financial statements at cost.

> "***32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually."***

D. Opinion

11. On the basis of the above, the Committee is of the opinion that the investment should be carried in the balance sheet of the Pension Fund Trust as 'long term investment' at cost, as explained in paragraph 10 above, in case there is no regulatory requirement, express or implied, to the contrary.

Query No. 41

Subject: Accounting treatment of income from credit card membership & joining fees and credit card acquisition/ sourcing costs. [1]

A. Facts of the Case

1. A company is an unlisted, non-deposit accepting non-banking financial company registered with the Reserve Bank of India (RBI). The company is engaged in issuing credit cards to consumers in India.

2. As per the 'Notes to Accounts' in the financial statements for the financial year (F.Y.) 2013-14, following are the policies followed for the relevant income and expenditure:

Notes to Accounts 1C (ii) - Income from membership fees and services:

"Joining membership fee and first annual fee is recognised over a period of one year as this more closely reflects the period to which the fee relates to."

[1] Opinion finalised by the Committee on 16.1.2015.

The querist has stated that the joining fee is paid once in lifetime by some set of customers and the membership fee is paid annually. The company amortises only the joining fees and first annual membership fees over 12 months net of any credit/reversals/waivers given to customers. On payment of fees, the customers can use the credit card for managing their spends and all these customers are entitled to free credit period upto 50 days from the date of transactions.

> *Notes to Accounts 1f (i) - Amortisation of card acquisition cost:*
>
> "The productive sales force compensation, card acquisition cost (sales service provider expenses, incentives related to card acquisition, credit investigation cost and application printing cost), consumption of plastic cards and delivery charges are amortised over a period of one year. In the opinion of the management, the period of one year more closely reflects the period to which the costs relate to."

The company incurs these costs for acquiring new customer who in turn pays the joining fees and membership fees. These costs are also amortised over next 12 months as the related income is also being deferred for next 12 months. According to the querist, as there are no specific provisions/ guidelines for credit card industry on above components of income and costs, the company adopted above policies to disclose and present the financial statements in a more better way. The company has been following the above two policies consistently since F.Y. 2005-06. Before F.Y. 2005-06, the company used to recognise income and expenses on upfront basis without any amortisation.

3. The querist has stated that while adopting the above accounting policy, the management also referred the following pronouncements:

> *Paragraphs 12 and 13 of the Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' which allows management to choose more appropriate accounting principles and methods of applying those principles in differing circumstances:*
>
> "12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those

principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

13. The various standards of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises."

For capitalisation/deferment of membership fees the following pronouncements have been referred by the querist:

Paragraph B(3c) of Illustrations to Accounting Standard (AS) 9, 'Revenue Recognition', inter alia, states as follows:

"Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto."

Paragraph B(6) of Illustrations to AS 9, inter alia, states as follows:

"If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided."

4. Current method of income recognition from joining fees and membership fees:

Fees/Income components	**Remark**
First year annual membership fees	Recognised over a period of one year net of all the credits/waivers/ reversals
Joining fees (once in life time)	Recognised over a period of one year net of all the credits/waivers/ reversals
Renewal membership fees (second year onwards)	Recognised as an when levied to the customer net of all the credits/ waivers/reversals

Current process for amortisation of card acquisition costs:

Amortisation of cost elements	**Remark**
Directly identifiable costs : These costs are amortised in full without any adjustments over a period of one year	
Pay out to co-brand partner/bank branches on the basis of per new card boarded/membership fees received.	
Joining gifts, e.g., air tickets, movie tickets etc. to customers	
Purchase cost of plastic for the cards	
Card delivery/pin mailer costs e.g. courier expenses, welcome pack stationary	Costs pertaining to new card/ accounts only in the new card ratio to total cards
Other costs which are deferred after some adjustments	
Third party costs for card sourcing (actual salary, rent, electricity, tele-calling, other office expenses incurred to solicit the card and to identify the prospective customer)	These costs (vendor infrastructure and staffing) are directly paid to the vendors for card sourcing activities, i.e., going in the market and acquiring a new customer. Further, the deferment is done only to the extent of success rate for the month,

	For Example: Total third party cost Rs. 100 Card success ratio (successful application as a % to total application received) – 50% Cost deferred for 12 months - Rs. 100*50% = Rs. 50 Cost expensed off immediately - Rs. 50
Credit bureau cost (CIBIL) paid to bureau per case	Deferred only to the extent of success rate for the month, Example same as above for third party costs
Credit investigation for applicant, paid to outside agency per case	Deferred only to the extent of success rate for the month, Example same as above for third party costs
Sales employee (FTE) payroll costs	First adjusted to arrive at the costs for origination activity (basis: yearly survey results, survey coverage > 50% employees across) and further deferred only to the extent of success rate for the month, **For Example:** Total sales employee cost - Rs. 100 % of time spent on card sourcing related activities (basis: annual survey of employees) - 30% Total cost of sales employees for card sourcing – Rs. 100*30% = Rs. 30 Card success ratio (successful application as a % to total application received) – 50 % Cost deferred - Rs. 30*50 % = Rs. 15 Cost expensed off immediately - Rs. 85 (Rs. 100 -15)

5. The statutory auditors for F.Y. 2013-14 have advised that the accounting policy adopted by the company needs to be reconsidered. In their opinion, all the income and expenditure should be booked as and when incurred rather than the practice being followed by the company. However, the management has adopted this policy in F.Y. 2005-06 considering the information provided in above paragraphs. Further, this policy has been consistently followed and disclosed in the notes to accounts of the company.

B. Query

6. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the current accounting policy followed by the company is appropriate or the company should make any changes in this policy.

C. Points considered by the Committee

7. The Committee notes that the issue raised by the querist relates to appropriateness of the current accounting policy followed by the company for recognition of joining fees and membership fees on credit cards and credit card acquisition costs (as detailed in paragraphs 2 and 4 above). Therefore, 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, allocation of various elements of costs to determine card acquisition costs, accounting for waivers/reversals/credits allowed on the joining and membership fees, etc. Further, the Committee wishes to point out that the Committee has expressed its opinion purely from accounting perspective and not from legal perspective, such as, RBI Guidelines, if any, etc.

8. With regard to recognition of joining fees and membership fees on credit cards, the Committee notes the following paragraphs from Part 'B. Rendering of Services' of Illustrations to Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> *"3. Financial service commissions*
>
> A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be

settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

(a) whether the service has been provided "once and for all" or is on a "continuing" basis;

(b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto."

"6. Entrance and membership fees

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided."

The Committee notes from the Facts of the Case that joining fee is paid once in a life time and it entitles the customers to use the credit cards to manage their credit card spends. The Committee also notes that apart from such joining fee, the company also charges annual membership fee from the customers. Accordingly, the Committee is of the view that joining fee in the extant case confers only joining rights and not any other right/privilege and therefore, is similar to the membership fee in a case where other services are to be paid for separately. It gives rise to merely an entitlement for a customer to receive certain services against payment of the price. Accordingly, as stated in AS 9, such lumpsum amount should be treated as an income in the statement of profit and loss at the time of receipt. In respect of annual membership fee, the Committee notes that irrespective of whether it is first year annual membership fee or renewal membership fee (which is payable second year onwards), it is akin to annual charges for use of credit cards and the customers have to pay the annual membership fee annually every year for them to be entitled to receive the services of credit card during the year. Accordingly, considering the requirements of AS 9, the annual membership fees should be recognised on a systematic and rational basis over a period of one year to which such fees relate.

9. With regard to the accounting policy for recognition and amortisation of credit card acquisition costs as stated in the Facts of the Case, the Committee notes that the term 'amortisation' as per Accounting Standard (AS) 26, 'Intangible Assets' is "the systematic allocation of the depreciable amount of an intangible asset over its useful life". Thus, for amortisation of an item of cost, it is necessary that it should result in an 'asset'. In this regard, the Committee notes the definition of 'asset', paragraphs 95 and 96 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, and paragraph 56 of AS 26, notified under the 'Rules' which provide as below:

> *Framework for the Preparation and Presentation of Financial Statements*
>
> "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."
>
> "95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.
>
> 96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic

benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

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. ..."

From the above, the Committee notes that the card acquisition costs in the extant case, although result into creation of credit card customers for the company from which future economic benefits are expected to arise, no tangible or intangible resource controlled by the company comes into existence. Accordingly, considering the above-reproduced requirements of the Framework and AS 26, no asset can be recognised and consequently, no such costs can be amortised over a period as an asset in the financial statements. Therefore, such costs should be recognised in the statement of profit and loss. With regard to the querist's argument regarding association of such costs with joining and membership fees, the Committee wishes to mention that even if an association of such costs with an item of income is to be established as per paragraph 95 of the Framework, the same can be more associated with the joining fee, which is received from the new customers and which, as discussed in paragraph 8 above, should be recognised as an income in the statement of profit and loss at the time of receipt of such income. Accordingly, the Committee is of the view that the card acquisition costs should be expensed and charged to the statement of profit and loss as and when these are incurred.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that the accounting policy of the company of recognising joining fees over a period of one year, recognising renewal membership fees immediately and amortisation of card acquisition cost is not appropriate, as discussed in paragraphs 8 and 9 above. The accounting policy should be modified accordingly.

Query No. 42

Subject: Accounting treatment of borrowing cost for oil & gas assets acquired directly and through overseas subsidiary companies. [1]

A. Facts of the Case

1. A public limited company, which is a wholly owned subsidiary of a listed Government company (hereinafter referred to as the 'company'), is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India.The company acquires oil and gas properties/blocks by way of acquisition of Participating Interest (PI) 100% or less, therein either directly or through acquisition of the legal entity owning the right in the oil and gas properties/blocks. The overseas oil and gas operations are generally conducted in joint ventures with other partners. The company has PI in these joint ventures either directly or through acquisition of a company holding PI in the asset or through its wholly owned overseas subsidiary companies. Main consideration for holding PI through subsidiary companies is because of tax or host country's regulations or risk management point of view.

