Compendium of Opinions

(Volume XXXIII)

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

In an ever changing business environment, a robust financial reporting has become imperative to present a real picture of operating results of business transactions from the perspective of investors and other stakeholders. For this purpose, it is essential to prepare and present the financial reports using established accounting principles and reporting framework. With a view to give guidance to the professionals on interpreting such accounting principles and framework of financial reporting, the Council of the Institute of Chartered Accountants of India (ICAI) constituted the Expert Advisory Committee to reply to the queries on accounting, auditing and allied matters received from the members of the Institute.

Since its inception, the Expert Advisory Committee has been giving independent and objective opinions to the members in industry and practice. The Committee has also been providing opinions on various accounting issues to the Regulatory and Government authorities, such as, Comptroller and Auditor General of India, Ministry of Corporate Affairs, etc. I compliment CA. Sanjiv Chaudhary, Chairman, CA. Shriniwas Y. Joshi, Vice-Chairman and other members of the Expert Advisory Committee in the working of the Committee.

I am pleased to inform that the Expert Advisory Committee has brought out compilation of its opinions finalised during the year 2013-14 in this thirty-third volume of the Compendium of Opinions.

I am confident that this volume of Compendium of Opinions, like all the previous volumes, will be helpful to the professionals and other stakeholders.

New Delhi
May 8, 2015

CA. Manoj Fadnis
President

Preface

I am pleased to present this thirty-third volume of the Compendium of Opinions containing opinions finalised by the Expert Advisory Committee during the Council year 2013-14. It is my privilege to be continuously associated with this Committee during my tenure in the Council and to Chair the Committee for the current Council Year (2015-16). I am happy to note that I was part of the Committee as Vice-Chairman during the period, when the opinions contained in this volume were finalised by the Committee, under the Chairmanship of CA. Nilesh Shivji Vikamsey.

The opinions contained in this volume pertain to diverse subjects, such as, consolidation of ESOP Trust in the standalone financial statements, recognition of distribution network acquired in a business acquisition as an intangible asset, accounting treatment of share application money pending for allotment invested by holding company in subsidiaries, Exempt Provident Fund - disclosure and valuation as per Accounting Standard (AS) 15, 'Employee Benefits', accounting for revenue by a real estate developer, recognition of duty credit entitlement certificates issued under the 'Served from India Scheme', determination of 'normal operating cycle period' under revised Schedule VI to the Companies Act, 1956, capitalisation of borrowing cost under AS 16, accounting treatment of post retirement medical benefit scheme, accounting treatment of hedging costs incurred on external commercial borrowings, etc.

I would like to inform the readers that the opinions of the Expert Advisory Committee are the opinions or views of the members of the Committee and are not the opinions of the Council of the Institute. The opinions are based on the given facts and circumstances, as provided by the querist, as well as on the basis of the applicable accounting/auditing principles and the relevant laws and regulations applicable under the circumstances of the query on the date of finalisation of the opinion. The date of finalisation of the opinion is indicated in respect of each opinion. The opinions must be read and applied in the light of any subsequent developments and /or amendments in the applicable legal position and accounting/auditing principles.

Keeping in view the significance of information technology and the requirements of the users, this volume also contains a Compact Disk (CD), which incorporates all the opinions published not only in this volume but also published in earlier volumes of the Compendium of Opinions (viz., Volume I to Volume XXXIII). The CD of Compendium of Opinions is equipped with advanced and user friendly search facilities to locate the opinions on desired subject(s) in a jiffy. I hope that this CD would prove to be of great significance to all accounting professionals.

I would also like to inform you that the queries received by the Committee are answered in accordance with the Advisory Service Rules, which have also been published at the end of this volume.