2. The company compiles standalone financial statements as well as consolidated financial statements including the overseas subsidiaries denominated in INR, following the requirements of the Companies Act and the accounting standards and relevant guidance notes issued by the Institute of Chartered Accountants of India (ICAI).

3. The querist has stated that recently, the company has acquired PIs in the same oil and gas assets as under:

(i) X% PI in an overseas oil and gas joint venture project directly by the company as an asset transaction, and

(ii) Another Y% PI by way of acquiring shares of an overseas subsidiary company which ultimately holds the PI in the *same* overseas oil and gas joint venture project. (Emphasis supplied by the querist).

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[1] Opinion finalised by the Committee on 16.1.2015.

The company had financed both the above acquisitions in the oil and gas joint venture project partly by external borrowings and partly by internal accruals. The project is currently under development and would be taking substantial time for commencement of oil and gas production. The borrowing costs incurred for the acquisition of the PIs in the oil and gas joint venture project was accounted for in the books of account as per the following:

(i) The borrowing cost related to the acquisition of X% PI directly by the company by way of asset acquisition was capitalised to the eligible assets following the provisions of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006.

(ii) The borrowing cost related to the acquisition of Y% PI by way of acquiring shares of the overseas subsidiary company which ultimately holds the PI in the same overseas oil and gas joint venture has been charged off following the provisions of AS 16 since the investment in shares is not a qualifying asset.

4. The querist has observed that though the company has acquired PI in the same oil and gas joint venture project through two different legal structures to optimize the taxation or host country's regulations etc., which are quite similar in substance but different in form, the accounting treatment for borrowing costs differs significantly. This does not reflect the true economic value of the acquisition of the underlying oil and gas asset. In view of the above, the company believes that the borrowing cost incurred by the company for both the transactions to ultimately acquire PI interest in the same oil and gas assets should be capitalised to the underlying eligible assets of the project.

5. The querist has further stated that paragraph 35 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI deals with the issue of 'substance over form' as one of the principles for reliability of financial statements. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that these are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. The principle of 'substance over form' is used "to ensure that financial statements give a

complete, relevant, and accurate picture of transactions and events". If an entity practices the 'substance over form' concept, then the financial statements will show the overall financial reality of the entity (economic substance), rather than the legal form of transactions. In accounting for business transactions and other events, the measurement and reporting is for the economic impact of an event, instead of its legal form.

6. According to the querist, the principle of 'substance over form' is relevant in the instant case as the company in essence has acquired the PI in the assets in different forms only. So considering the 'substance over form', the borrowing costs incurred in both cases should be capitalised to the underlying eligible assets.

Suggested accounting treatment of borrowing costs for acquiring PI in oil and gas assets through acquiring shares of subsidiary company

7. As per the querist, considering the above facts, to uniformly record and present the true economic value of the above two transactions which are same in substance but different in form, the borrowing costs incurred by the company related to acquiring shares in the overseas subsidiary company ultimately holding the participating interest in the joint venture should also be capitalised to the respective eligible assets. In the standalone books, the borrowing cost related to acquisition of PI through the subsidiary company would be charged off to the statement of profit and loss. However, in the consolidated financial statements of the company, the borrowing cost incurred by the company relating to acquisition of PI through the subsidiary company will be capitalised to the respective eligible assets by necessary adjustment to the statement of profit and loss.

B. Query

8. In view of the above facts, the opinion of the Expert Advisory Committee (EAC) of the ICAI is sought on the following issues:

(i) Considering 'substance over form', whether the suggested accounting treatment of capitalising the borrowing cost related to acquiring PI in the oil and gas project through the overseas subsidiary company to the respective eligible assets held by the subsidiary company in the underlying oil and gas project as per paragraph 7 above is appropriate.

(ii) Is there any other accounting treatment to bring in uniformity in the accounting for borrowing costs for both the transactions in the extant case?

(iii) Whether there is any need for addition to the relevant Accounting Standards to provide for the extant situation of capitalising the borrowing cost.

C. Points considered by the Committee

9. The Committee notes that the basic issue relates to accounting for borrowing costs incurred on acquisition of participating interest in oil and gas assets through participating interest in joint operations with other partners through acquisition of shares in overseas subsidiary. 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, accounting for joint venture as per AS 27, whether the 'oil and gas assets' acquired directly in the joint venture can be considered as 'qualifying assets' as per the principles of AS 16, accounting in the books of subsidiary company, consolidation of financial statements of subsidiary companies as per AS 21, etc. Further, it is presumed from the Facts of the Case that joint venture referred in the extant case is not a jointly controlled entity since acquisition of oil and gas assets through a jointly controlled entity cannot be considered as a qualifying asset for the company.

10. With regard to the issue of accounting treatment of borrowing costs incurred on acquisition of participating interest in joint venture by way of asset (oil and gas assets) acquisition through overseas subsidiary, the Committee notes the definition of 'qualifying asset' and paragraphs 5, 6, 14 and 16 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006 as follows:

"3.2 A <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

..."

"5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

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."

"16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation."

The Committee is of the view that where the company is acquiring the oil and gas assets through subsidiary, the company is acquiring only the investment in overseas subsidiary and not the qualifying asset (viz., oil and gas asset) as such and accordingly, considering the specific requirements of AS 16, borrowing costs incurred on such acquisitions cannot be capitalised in the separate financial statements of the company. Since the capitalised asset itself does not appear in the books of the company, the question of capitalisation of borrowing costs with such asset does not arise in the separate financial statements of the company. The Committee is of the view that as per the above-reproduced principles of AS 16, borrowing costs can be capitalised only when all the conditions as per paragraph 14 of AS 16, are satisfied. Accordingly, even in the first situation where the company directly acquires the oil and gas assets, if these conditions are not met, for example, the expenditure for the acquisition, construction or production of a qualifying asset is not being incurred, the borrowing costs cannot be capitalised. Similarly, in the second situation also, the borrowing costs can be capitalised in the subsidiary company's separate financial statements and consolidated financial statements only when the above-mentioned conditions of AS 16 are satisfied.

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) and (ii) No, the suggested accounting treatment of capitalising the borrowing cost related to acquiring PI in the oil and gas project through the overseas subsidiary company to the respective eligible assets held by the subsidiary company in the underlying oil and gas project in the consolidated financial statements as per paragraph 7 above is not appropriate.

(iii) As per the terms of reference of the Committee, it answers issues only from the perspective of existing accounting standards and other pronouncements.

Query No. 43

Subject: Accounting treatment of funds received for land acquisition.[1]

A. Facts of the Case

1. A wholly owned company of the Government of India (hereinafter referred to as the 'company') is registered under the Companies Act, 1956. The company is engaged in construction of railway tracks for freight, popularly known as dedicated freight corridor (hereinafter referred to as the 'project'). Presently, two corridors are under construction, viz., Eastern Dedicated Freight Corridor and Western Dedicated Freight Corridor. Construction of these corridors is being funded through equity participation from the Ministry of Railways and debt from the World Bank and Japan International Cooperating Agency (JICA).

2. Land for the project is acquired in the name of the Ministry of Railways (MOR) under the Railways Act, 1989 as modified by the Railways (Amendment) Act, 2008. Chapter IVA of the Act contains detailed provisions for land acquisition for a special railway project. Railway Board has been nominated as the 'Central Government' for the purpose of the above Act and 'Competent Authority' for acquisition of land as per the Act are State Land Acquisition Officers (SLAOs), which are the officials of the Government of the State concerned in which land is being acquired and are not the officers of the company. All the acts in terms of above-mentioned Chapter IV A are being performed by the SLAOs.

3. The owner of land being acquired is the Ministry of Railways (MOR). The company will use the land as a lessee. As per the directions of the MOR, the possession of the land will be taken by Railways officials and immediately handed over to the concerned official of the company. For this purpose, officials from the Railways and the company will sign on the land handing-over documents. Subsequently, lease agreement would be signed based on these documents. The company would pay a lease rent @ 6% per annum of land cost, which shall commence from the date of commissioning.

4. Since the land is being acquired for the project, it has been mandated by the MOR that the company will actively associate in the land acquisition process and following actions need to be taken by the company:

[1] Opinion finalised by the Committee on 16.1.2015.

(a) Advise the Railway-wise and district-wise details of the land to be acquired for preparing the schedule of land to be acquired by SLAOs;

(b) To prepare and forward the draft notification, to be issued after the approval of the Central Government and vetted by the Ministry of Law & Justice, if required;

(c) To nominate coordinators to work with SLAOs;

(d) To open a Special Joint Saving Bank Account in the name of SLAO and the officials nominated by the company;

(e) Preparation of all the documents required for taking possession of land;

(f) After receiving possession of land, the company will erect boundary pillars as per railways standards, or similar to demarcate the land;

(g) To ensure sufficient watch and ward to retain encroachment free possession of land;

(h) To liaison with the railways officials and will arrange for signing of lease agreement.

As such, the company is involved in the land acquisition process as a facilitator since ultimate user of land to be acquired would be the company. Considering the position of the company as a facilitator, the MOR is reimbursing all the expenditure incurred by the company towards activities enumerated above on actual basis. Further, administrative cost towards land acquisition which includes establishment expenditure of SLAOs, expenditure incurred on facilities provided to SLAOs, such as, providing of fixed assets and providing of vehicles etc., are also reimbursed by the MOR to the company on actual basis.

5. Funds towards compensation of land are being released by the MOR to special joint saving bank account maintained in the name of SLAO and the officials nominated by the company. Disbursement of compensation is done by cheques jointly signed by the account holders. The MOR has further casted a duty on the company for submission of monthly accountal of the money released by the MOR and actually disbursed as compensation. It is

pertinent to note that the money released by the MOR to SLAOs accounts cannot be used for ordinary business of the company and the company has no right to utilise such money except for land acquisition for the MOR. Without the authorisation of SLAO, no disbursement out of that money can be made. The querist has also separately clarified that interest accrued on deposit balance in the joint saving bank account will be to the MOR's benefits and any unused funds will have to be transferred to MOR after the land acquisition process is over.

6. The querist has stated that in view of above, expenditure incurred towards facilitation/administrative cost of land acquisition is shown as amount recoverable from the MOR. The amount recoverable from the MOR and the funds released by the MOR in the special joint saving bank account are not included in the accounts of the company. This fact is disclosed in the financial statements of the company through notes to accounts. This practice is being followed consistently by the company since its inception. In the financial statements of the company for the financial year (F.Y.) 2013-14, the following note is given to disclose the above fact:

> *"As per the directions of the Ministry of Railways (MOR), Land for the project shall be acquired in the name of MOR under the Railways Act, 1989 as modified by the Railways (Amendment) Act, 2008 and the land so acquired shall be leased to the Company at lease rent of 6% per annum of the land cost. Lease rent shall commence from the date of commissioning. Funds for acquisition of land are being provided by MOR to separate bank accounts, being operated jointly by the State Land Acquisition Officer, being the Competent Authority under the above Act and a nominated official of the Company. Such Bank Accounts do not form part of the Company's accounts.*
>
> *In addition to the compensation payments for land acquisition, for which funds are given by MOR in separate account as explained above, Company is incurring facilitation & administrative expenditure in connection with acquisition of land, which are reimbursable by MOR on actual basis."*

7. Office of the Comptroller and Auditor General of India (C&AG), while carrying out the supplementary audit of financial statements of the company for the F.Y. 2013-14 has given following observation:

> *"As per the above note, the funds for land acquisition are provided for by the Ministry of Railways which are being kept in separate bank account operated jointly by SLAO and the Company.*
>
> *As on 31st March, 2014, Rs. 1,67,905 lakh was lying in the above account. As the Company is authorized to use the funds along with the SLAO, hence, the same should have been included in "Cash and Bank Balance" and "Other Current Liabilities".*
>
> *The above has resulted in understatement of "Cash and Bank Balance" and "Other Current Liabilities" to the extent of Rs. 1,67,905 lakh."*

During discussion on the above observation, it was contended by the company that funds are received directly by SLAOs and being utilised by them for disbursement and the company has no role in utilisation of those funds. It was further contended by the company that funds belong to the MOR and land for which funds are released also belongs to MOR. Role of the company is merely a facilitator in the instant case, which has been amply disclosed in the financial statements. Bringing the above funds in the books of the company would tantamount to overstating the cash and bank balances of the company, which would not be a correct statement of affairs.

8. The querist has also stated that the observation was not pressed further in view of the assurance of the management that the issue shall be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India for an expert opinion. The querist is of the view that funds for land do not form part of the company's accounts and disclosure referred to in paragraph 6 above is sufficient.

B. Query

9. Keeping in view the above, the opinion of the Expert Advisory Committee is solicited as regard to the following:

(i) Whether the accounting practice followed by the company of not accounting for the funds received for land from the MOR, as part of the company's books with suitable disclosure in the financial statements is correct.

(ii) Would it not be an overstatement of balance sheet if the observation of the Government auditor is complied with?

(iii) In case the accounting practice followed by the company is not correct, what should be the accounting treatment for such funds?

C. Points considered by the Committee

10. The Committee notes that the basic issue relates to accounting treatment of the funds received by the company as a facilitator for acquisition of land to be transferred to the Ministry of Railways (MOR). 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 funds received as equity from the MOR and debt from the World Bank and Japan International Cooperating Agency (JICA), treatment of acquisition of land by the company for the MOR, treatment of lease rent paid by the company, treatment of expenditure incurred by the company as administrative cost which is reimbursed by the MOR, etc.

11. With regard to the accounting for funds received for acquisition of land from the MOR, the first issue to be examined is whether such funds held in separate joint saving account can be considered as an 'asset' of the company. In this regard, the Committee notes the definition of the term 'asset' as per paragraph 49(a) of the Framework for the Preparation and Presentation of Financial statements, issued by the ICAI as follows:

> "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 from the Facts of the Case (refer paragraph 5 above) that the funds towards compensation of land are being released by the MOR to special joint saving bank account maintained in the name of SLAO and the officials nominated by the company and that the interest accrued on deposit balance in the joint savings bank account will be to the MOR's benefits and any unused funds will have to be transferred to MOR after the land acquisition process is over. Further, the money released by the MOR to joint savings account cannot be used for ordinary business of the company and the company has no right to utilise such money except for land acquisition for MOR. From this, the Committee notes that the company does not have any right to use the amount lying in the joint savings bank account and therefore, no control is exercised by the company on such account. Further, since the balance of funds in the joint savings account with SLAOs can be used only for the acquisition of land which will be owned and controlled by the MOR, no future economic benefits from such funds arise to the company. Accordingly, the Committee is of the view that the funds lying in the joint savings account is not an 'asset' of the company and therefore, should not be accounted for as 'cash and bank balance' in the financial statements of the company. Thus, the accounting treatment followed by the company of not recognising the funds received from the MOR as its 'cash and bank balance' is appropriate. However, considering the role for the company as a facilitator of the MOR for acquisition of land and since the company has also to submit monthly accountal of the money released by the MOR and actual disbursements, the Committee is of the view that the company, in the extant case, is acting in a fiduciary capacity to the MOR. Accordingly, the Committee is of the view that the funds received by the company should be duly disclosed in the notes to accounts giving details of nature of funds received, the purpose and restrictions imposed and its relationship with the MOR.

D. Opinion

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

(j) and (iii) The accounting practice followed by the company of not accounting for the funds received for land from the MOR, as part of company's books is appropriate. However, the company should give appropriate disclosures in the notes to accounts, as discussed in paragraph 11 above.

(ii) Inclusion of the funds received from the MOR in the cash and bank balances of the company as per the observation of the Government auditor would not be appropriate, as discussed in paragraph 11 above.

Query No. 44

Subject: Accounting treatment of interest on deposits made out of equity share capital and interest free subordinate debt funded by Government. [1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company'), which is a joint venture between the Government of India (GOI) and the Government of Tamil Nadu (GOTN) has been incorporated for the implementation of chennai metro rail project (hereinafter referred to as the 'project'). The project will be implemented as a central sector project through the executing agency, viz., the company, which will work as a special purpose vehicle (SPV) for the implementation of project with the GOI and GOTN being the joint promoters with equal equity holding.

2. The estimated cost of the project is Rs. 14,600 crore and the same will be funded in the following manner:

(Rupees in crore)

Details	**Means of finance for the project**		
	Government of India	**Government of Tamil Nadu**	**Total**
Equity share capital	2,190	2,190	4,380
Subordinate debt (Interest free)	730	844	1,574
Senior term debt (Loan from Japan International Cooperation Agency (JICA))	8,646	-	8,646
Total	**11,566**	**3,034**	**14,600**

The funds are provided by the joint venturers for the purpose of construction based on the Government's budgetary provision. The Central Government, State Government and the company had entered into memorandum of understanding (MOU) for the purpose of execution of the project.

[1] Opinion finalised by the Committee on 16.1.2015.

3. The company is in the construction stage (i.e., pre-commencement period). The company has appointed various contractors for the execution of the project. The Government releases amount towards equity and interest free subordinate debt by way of budgetary allocation. As per the MOU, any increase in the cost by way of price rise, rise in foreign exchange (forex) rate will be borne by the Central and State Government equally as equity.

4. The querist has stated that the company borrows money from Japan International Cooperation Agency (JICA). Loan agreement is executed between JICA and the Central Government (on behalf of the company). As per the loan agreement with JICA, the money can be borrowed by any one of the following ways:

1. Commitment method
2. Reimbursement method

The company opted for the reimbursement method wherein the company initially makes payment to the contractor based on the running bills given by them and will then apply to JICA based on the payments made to contractors, the equity capital and subordinate debt being the source to fund the initial payments. JICA releases the money in JPY to the credit of Central Government on its receipt of application from the company. The Central Government releases the funds out of the JICA loan to the company as pass-through as per budgetary allocation. Interest and commitments payable on this loan are recognised in the books based on the funds released by JICA to the Central Government and the same is reconciled every year with AAAD (Aid, Accounts and Audit Division) statement maintained by the Central Government. The interest paid on the borrowing is taken as preoperative expenditure and added to the capital work in progress (CWIP).

5. *Funds deployed by the company over the years:*

The equity and subordinate debts received from the Governments including the pass-through assistance of loan received from JICA, which are pending to be utilised for the project, are temporarily parked in short term deposits with the banks. The fund flow in the business for the last four years is tabulated below:

(**Rupees in crore)**

Particulars	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
Equity including share application money –(a)	4141	3659	1919	999	262	50	50
Reserves and Surplus-(b)	244	164	76	5	3	0	0
Subordinate debt -(c)	1131	1082	968	886	841	500	500
Total-(a+b+c)=(d)	**5516**	**4905**	**2963**	**1890**	**1106**	**550**	**550**
Pass through received from GOI for JICA loan-(e)	4325	2582	1860	570	100	0	0
Excess of equity over debt-(d-e)	1191	2323	1103	1320	1006	550	550
Deposits at banks-(f)	1567	1300	1154	355	4	4	1
Interest earned from deposits during the year	124	131	104	5	1	0	0
Excess of equity over debt over deposits-(d-e-f)	**(376)**	**1023**	**(51)**	**965**	**1002**	**546**	**549**

6. *Sources of Income:*

The company earns income from various sources. Treatment of income and expenditure in the books are given below:

S. No	**Source of Income**	**Accounting treatment in the books**
1	Interest earned on bank deposits The company places deposits in banks out of the funds received in the form of equity capital, subordinate debt and reimbursements received on account of JICA loan pending utilisation.	The company did not prepare profit and loss account till F.Y. 2010-11. Interest earned on deposits till that year was adjusted against CWIP. From F.Y. 2011-12, the income earned is credited to the profit and loss account as the income earned on these deposits is not directly attributable to the project.

2	Sale of tender document The company charges fee on tender documents relating to project from the pre bid contractors.	The income earned on sale of tender documents is directly attributable to the project. The income earned is shown as deduction from CWIP. There has been consistency in accounting treatment of income earned from the beginning.
3	Interest earned on advances provided to contractors. The company provides advances to the contractors in the form of mobilisation advance, plant and machinery advance and special advance for the purpose of facilitation of work. The company charges interest on these advances from the contractors.	The income earned on these advances is shown as deduction from CWIP. There has been consistency in treatment of interest earned from the beginning.