I wish to place on record my sincere thanks to all the Committee members during the Council Year 2013-14, including co-opted members, namely, CA. Nilesh Shivji Vikamsey (the then Chairman), CA. Subodh K. Agrawal (the then President), CA. K. Raghu (the then Vice-President), CA. Rajkumar S. Adukia**,** CA. Pankaj Inderchand Jain, CA. Nihar Niranjan Jambusaria, CA. Shriniwas Y. Joshi, CA. Dhinal Ashvinbhai Shah**,** CA. S. Santhana Krishnan, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay**,** CA. Sanjay Agarwal, CA. Atul Kumar Gupta, Shri Gautam Guha (represented by Shri P. Sesh Kumar), Shri Bhaskar Chatterjee, Shri Salil Singhal, Shri Sidharth Birla, CA. Archana Bhutani, CA. Himanshu Kishnadwala, CA. Tushar J. Shah, CA. B.P. Rao (Past President), CA. Jayant Gokhale and CA. Jigar Parikh for their invaluable support and contribution in finalisation of the opinions. 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 thank Dr. Avinash Chander, Technical Director, Dr. Rashmi Goel, the then Secretary, Expert Advisory Committee, CA. Parul Gupta, Assistant Secretary and CA. Prafulla Raut, Executive Officer, for their untiring efforts and support in the process of finalisation of opinions throughout the year.

I firmly believe that this volume of the Compendium like earlier volumes would continue to justify the much faith and confidence reposed in the Committee by the accounting profession.

New Delhi
May 26, 2015

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

Contents

Query No. 1

Subject: Treatment of reversal of writing off of development expenses recognised under capital work in progress.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the ‘company’) was in the process of developing Gas Insulated Switchgear (GIS) technology due to huge market demand. GIS technology helps in stable power supplies. The said technology was developed in one of the subsidiaries of the company located at Hungary. Expenses incurred during research phase were expensed out. The development had started from the year 2002 onwards and all the eligible expenses, which comprised material costs, salary costs of employees directly engaged in development of GIS technology and other expenses such as, testing fees, professional fees, etc. had been capitalised and kept under capital work-in-progress (CWIP). The purpose of expenses was solely to develop GIS technology. The eligible expenses incurred during development phase were capitalised under CWIP as per the Hungarian Accounting Law (sections 24 and 25) (a copy of the Hungarian Accounting Law has been supplied by the querist for the perusal of the Committee). The same was also considered as CWIP while preparing and presenting consolidated financial statements of the company as per Indian Generally Accepted Accounting Principles (GAAPs). However, due to failure in some of the significant tests where result was not as per set internal standards and not meeting the criteria of cost-benefit for incremental cost due to poor market conditions, the company did not utilise its resources further. Accordingly, the company could not launch the product and had written off CWIP as an extra-ordinary depreciation at local level as per the Hungarian Accounting Law. The querist has separately informed that conditions as mentioned in paragraph 44 of Accounting Standard (AS) 26, ‘Intangible Assets’ were satisfied at the time of initial recognition and were continuously satisfied till the write-off of capital work-in-progress as extra-ordinary depreciation except conditions as mentioned in sub-paragraph (d) and to some extent sub-paragraph (e).

Extra-ordinary depreciation, in the books of the company’s subsidiary was provided in compliance with the Hungarian Accounting Law (sections 53(1)(b) and 53(2)). As mentioned in section 53(2) of the Hungarian Accounting Law,

[1] Opinion finalised by the Committee on 5.4.2013 and 6.4.2013

the CWIP was not derecognised and removed from the asset register and books of account. Instead, it was retained at gross value along with the same amount of accumulated depreciation as the company had not terminated the development activities and also the result of development was not sold or scrapped. Thus, asset was very much in existence but with zero value.

2. The querist has stated that vide section 53(3) of the Hungarian Accounting Law, such extra-ordinary depreciation can be reversed when the reasons for which the depreciation was provided, no longer exist. The company is now re-exploring the opportunity of developing the GIS technology once again as there is breakthrough in design configuration of existing technology which will help the company to generate business and positive cash flow. The said technology will remain in market for next 10 years. Further, as the market has improved significantly for Gas Insulated Switchgear and significant orders are also received from customers, conditions as mentioned in sub-paragraph (d) are now satisfied. Thus, on the basis of positive commercial prospects, the company now intends to reverse the extra-ordinary depreciation and bring back the CWIP to the extent of lower of market value or value in use which had been written off in the earlier year (section 57 of the Hungarian Accounting Law). The querist has also separately informed that fine-tuning of product configuration subsequent to improvement in market conditions has led to successful development of know-how of GIS technology.

3. The querist has also stated that as the subsidiary company is effecting the reversal of extra-ordinary depreciation in compliance with the Hungarian Accounting Law, the same should be consistent with the Indian GAAPs also as the financial statements of subsidiary will be consolidated as per Accounting Standard (AS) 21, 'Consolidated Financial Statements' and paragraph 20 of AS 21 stipulates about uniform accounting policies.