7. *Query raised during Comptroller and Auditor General of India (CAG) audit:*

During the audit of F.Y. 2013-14, the CAG has raised a query that interest earned on these deposits is earned from the funds received as equity and also as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets', income earned during the construction period should be deducted from the capital works and also stated that income should have been shown as deduction from expenditure to be capitalised. However, this has not been consistent with the treatment in the past and the CAG had not raised any query on treatment of interest income.

B. Query

8. In light of the query raised by CAG, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed by the company in respect of the interest income earned on short-term deposits is in compliance with Accounting Standards.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting treatment of interest income earned on short term deposits out

of the surplus funds received in the form of equity and debt for the implementation of Chennai metro rail project. 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 equity and debt contribution by the Government of India and Government of Tamil Nadu, treatment of interest on JICA loan, propriety of not preparing statement of profit and loss till F.Y. 2010-11, disclosure of deposits by the company in its financial statements, treatment of fees on sale of tender document, treatment of interest earned on advances provided to contractors, accounting for prior period item, if any, to be reported in the current reporting period, etc. Further, the Committee notes from the Facts of the Case that with respect to loan from JICA, the company has opted for the reimbursement method wherein the company initially makes payment to the contractor based on the running bills given by them and then apply to the JICA for release of funds. Thus, a question may arise as to whether there would be any surplus funds out of loan from JICA. However, since the Committee is addressing the issue from the perspective of accounting principles and not from the perspective of determination of various amounts, this would not impact the opinion being expressed hereinafter.

10. The Committee notes that the company places deposits in banks out of the funds received in the form of equity capital, interest free subordinate debt and JICA loan pending utilisation. Thus, the source of investment consists of three categories, viz., equity capital, interest free subordinate loan and JICA loan. Therefore, the Committee has examined the treatment of interest income from these three sources separately.

11. With regard to treatment of interest earned on short term deposits made out of equity capital, 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'):

> "9.1 The cost of an item of fixed asset comprises its purchase price, including… and any directly attributable cost of bringing the asset to its working condition for its intended use ..."
>
> "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 the above, the Committee notes that only those items of costs which are directly attributable to bringing the asset to its working condition can be included in the cost of an asset. The Committee is of the view that the same principle can also be extended in respect of an item of income arising during the acquisition/construction of an asset/project. Thus, only those items of income arising from the activities would go on to reduce the asset/ project cost, that are directly attributable to the acquisition/construction of an 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 short term deposits made out of equity portion 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 rail project. Accordingly, interest income earned on the deposits made out of equity funds cannot be capitalised/included in the cost of the asset/project and therefore, should be recognised in the statement of profit and loss.

12. With regard to recognition of the interest earned on short term deposits made out of borrowed funds, viz., interest free subordinate loan and loan from the JICA, the Committee notes the definition of the term 'borrowing costs' and paragraphs 10 and 11 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the 'Rules', which state as follows:

"3.1 <u>Borrowing costs</u> are interest and other costs incurred by an enterprise in connection with the borrowing of funds."

"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 borrowed funds while the project is in the stage of construction. Thus, the income earned during the construction period can be set-off only against the borrowing costs to be capitalised as per the principles of AS 16. Accordingly, in respect of a loan where no such borrowing costs as per AS 16 would arise, as in the case of interest free subordinate loan in the extant case, the interest income out of investment of such borrowed funds cannot be adjusted against the borrowing costs to be capitalised in the cost of the asset and the same shall have to be recognized in the statement of profit and loss.

13. With regard to income earned from the temporary investment of funds out of JICA loan during the period of construction, the Committee is of view that considering the principle discussed in paragraph 11 above, the said income should be adjusted against the borrowing costs to be capitalised as per the principles of AS 16 in the cost of the asset/project concerned.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that the accounting treatment followed by the company in respect of interest income is not appropriate, as discussed in paragraphs 11, 12 and 13 above. Interest income from investment of surplus equity funds and interest free subordinate debt should be recognised in the statement of profit and loss and interest earned from investment of loan from JICA during construction period should be adjusted against the borrowing cost to be capitalised in the cost of asset/ project concerned as per the principles of AS 16.

Query No. 45

Subject: Revenue recognition for reimbursement of operating and maintenance expenses under a contract governed by Central Electricity Regulatory Commission.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') was incorporated as a wholly owned subsidiary of A Ltd. (holding company) on 20.03.2009 and obtained the certificate for commencement of business on 23.03.2010. It is in the business of scheduling and despatch of electricity over inter-regional links in accordance with Grid standards specified by the Authority and Grid code specified by Central Commission. These functions are being exercised through National Load Dispatch Centre (NLDC) and five Regional Load Dispatch Centres (RLDC) located at Delhi, Mumbai, Kolkata, Chennai and Bangalore. Prior to its incorporation this function was being carried out by the holding company.

2. The querist has stated that revenue (RLDC fees and charges) of the company is governed by the Regulation notified by the Central Electricity Regulatory Commission (CERC) on the philosophy of cost plus basis. The present RLDC fees and charges have been notified by the CERC for five year term starting from April 2009 and ending on March 2014. The main components of RLDC fees and charges are given as below:

(a) Return on equity;

(b) Interest on loan capital;

(c) Depreciation;

(d) Operation and maintenance expenses excluding human resource expenses;

(e) Human resource expenses;

(f) Interest on working capital;

The basic principle being followed by the Regulator is to allow the RLDC fees and charges on actual reimbursement of expenditure incurred (without

[1] Opinion finalised by the Committee on 6.2.2015.

any profit motive). This principle is implied from the fact that the Regulations require component (a), (b), (c) and (f) along with any other income earned by the company to be deposited in the LDC Development Fund. This fund is to be utilised for the specific purposes for development of new assets after meeting the statutory payments, like interest, repayment of loan, income tax, dividend etc. No return on equity is allowed by the Regulator on the capital expenditure incurred on the new assets created out of this fund. Extracts of the Regulation have been supplied by the querist for the perusal of the Committee.

The components (d) and (e) i.e., operation and maintenance (O&M) and human resource (HR) expenses (hereinafter referred as the 'expenditure') are being reimbursed on actual basis. These expenditure for the years 2009-14 have been determined by CERC based on the actual expenditure incurred for the period 2004-09 escalated with the inflation index and the manpower projection given by the company.

3. The querist has stated that as per the Regulation, actual expenses shall be allowed by CERC subject to the prudence check by CERC. The difference between actual and allowed shall be considered at the time of truing up exercise after the control period i.e., after 31st March, 2014. The expenditure allowed by the Regulator and the actual expenditure incurred for the period 2009-14 are given as below:

(Rs. in crore)

Year	*Expenditure allowed by the CERC*	*Actual expenditure*	*Reimbursement of expenditure considered as revenue in the statement of profit and loss*
2010-11(Six months)	51.49	57.06	49.09
2011-12	112.67	114.36	97.54
2012-13	122.32	131.59	131.59
2013-14 (upto Dec. 13)	98.76	96.06	96.06

Upto 31.03.2012, the revenue including reimbursement of above expenditure was being allowed as per the norms notified by the CERC under the Regulations for RLDC fees and charges. In case, the amount allowed by the CERC was more than the actual expenditure, the revenue recognition was restricted to actual expenditure. However, no additional revenue was recognised in case the actual expenditure was more than the reimbursement allowed by the CERC i.e., actual expenditure incurred or amount allowed by the CERC *whichever is less* **(**unit wise). Any excess in collection of system operation and market operation charges over the revenue recognised is transferred to the liability to be adjusted on truing up exercise by the CERC after the expiry of the control period.(Emphasis supplied by the querist.)

4. Since the actual expenditure was more than the approved expenditure allowed by the CERC, the company filed a petition with the CERC for allowing additional expenditure based on actual. The Hon'ble Commission vide its Order dated 28.09.2012 has directed that "any additional legitimate HR expenses over and above that approved by the Commission in its various tariff order may be temporarily met by petitioner out of the LDC Development Fund which will be recouped at the time of truing up". Order copy has been supplied by the querist for the perusal of the Committee. Considering the outcome of CERC order dated 28th September, 2012, the accounting policy regarding revenue recognition was changed in financial year (F.Y.) 2012-13 to account for revenue on account of reimbursement of such expenditure based on the actual expenditure incurred. The accounting policy was changed with retrospective effect from 01.10.2010 i.e., the date of commencement of business and the difference in revenue was also accounted for in 2012-13. Extracts of revised accounting policy in the annual accounts of F.Y. 2012-13 is given as under:

> "System operation and Market operation charges comprising RLDC fees and charges are recognized on the basis of tariff approved by Central Electricity Regulatory Commission (CERC). Human Resource and Operation and Maintenance expenses component of tariff are accounted on the basis of actual expenditure. Charges towards projected capital expenditure are restricted to charges based on actual capital expenditure."

The change of accounting policy and its impact were disclosed in the notes and accounts as under:

"Revenue recognition of HR and O&M expenses was hitherto being made based on actual expenditure incurred or amount allowed by CERC whichever is less. However, such actual expenditure incurred is allowable as per CERC regulations subject to truing up after the end of the control period i.e., 2009-14. On the petition filed by the company, CERC vide order dated 28th September 2012, has directed that "Any additional legitimate HR expenses over and above that approved by the Commission in its various tariff orders as mentioned in para 3 of this order may be temporarily met by the petitioner out of the LDC Development Fund which will be recouped at the time of truing up"."

5. *Management's view regarding change of accounting policy:*

(i) Change in accounting policy was solely attributed to the CERC order dated 28th September, 2012, wherein it was mentioned that "Any additional legitimate HR expenses over and above that approved by the Commission in its various tariff orders may be temporarily met by the petitioner out of the LDC Development Fund which will be recouped at the time of truing up". It was very clear from this order that all legitimate expenses incurred by the company shall be approved by the Hon'ble Commission at the time of truing up. In view of the management, all the expenses incurred are legitimate expenses and deemed to be allowed by the Hon'ble Commission (CERC), though after prudence check.

(ii) Management was of the view that outcome of the CERC order dated 28^{th} September, 2012, confirms the *certainty of receipt* of additional expenses (O & M including HR expenses) over and above allowed by the CERC in its earlier tariff orders.

(iii) The revised accounting policy shall be fulfilling the criterion of *matching revenue with expenditure incurred*.

(iv) The revised accounting policy shall be fulfilling the criterion of *accrual system of accounting* and shall give *true and fair view of accounts* and will avoid the deferment of income of the entire control period till the truing up exercise by the CERC.

(v) The same is in line with Accounting Standard (AS) 9, 'Revenue Recognition'. Paragraph 12 of AS 9 also emphasises on revenue recognition where no significant uncertainty exists regarding the amount of consideration. The paragraph is reproduced as below:

> ***"12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service."***

6. The statutory auditors have qualified the change in accounting policy and have stated in their auditors' report that:

> "Except for the matters described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, the Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act.
>
> Basis for Qualified Opinion: During the year, the company has changed the Accounting Policy regarding Revenue Recognition (Refer Note No 2.39 of other Notes). The change of Accounting Policy has resulted in increase of Profit for the year by Rs. 52.92 crore, Income Tax Provision by Rs. 17.17 crore and Shareholders' Funds by Rs. 35.75 crore, same is subject to admissible by Central Electricity Regulatory Commission (CERC) after prudence check at the time of truing up. The extent of uncertainty involved on account of additional revenue is dependent upon outcome of CERC order. Recognition of such additional revenue to the extent of uncertainty involved is departure from the Accounting Standards referred to in sub section (3C) of section 211 of the Act."

Management reply to above qualification as produced in the annual report is reproduced below:

> "The HR and O&M expenses were accounted for as 'actual expenditure or expenditure allowed by CERC, RLDC wise whichever is less', upto F.Y. 2011-12. However, such actual expenditure is allowable as per CERC regulations subject to truing up after the end of the control period i.e., 2009-14. On the petition filed by the company, CERC vide order dated 28th September, 2012, has directed that "Any additional legitimate HR expenses over and above that approved by the Commission in its various tariff orders as mentioned in Para 3 of this

order may be temporarily met by the petitioner out of the LDC Development Fund which will be recouped at the time of truing up".

Considering certainty of receipt as per AS 9, matching revenue concept and accrual system of accounting, the accounting policy has been changed as 'Revenue recognition based on actual HR and O&M expenditure incurred'. In view of CERC Regulations, CERC order dated 28th September, 2012 and past CERC orders on the above matters, management is of the view that uncertainty involved on account of additional revenue is negligible. Only the legitimate expenditure eligible under CERC Regulations has been considered for additional revenue."

7. Comptroller and Auditor General (CAG) during the audit of accounts issued a half margin which has been provided by the querist for the perusal of the Committee, along with management reply. However, CAG in its report under section 619(4) of the Companies Act, 1956 has not commented upon the qualification included in the auditors' report.

8. The querist has separately clarified as follows:

(i) As per the Regulation, actual HR and O&M expenditures incurred during the block period of 2009-14 shall be allowed by CERC subject to prudence check. The amount of reimbursement allowed during the period 2009-14 has been determined by CERC based on the actual expenditure incurred for the period 2004-09. The same are to be adjusted with the escalation factor based on inflation index and manpower projection given by the company.

(ii) Based on the petition filed by the company for reimbursement of additional expenditure incurred the Hon'ble Commission vide its order dated 28/09/2012 has directed that 'any additional legitimate HR expenses over and above that approved by the Commission in its various tariff order may be temporarily met by petitioner out of the LDC Development Fund *which will be recouped at the time of truing up'.* (Emphasis supplied by the querist)

(iii) As such, the regulatory framework in general and regulator in the specific order provides for reimbursement of actual expenditure incurred.

(iv) The management is of the view that quantum of amount to be allowed by the CERC, while determining the truing of petition, may not vary in a very significant way. This view is based on earlier practices of the regulator on the similar issues. In this regard copies of the following orders issued by CERC have been supplied by the querist for the perusal of the Committee:

(a) order issued by CERC dated 17.12.2013 (Petition No:59/TT/2012) pertaining to NR-ULDC (A Ltd. portion) for revision of O&M charges for the period 2009-10 to 2012-13, wherein this issue has been dealt with from paragraph No. 38 to 43 of the said order.

In this case petition was made for reimbursement of O&M expenditure actually incurred. The CERC after prudence check allowed entire O&M expenditure except very negligible amount of miscellaneous expenditure for which details could not be provided by the petitioner as detailed below:

Rs. In lakh

Sl. No.	**Financial year**	**Amount claimed**	**Amount disallowed**	**Reason**
1	2009-10	949.61	3.46	Details not provided by the petitioner
2	2010-11	835.58	2.57	‘’
3	2011-12	1008.38	0.44	‘’
4	2012-13	413.99	2.33	‘’

(b) order issued by CERC dated 03.08.2011(Petition No:48/2010) pertaining to ER-ULDC (A Ltd.) for revision of O&M charges for the period 2004-09, wherein this issue has been dealt with from paragraph No. 12 to 19 of the said order.

In this case, petition was made for reimbursement of O&M expenditure actually incurred. The CERC after prudence check allowed entire O&M expenditure except the provision for wage revision for which no cash out flow happened during the said block period. As per paragraph 14 of the order, the actual O&M

charges as per accounts for the 2004-09 block period were Rs. 4495.03 lakh which included provision of Rs.501.63 lakh; therefore, the cash O&M expenditures were Rs. 3993.40 lakh (Rs. 4495.03 - Rs. 501.63). After truing up and prudence check, the CERC allowed the additional O&M expenses amounting to Rs. 890.77 lakh from the earlier allowed O&M charges (Rs. 3993.40 - Rs. 3102.63).

(v) After issuance of order by the CERC as stated above, the company shall revise the billing for each financial year of the block period 2009-14 and supplementary/revised bills /credit/debit note shall be issued by the company to the same customers (mainly state utilities) to whom the bills were issued earlier. It has no relationship as far as billing for the next block period, i.e., 2015-19.

(vi) The amount to be allowed by the regulator after truing up exercise, is towards the services which have already been provided in the block period 2009-14. As such, it is covered under AS 9 since the services have already been provided and there is no significant uncertainty regarding the amount of consideration.

(vii) CERC regulations permit billing only when specific orders have been issued. It is a practice in the Power Sector to recognize the revenue which is permitted under the norms & for which billing is pending for want of specific orders to be issued by CERC. The same is included under unbilled revenue. The practice is based on matching concept in which revenue and expenditure are accounted for in the year to which it pertains.

B. Query

9. In the above background, the querist has sought the opinion of the Expert Advisory Committee as to whether the change in accounting policy and revenue recognition of re-imbursement of O&M and HR expenditure is as per the Accounting Standards of the Institute of Chartered Accountants of India (ICAI) and as per the prevalent accounting practices.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to recognition of reimbursement of operation and maintenance (O&M)

expenses and human resources (HR) expenses by the company under the Regulations of the Central Electricity Regulatory Commission. 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, recognition of recovery on account of expenses other than O&M and HR expenses, whether change in accounting treatment of reimbursement of such expenditure should be classified as change in accounting policy and whether same has been appropriately dealt with or not, accounting for recoupment of HR and O&M expenses out of the LDC Development Fund, accounting for charges towards projected expenditure, etc.

11. The Committee notes that the issue relates to recognition of reimbursement of HR and O&M expenses as 'revenue' as and when the related expenditure is incurred, or only when the truing up exercise is completed by the regulatory authorities. In this connection, at the outset, the Committee notes that although the term 'reimbursement' has been used by the querist and subsequently in this opinion also, in respect of O&M and HR expenses in the extant case, the reimbursement is basically a recovery as a part of the revenue fixed as tariff as per the tariff regulations and accordingly, the principles of revenue recognition as per Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006 would be applicable. Therefore, the Committee notes the definition of the term 'revenue' as per the following paragraph of AS 9, notified under the Rules:

> ***"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. ..."***

From the above, the Committee notes that revenue is the charge made to the customers/clients for the goods supplied or the services rendered. The Committee notes from the Facts of the Case that the revenue (RLDC fees and charges) of the company is governed by the Regulations notified by the Central Electricity Regulatory Commission (CERC) on the philosophy of cost plus basis. The present RLDC fees and charges have been notified by the CERC for the block period of 2009-14. Accordingly, the company charges the existing RLDC fees and charges (tariff) determined by the CERC from its customers. Further, as per the Regulations, actual HR and O&M expenditure incurred during the block period of 2009-14 shall be allowed by the CERC subject to prudence check at the end of the block period. The Committee also notes that after issuance of order by the CERC, the company shall revise the billing for each financial year of the block period 2009-14. The supplementary/revised bills /credit/debit note shall be issued by the company to the same customers to whom the bills were issued earlier and that it has no relationship as far as billing for the next block period, i.e., 2015-19. Thus, it is the existing customers who are being charged in future for the services rendered to them in the past. Accordingly, the Committee is of the view that in the extant case, incurrence of HR and O&M expenditure gives rise to a right of recovery from the present customers which should be recognised as revenue provided other conditions of AS 9 are fulfilled.

12 With regard to the issue relating to the timing and measurement of revenue recognition, the Committee notes the following paragraphs of Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006:

> "9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
>
> 9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments."

From the above, the Committee notes that if at the time of booking revenue, it is unreasonable to expect ultimate collection thereof, revenue recognition should be postponed to the extent of uncertainty. The Committee is of the view that to assess the certainty or uncertainty of ultimate collection is a matter of judgement, which should be exercised considering various factors peculiar to the facts and circumstances of the case. The Committee notes that in the extant case, the CERC has a right not to allow the reimbursement of the expenditure if it is not legitimate. In other words, only legitimate expenses will be allowed by the CERC to be reimbursed to the company. Thus, although the company considers that all the expenses incurred are legitimate expenses and is also of the view that the CERC order dated 28/09/2012 confirms the certainty of receipt of additional expenses, the Committee is of the view that whether there is certainty of ultimate collection of revenue is a matter of judgement which should be assessed considering various factors, such as, on the basis of past experience, legitimacy of the expenditure, etc. Accordingly, the Committee is of the view that the actual O&M and HR expenditure should be recognised as revenue only when and to the extent, there is no such uncertainty of recovery.

13. Incidentally, the Committee has also examined the applicability of the Guidance Note on Accounting for Rate Regulated Activities, issued by the ICAI, (hereinafter referred to as the 'Guidance Note'), which contains the guidance on accounting for rate regulated activities. In this regard, the Committee notes the following paragraphs of the Guidance Note:

> "13. The objectives of this Guidance Note are to recommend:
>
> (i) the recognition of a regulatory asset or regulatory liability if the regulator permits the entity to recover specific previously incurred costs or requires it to refund previously collected amounts and to earn a specified return on its regulated activities by adjusting the prices it charges to its customers;
>
> ..."
>
> **"Scope**
>
> 14. An entity should apply this 'Guidance Note' to its operating activities that meet the following criteria:
>
> (i) the regulator establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and
>
> (ii) the price established by regulation (the 'rate') is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return. The specified return could be a minimum or range and need not be a fixed or guaranteed return."

> "22. Rate regulation of an entity's business activities creates operational and accounting situations that would not have arisen in the absence of such regulation. With cost-of-service regulation, there is a direct link between the costs that an entity is expected to incur and its expected revenue as the rates are set to allow the entity to recover its expected costs. However, there could be a significant time lag between incurrence of costs by the entity and their recovery through tariffs. Recovery of certain costs may be provided for by regulation either before or after the costs are incurred. Rate regulations are enforceable and can create legal rights and obligations for the entity.
>
> 23. An issue therefore arises as to whether an entity should recognise in its financial statements the right to recover incurred costs or the obligation to refund amounts received for which costs have not been incurred through future tariff adjustments. Recognition of the right to recover incurred costs in the future or the obligation to refund amounts received in the financial statements of the entity would arise if they meet the definition of assets and liabilities as provided in the *Framework for the Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India."

On a combined reading of the above paragraphs of the Guidance Note, the Committee is of the view that the Guidance Note does not apply in the extant case as the Guidance Note covers only those 'costs of service' type of rate regulation where the recovery of excess cost incurred in the current period is through adjustment of future tariff to be charged from the customers for the services to be provided in future. In the extant case, the recovery of actual cost (O&M and HR) incurred by the company is not to be adjusted for determining the future tariff; rather it is to be recovered by the company from its past customers for the services rendered to them in the past.

D. Opinion

14. On the basis of above, the Committee is of the opinion that whether there is certainty of ultimate collection of revenue viz., recovery towards expenditure incurred, is a matter of judgement which should be assessed considering various factors, such as, on the basis of past experience, legitimacy of the expenditures, etc., as discussed in paragraph 12 above. Therefore, the actual O&M and HR expenditure should be recognised as revenue only when and to the extent, there is no such uncertainty of recovery. Accordingly, the accounting policy of recognition of revenue towards recovery

of expenditure incurred in the period in which the expense is incurred would be appropriate provided on consideration of various factors as afore-mentioned, it is reasonably certain that the ultimate collection of the revenue would be made.

Query No. 46

Subject: ***Classification of investments in subsidiary and other companies and bonds of infrastructure finance companies/ banks as trade investment.*** [1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as the 'company') was registered under the Companies Act, 1956 in January 2006. The company was set up as a special purpose vehicle to provide long term infrastructure finance as per the Scheme for financing viable infrastructure projects (SIFTI) through a special purpose vehicle. The company was also registered as Non-Banking Financial Company (NBFC) - Infrastructure Finance company with the Reserve Bank of India on 9th September, 2013. The company provides long term financial assistance to infrastructure projects in the country. The entire paid up equity capital of the company of Rs. 3300 crore is held by the Government of India. The company provides infrastructure finance through direct lending, refinance and take out finance scheme(s) as per SIFTI. The company has also taken up pilot Credit Enhancement Scheme to provide guarantee for bonds issued by infrastructure project companies.

2. The company has raised long term debt by way of loans from Life Insurance Corporation of India, National Small Saving Fund (NSSF) and privately placed and public issue of bonds listed in India, foreign currency loans from bilateral and multilateral institutions viz., Asian Development Bank, Kreditanstalt für Wiederaufbau and the World Bank. The borrowings of the company except those guaranteed by the Government of India (GOI)

[1] Opinion finalised by the Committee on 6.2.2015.

are secured by charge on the assets of the company. The resources of the company are held in the form of bank deposits or loans to infrastructure projects. Besides, the company also holds investments in subsidiary and other companies engaged in infrastructure sector viz., Delhi Mumbai Industrial Corridor Development Corporation Limited (DMICDC) and bonds of infrastructure finance companies (IFC)/banks as per the investment policy approved by the Board of Directors.

3. The company holds entire paid up equity share capital in the following subsidiary companies:

- **A Limited** was incorporated with the Registrar of Companies of England and Wales at London in February 2008 under the UK Companies Act, 1985 to provide foreign currency lending to Indian companies implementing infrastructure projects in India, by way of co-financing by extending long term financing (minimum average maturity of 8.5 years for the purpose of import of plant and machinery) for such projects, solely for the capital expenditure outside India.

- **B Limited** was promoted by the company in February 2012 with the objective of providing project advisory services in the areas of project appraisal, debt syndications and project development services including feasibility studies, project structuring, financial structuring, and transaction advisory services. B Ltd. started its business operations in March 2012.

- **C Limited,** a public limited company, incorporated under the Companies Act, 1956 on 28th March, 2012, was established to act as Asset Management Company (AMC) of infrastructure debt funds (IDF) by way of mutual fund route. C Ltd. has also been granted the approval by the Securities and Exchange Board of India (SEBI) to act as the asset management company of the company – Mutual Fund (IDF).

- Besides, the Government of India (GOI) vide letter no. 19/08/2012-IF dated 4th January, 2013 conveyed in-principle approval for merger of Irrigation and Water Finance Corporation Limited (IWRFC) in the company. The Government has conveyed approval for making it a subsidiary of the company, vide letter no. 19/8/2012-IF-I, dated 13th December, 2013. The process of making

IWRFC as subsidiary of the company and thereafter merger into the company is underway. The Board of Directors of the company in a meeting held on 11th August, 2014 decided to request the Government of India to consider the proposal to merge IWRFC into the company by-passing the step of making it as subsidiary of the company.

Background for classification of investments in subsidiary and other companies and bonds of infrastructure finance companies/banks as trade investment

4. The company has been classifying the investments in subsidiary and other companies engaged in infrastructure, viz., DMICDC and bonds of IFC/ banks as trade investments in line with the objective of the company to provide long term financing to infrastructure sector. The company has made these investments since it was not possible for the company to directly undertake business activities undertaken by the subsidiary companies and DMICDC. Further, the company also acquired and held investment in bonds of Non Banking Financial Companies -Infrastructure Finance Companies viz., Rural Electrification Corporation Limited (REC), Power Finance Corporation Limited (PFC), Indian Railway Finance Corporation Limited (IRFC). Accordingly, business activities of investee companies are considered as activities for promotion of trade of the company and investment in subsidiary companies and DMICDC are classified as trade investment. Likewise, investment in bonds of NBFC-IFCs and banks are also classified as trade investment.

5. The querist has stated that as per paragraph 8.7.2.1 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, the term 'trade investment' is normally understood as an investment made by a company in shares or debentures of another company, to promote the trade or business of the first company. However, Comptroller and Auditor General of India (CAG) which conducts supplementary audit of accounts of the company under section 619 (3) (b) of the Companies Act 1956, while conducting audit of accounts of company for the year ended 31st March, 2014 inter-alia commented that:

> "Trade investment, as per the para 8.7.2.1 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, is normally an investment made by a company in shares or debentures of another

company, to promote the trade or business of the first company. The investments shown as 'trade investments' are not in the nature of trade investments as tabulated below:

Sl. No.	Investment	Audit observation
1.	Equity instruments in wholly owned subsidiaries of the company – Rs. 24,694.80 lakh	The investment is the seed capital in the wholly owned subsidiaries – hence not trade investment
2.	Equity instruments in Delhi Mumbai Industrial Corridor Development Corporation Ltd. – Rs. 411.03 lakh	There is no business transaction done by the company with the investee company – hence not trade investment
3.	Venture Capital Units of IDFC Project Equity Domestic Investors Trust II – 7,855.23 lakh	The investment is done under a subscription agreement, signed at the initiative of the GoI – hence not trade investment
4.	Bonds of REC, PNB, IRFC and PFC – 4,048.93 lakh	The Companies are competitors of the company – hence not trade investment

In view of the above, the said investments should be classified as Other Investments."

6. The company's reply on the above audit observation has been supplied by the querist for the perusal of the Committee**.** The statutory auditors of the company also agreed with the views of the company. According to the querist, the classification of investment by the company in subsidiary and other companies, viz., DMICDC and also in bonds of NBFC-IFC's and banks is in line with the Guidance Note on the Revised Schedule VI to the Companies Act, 1956. The company, vide letter dated 4th July, 2014, has given assurance to the CAG that matter regarding classification of investments in subsidiary and other companies and bonds of NBFC infrastructure finance companies / banks as trade investments will be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) for opinion for appropriate treatment from the next financial year.

7. *Views of the company:*

The company has been classifying investments in subsidiary companies, DMICDC and bonds of infrastructure finance companies/ banks as trade investment considering the following factors:

(a) Nature of operation **–** The objective of the company is providing long term financial assistance to infrastructure projects. Accordingly, the investments made in the infrastructure sector to promote the business of the company are classified as trade investment.

(b) Compliance with the Guidance Note on the Revised Schedule VI to the Companies Act, 1956 – Paragraph 8.7.2.1 of the Guidance Note reads as follows:

"The term trade investment is normally understood as an investment made by a company in shares or debentures of another company to promote the trade or business of the first company".

B. Query

8. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether it is appropriate for the company to classify the investments in subsidiary and other companies viz., DMICDC and bonds of NBFC infrastructure finance companies and banks as per its mandate as trade investment.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to classification of investments in subsidiary and other companies and bonds of NBFC infrastructure finance companies and banks as trade investments. 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 accounting for various investments made by the company, accounting for merger of IWRFC into the company, consolidation of various subsidiaries in the consolidated financial statements, etc. Further, the opinion being expressed hereinafter is purely from the perspective of classification and disclosure as per the requirements of Schedule VI (revised) to the Companies Act, 1956 and not from any other perspective.

10. With regard to classification of trade investments, the Committee notes that Note 6 (K) (i) of General Instructions for Preparation of Balance Sheet to Schedule VI (revised) to the Companies Act, 1956 states as follows:

> "**K. Non-current investments**
>
> (i) *Non-current investments shall be classified as trade investments* and other investments and further classified as:
>
> (a) Investment property;
>
> (b) Investments in Equity Instruments;
>
> (c) Investments in preference shares;
>
> (d) Investments in Government or trust securities;
>
> (e) Investments in debentures or bonds;
>
> (f) Investments in Mutual Funds;
>
> (g) Investments in partnership firms;
>
> (h) Other non-current investments (specify nature)
>
> Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given." (Emphasis supplied by the Committee.)

Further, paragraph 8.7.2.1 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India states as follows:

> "**8.7.2.1 Trade Investment**
>
> Note 6(K)(i) of Part I requires that non-current investments shall be classified as "trade investment" and "other investments". The term "trade investments" is defined neither in Revised Schedule VI nor in Accounting Standards.

> The term "trade investment" is, however, normally understood as an investment made by a company in shares or debentures of another company, to promote the trade or business of the first company."

From the above, the Committee notes that a trade investment is a non-current investment. Further, the Committee notes that trade investment can be in the form of equity instruments in subsidiaries, joint ventures, associates, etc. or debt instruments in the form of debentures and bonds, etc. Thus, the classification as trade investment does not depend upon the legal form; rather it depends upon the purpose/intent of such investment, viz., for promotion of the trade or business of the investing company. The Committee is of the view that whether the investment is made by the company to promote its trade or business should be determined from the actual facts and circumstances, which may be evidenced from the resolution of the Board of Directors, or the shareholders' approval, minutes of the meetings of the Board of Directors or shareholders or any other approving authority, etc. The Committee is further of the view that the term, 'to promote the trade or business' can be commonly understood in relation to investments for protecting or enlarging the activities of the investing enterprise and accordingly, while determining the nature of investment, the type/nature of business of the investing and investee company and connection with the business of investee company should also be considered. Accordingly, the Committee is of the view that to determine which investments are trade investments in the extant case, the company should consider its own facts and circumstances keeping in view the various factors as discussed above, such as, whether the investment is non-current investment, the intent of the company while making investment viz., to promote its trade or business, the type/nature of the businesses of the investing and investee company, connection with the business of the investee company, etc.

D. Opinion

11. On the basis of the above, the Committee is of the view that appropriateness of classification of investment in subsidiary and other companies viz., DMICDC and bonds of NBFC infrastructure finance companies and banks as per its mandate as trade investment would depend upon the consideration in the facts and circumstances of the company considering various factors, as discussed in paragraph 10 above.

Query No. 47

Subject: Accounting treatment of an arrangement with a service provider for digital signage solution. [1]

A. Facts of the Case

1. A company is one of the fastest growing Indian life insurance companies in India. It has appointed three banks as its corporate insurance agents for marketing/sale of insurance policies to their customers. The company is desirous of having publicity of its products. Its potential customers are customers of these banks. Hence, the company explored a solution to advertise its publicity materials to be streamed/run inside the banks' branches. It came across a solution which is offered by a service provider, who is one of the largest telecom/cellular/Dish TV service providers in India.

2. The arrangement of the company with the service provider is in the form of a service agreement. (Copy of the purchase orders have been furnished by the querist for the perusal of the Committee). The terms have been agreed/finalised based on a Letter of Intent. (Letter of Intent has also been furnished by the querist for the perusal of the Committee) The highlights of the arrangement are as follows:

- The company is desirous of having an end to end managed solution with respect to displays, connectivity and a robust platform with content storage services to be shared dynamically through multimedia contents to be displayed pan India at different bank branches of its corporate agents.

- The company is desirous of having a centralised control and administration of the aforementioned activities for seamless streaming of its publicity material to the right audience.

- The entire hardware (32" LCD, media player with operating system and relevant software, signage platform) for the above arrangement has to be owned and managed by the service provider including its warranties and maintenance throughout the term of the contract.

- The service provider is also responsible to resolve any complaints,

[1] Opinion finalised by the Committee on 6.2.2015.

non-working/streaming of the publicity material of the company within an agreed turn over time on any of the bank's branches.

- The term of the contract is for 3 years with an early exit clause subject to payment of certain residual value. The company has introduced the exit clause through a provision that *only* LCD screens will be transferred to the company by the service provider (to safeguard its interest).

- Under the said arrangement, the service provider is currently managing the said services at 900 bank branches.

- The company has chosen the service provider, as the company is technologically/logistically not capable of managing the entire solution itself.

- The company is not having any data regarding to the cost of the 32" LCD screens. However, such screens of similar brands are available in the market in the range of Rs.18,000/- to Rs.20,000/-.

3. The querist has stated that the company has treated the above arrangement as a service level agreement and, hence, has been accruing the expenses based on monthly charges payable to the service provider considering the following points:

- Value of service is significantly higher than value of hardware. Total contracted payments over the 3 year period amount to Rs. 1,17,000 per unit (Rs. 39,000 p.a for 3 years). Out of this, the *value of TV is not independently identifiable.* Even if the value of TV is assumed to be Rs. 20,000, then also significant portion of the contracted payments of Rs. 97,000 (Rs. 1,17,000 less Rs. 20,000) is towards the services, AMC, upkeep and IT support of the complete arrangement.

- The service contract mentions 'Monthly Charges for Digital Signage Solution: Rs. 2,750/- per month per screen (Display: 32" LCD LG / Samsung Screen, Player: Media Player with Operating System and relevant software, Platform: Signage Platform, Responsible for managing the services)'. *Important point to be noted in the above term is that the whole agreement is for a*

'Digital Signage Solution', the display screen is just incidental and part and parcel of the larger service arrangement.

- There are 3 major components of the whole solution:

  - Display

  - Player

  - Platform

- *On the display piece (screen), an option has been given to the service provider to provide any LCD screen (LG/Samsung) without giving any specifications of the technical specification/quality/model/brand.*

- *It is clear from the above facts that the company exercises no direct or indirect control over the hardware to be used by the service provider which is essential for considering such an arrangement as a lease.*

- Complete AMC, repairs, upkeeping of equipment and services etc. are the responsibilities of the service provider.

- *Risks associated with the hardware lies with service provider* for the contracted period. As per paragraph 3.2 of Accounting Standard (AS) 19, 'Leases', issued by the Institute of Chartered Accountants of India, ***"A <u>finance lease</u> is a lease that transfers substantially all the risks and rewards incident to ownership of an asset".***

- The company has neither the *capability nor intent* of utilising the hardware without the service part as provided by the service provider.

- *Without the specialised services* of the service provider, the associated hardware has no use to the company.

- No capability exists with the company to *use the assets for intended usage without paying the fees* to the service provider as agreed in the service contract.

- The company has *neither the infrastructure nor the technical know-how* to use the hardware on its own.

- Insertion of the term of transfer of assets in the service contract was introduced *just to safeguard the interest* of the company, but assets will not have any usage to it as it does not have the capability of running the service without service provider's support.

- The said assets will be transferred to the company only after the end of the contract term of 3 years when the economic useful life of the assets will be negligible/Nil. In fact, the economic useful life of the screens will become Nil even much before the end of the contract period, as the assets are to be used at commercial places (banks' branches) and the upkeep, repairs, AMC (and at few places, replacement as well, if required) will have to be taken care of by the service provider till the end of the contract period.

- The company has the intention only to have the solution and not the assets. The transfer clause has been inserted only to safeguard its interest in case of any failure on the part of the service provider.

- At the end of the contract period, in case the company does not have the intention of continuing with the arrangement, the said assets will most likely be scrapped by it given the commercial prudence, since, even the storage of 900 screens will involve a huge cost (transporting it to a central place, hiring of a warehouse, packing etc.) and it does not have more than 20-30 offices in India where these can be installed. (Even these premises are not big enough for installing more than 2 screens at a place).

- Since, in such cases it is always the *substance which prevails over form,* and the intent being taking holistic services, it is a service agreement and not a lease of any equipment. As per paragraph 8 of AS 19, "Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form…."

(Emphasis in the above points, supplied by the querist).

4. The querist has separately clarified the following:

(i) The service provider is free to use media player and platform of his choice. Also, the service provider is free to use dongles of his choice. The company has not made any specific request regarding model/brand/quality/technical specifications of the hardware proposed to be used by the service provider.

(ii) Model/brand/quality/technical specifications of the display, media player and platform used by the service provider cannot be considered as implied. With regard to 'dongles', as the service provider is one of the largest telecom/cellular/Dish TV service providers in India, it can be assumed that it will be using dongles belonging to its brand/group company. However, an important point to be noted is that though the service provider is one of the largest telecom/cellular/Dish TV service providers in India, still it does not have a pan India presence/capability. Hence, at certain locations, it has been using 'dongles' of other service providers and the same is decided by the service provider itself and the company has no explicit or implied say in choosing the alternate 'dongle' provider. The company has not made any specific request regarding model/brand/quality/technical specifications of the hardware and software to be used by the service provider. The service provider is expected to provide a complete end to end display solution and is expected to use resources as deemed fit for the same.

(iii) The service provider can replace any display, media player, platform and dongles during the contract period even though there is no defect in their functioning.

(iv) The players and screens are not meant for exclusively advertising material of the company only. Advertising material of the partner banks where these are installed would also be displayed in case of requirement from the banks.

(v) According to the querist, if everything goes fine and the company is satisfied with the services of the service provider, then, after the period of 3 years, LCD screen along with media player and dongles would be transferred to the company on free of cost basis. For dongles, the lock-in-period is 18 months, which, would start from the 'effective date' (i.e., date of acceptance of letter of commission). If, after 18 months from the 'effective date', early exit clause is exercised by the company paying Rs. 8,000 for LCD screen, dongles also will become the assets of the company.

(vi) After the completion of 3 years, media player will be given to the company along with the operating software, if the company opts to continue the arrangement with the service provider. Currently, the media player is programmed with software of the service provider. However, if required, the media player can also be programmed with software of other service providers.

(vii) At the end of the contract period, if the company does not have the intention of continuing with the arrangement, the assets will most likely be scrapped. All material related to the display solution, including players and dongles, will most likely be scrapped by the company.

5. The querist has separately given the following additional information:

(i) Risk in respect of damage and obsolescence to the hardware lies with the service provider and not with the company. However, risk with respect to physical damage and theft lies with the company. The service provider would be responsible for the replacement of equipment in case of any technological or other obsolescence. *An important point to be noted here is that although the company has entered into a contract with the service provider for LCD screens (as mentioned in the Purchase Order and Letter of Intent), however, the service provider has installed LED screens (instead of LCD screens, LED screens being better quality product and the need has arisen due to technological obsolesce of LCD screens) at many of the locations. Also, the service provider has already replaced media players at all locations because of technological obsolescence.* To clarify further, the company has not made any specific request regarding model/brand/quality/technical specification of the hardware and software (except in case of display screens where only an option has been given to the service provider in terms of brand i.e., LG/Samsung, but model has not been specified). The service provider is expected to provide a complete end to end display solution and is expected to use resources as deemed fit for the same. In case of non-functioning of the installed equipment, it is the service provider who would be held responsible for it and will have to rectify the defects. The company is concerned with the display of its advertising materials and the means for the same i.e., model/

display equipment/software etc., fall under the domain/ responsibilities of the service provider. (Emphasis supplied by the querist).

(ii) The company is intimated by the service provider once the installation of the equipments is complete at the bank branch and display of its advertisements has been commenced. Documentation/supports evidencing the same are attached with the invoice raised by the service provider. As equipments have been installed at various bank branches, entry into the branches for replacing such equipments is coordinated by the company.

(iii) The company, as a part of its marketing strategy/plan, has entered into the arrangement on a pan India basis involving 1,000 locations (approximately) and to ensure an uninterrupted arrangement, has introduced the transfer clause to safeguard its interest. Also worth noting is that the company has neither the capability nor the intent of utilising the equipments on its own and, hence, has introduced the transfer clause in the arrangement to ensure that the service provider offers long term services to the company.

(iv) Partner banks' advertising material is displayed only for a small portion of the total air time. This, in turn, helps the company to cross sell its products, thereby, assisting the company only. Hence, no fee is charged for the same as it helps boosting revenue of the company.

(v) The equipments are to be used only for displaying marketing material of the company and partner banks (for a small portion of total air time).

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the above arrangement with the service provider can be categorised as a lease or a service agreement for hiring of services.

(ii) If it is a lease, whether the same is an operating lease or a finance lease as per the provisions of AS 19.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to whether the arrangement with the service provider is a lease or is simply a service contract. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting implications of exercise of early exit clause, etc.

8. The Committee notes the following paragraphs of Accounting Standard (AS) 19, 'Leases', notified under the Companies (Accounting Standards) Rules, 2006:

> "2. This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other."
>
> ***"3.1 A <u>lease</u> is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time."***

9. From the above, the Committee notes that an arrangement may involve both lease and service elements and that AS 19 applies to such arrangements even though service element may be substantial. However, the Committee notes that AS 19 does not apply to agreements that are contracts for services that do not transfer the right to use assets. The Committee is of the view that whether an arrangement is, or contains, a lease, should be determined based on the substance of the arrangement and requires an assessment of whether:

(a) fulfillment of the arrangement is dependent on the use of a specific asset or assets; and

(b) the arrangement conveys the right to use the asset.

10. The Committee notes that in the extant case, the company has, in substance, outsourced advertising activities in respect of its publicity material

using the digital signage solution provided by the service provider. The facts and additional clarifications/ information furnished by the querist in paragraphs 2-5 above indicate that the intention of the arrangement is to enable the company to have a complete end to end digital signage solution from the service provider rather than to have a right to use 'specifically' identified assets for an agreed period of time with or without effective ownership of such assets. The mere fact that the company is responsible for physical damage/theft of the equipments does not alter this situation, especially, because, the equipments are installed in the partner banks' branches. The service provider bears all other risks, including risk of technological obsolescence. The fulfillment of the arrangement is dependent on use of display (LCD screen), player, dongles and signage platform. However, the 'specific' pieces of the hardware are not identified in the arrangement, either expressly or impliedly, as evident from the facts furnished by the querist in paragraphs 3 to 5 above. In particular, the Committee notes that although LCD screens were contemplated in the purchase orders/ Letter of Intent, the service provider has installed LED screens at many locations and also has replaced media players at all the locations due to technological obsolescence. Since the fulfillment of the arrangement does not depend on 'specific' pieces of the hardware, there is no need to examine whether the arrangement conveys the right to use the asset. The Committee is, therefore, of the view that the arrangement with the service provider does not contain a lease and that it should be accounted for as a service arrangement.

D. Opinion

11. 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) The above arrangement with the service provider should be categorised as a service agreement for hiring of services.

(ii) In view of (i) above, this question does not arise.

Query No. 48

Subject: Applicability of the Guidance Note on Accounting for Rate Regulated Activities before its applicability date. [1]

A. Facts of the Case

1. A company is a listed central public sector enterprise, engaged in the construction and operation of hydro power plants. The gestation period of projects at construction stage is generally long varying from minimum 5 years to 10 years. The projects are generally situated in remote areas. During the construction phase, owing to socio-economic reasons, which are beyond the control of the enterprise, sometimes, interruptions in active construction of the projects take place. Since these projects are capital intensive and establishment is created on long term basis, the company continues to incur interest during construction (IDC) and incidental expenditure during construction (IEDC) during the period of interruption of active construction of the project. Capitalisation of such costs becomes a challenge for the management in view of the accounting as per the existing Accounting Standards.

2. The querist has stated that being a regulated entity, tariff rate of the company is fixed by the regulator, namely Central Electricity Regulatory Commission (CERC), based on the capital cost of the individual project as per the Tariff Regulations which are valid for a period of 5 years. The existing Tariff Regulations are effective for the period 01.04.2014 to 31.03.2019. The said Regulations, cover such interruptions under 'Force Majeure', if these are beyond the control of the developer and are allowable for the purpose of tariff. Regulation 11 of the said Regulations further goes to provide that if delay in achieving the Scheduled Commercial Operation Date (SCOD) is not attributable to the generating company and is due to uncontrollable factors as specified, these costs shall be considered as allowable costs to charge rates from customers. Thus, the regulator is permitting the company to include in the rate base, as part of the cost of self-constructed fixed assets, these amounts that would otherwise be recognised as expense in the statement of profit and loss in accordance with Accounting Standards.

[1] Opinion finalised by the Committee on 6.2.2015.

3. The querist has stated that the Institute of Chartered Accountants of India (ICAI) has issued a 'Guidance Note on Accounting for Rate Regulated Activities'. It has been clearly spelt out that a regulatory asset can be recognised when the regulatory framework provides for the recovery of the incurred costs. Thus, a regulatory asset should be recognised by the entity in respect of such costs since the same is recoverable from the customers in future through tariffs. Thus, the company intends to recognise regulatory assets and regulatory liabilities in accordance with the Guidance Note in addition to the assets and liabilities recognised in accordance with the Accounting Standards in normal course. However, the company has been made to understand that the Institute has made effective date of implementation of the said Guidance Note w.e.f. 01.04.2015.

4. The querist has further stated that pending notification regarding effective date of implementation of the Guidance Note on Accounting for Rate Regulated Activities, the company intends to apply this Guidance Note to its operating activities w.e.f. 01-04-2014 as it meets the following criteria:

- the regulator establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and
- the price established by the Regulation (the 'rate') is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return. The specified return could be a minimum or range and need not be a fixed or guaranteed return.

Accordingly, the company would recognise regulatory assets and regulatory liabilities in accordance with the Guidance Note in addition to the assets and liabilities recognised in accordance with the Accounting Standards in the normal course.

B. Query

5. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee of the ICAI regarding early adoption of the said Guidance Note w.e.f. 01-04-2014, i.e., prior to 01.04.2015.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to applicability of the Guidance Note on Accounting for Rate Regulated Activities (hereinafter referred to as the 'Guidance Note') with effect from 01.04.2014. 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 interest during construction (IDC) and incidental expenditure during construction (IEDC) during the period of interruption of active construction of the project, recognition of interest costs and other incidental expenditure incurred during interruption of active construction of the capital projects as regulatory assets as per the Guidance Note, whether delay in achieving the Scheduled Commercial Operation Date (SCOD) is attributable or not to the generating company and is due to uncontrollable factors and whether IDC or IEDC are allowable costs to charge from the customers as per the CERC Regulations, etc.

7. With regard to applicability of the Guidance Note before its effective date, the Committee notes that the Guidance Note has already been issued by the Institute although its implementation date has not yet been announced by the Council of the Institute. Accordingly, the Committee is of the view that since the treatment specified in the Guidance Note is the considered view of the Council, the company may adopt the principles of the Guidance Note as applicable to it even before its applicability date.

D. Opinion

8. On the basis of above, the Committee is of the opinion that the company can adopt the Guidance Note before its applicability date, as discussed in paragraph 7 above, in accordance with the applicable provisions of the Guidance Note.

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.