B. Query

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

(i) Whether the capitalisation of development expenses, as per the Hungarian Accounting Law, was in line with Indian GAAPs.

(ii) Whether the extra-ordinary depreciation charged under local

GAAPs can be considered as impairment as per Accounting Standard (AS) 28, 'Impairment of Assets' under Indian GAAPs.

(iii) If answers to (i) and (ii) above are positive, can the company reverse the impairment under AS 28, consistent with section 53(3) of the Hungarian Accounting Law and bring the assets back in the books?

C. Points considered by the Committee

5. The Committee, while answering the query, has considered 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, recognition of expenses incurred in research phase, accounting treatment in the standalone financial statements of subsidiary company as per the Hungarian Accounting Law, capitalisation of various expenses as development expenses, etc. The Committee also presumes from the Facts of the Case of the query that the issues have been raised in the context of consolidated financial statements of the company as per the Indian GAAPs. Therefore, the Committee has opined on the issues raised in paragraph 4 above only from the angle of consolidated financial statements of the company. Further, from a combined reading of the relevant facts of the query, the Committee has presumed that the conditions of paragraph 44 of Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') were satisfied initially at the time of capitalisation of development expenses and continuously till charging off of extra-ordinary depreciation under sections 53(1)(b) and 53(2) of the Hungarian Accounting Law and that at the time of charging off of the extra-ordinary depreciation, the conditions of paragraphs 44 (d) and (e) of AS 26 were not being satisfied in the context of Indian Accounting Standards. Also, at the time of reversal of extra-ordinary depreciation, condition mentioned at paragraph 44 (d) is presumed to be satisfied and since the querist has informed that the GIS technology has been developed, it is presumed that the condition at paragraph 44 (e) was also satisfied at that time.

6. As far as consolidated financial statements are concerned, the Committee notes that the company should follow uniform accounting policies for like transactions and other events in similar circumstances as per paragraphs 20 and 21 of Accounting Standard (AS) 21, 'Consolidated

Financial Statements', notified under the 'Rules', which are reproduced as follows:

> ***"20. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.***
>
> 21. If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements when they are used in preparing the consolidated financial statements."

From the above, the Committee is of the view that the company in the extant case should follow uniform accounting policy for the treatment of development expenditure in the consolidated financial statements unless it is impracticable to do so. Further, the parent company, being an Indian company, is required to prepare its consolidated financial statements in accordance with the Indian GAAPs. In case there is any difference in the two laws for the accounting treatment of development expenditure, then necessary adjustments should be made to the expenditure incurred in subsidiary so that the same is in line with the Indian GAAPs. In case it is not practicable to do so, disclosures as required under paragraph 20 of AS 21 should be made.

7. In the extant case, the Committee notes that the foreign subsidiary has capitalised the development expenses as per the laws prevailing in that country. However, for the purpose of consolidation, the Committee is of the view that uniform accounting policies have to be followed as discussed above and accordingly, the said expenditure should be capitalised only if it is in accordance with AS 26. The Committee notes paragraph 44 of AS 26, which is stated as below:

> ***"44. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:***

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably."

From the above, the Committee is of the view that the expenses incurred in development phase of an internal project should be recognised as an intangible asset if, and only if, an enterprise can demonstrate that all the conditions mentioned in paragraph 44 of AS 26 above are fulfilled. In the extant case, since the querist has stated that the conditions of paragraph 44 of AS 26 were satisfied at the time of initial recognition, the Committee is of the view that initial capitalisation of the expenses incurred in the development phase as 'capital work in progress' under 'Intangible Assets' is in line with AS 26.

8. As regards subsequent accounting for development expenditure in the consolidated financial statements, the Committee notes that extra-ordinary depreciation was charged in the books of the Hungarian subsidiary under sections 53(1)(b) and 53(2) of the Hungarian Accounting Law when the conditions of paragraphs 44(d) and (e) of AS 26 were not being met. The Committee notes the aforesaid sections of Hungarian Accounting Law as reproduced below:

"53(1) Extraordinary depreciation shall apply in connection with intangible and tangible assets, if:

(a) the book value of the intangible or tangible asset (not including assets in course of construction) remains permanently and substantially higher than the market value of such asset;

(b) the value of intellectual property and tangible assets (including assets in course of construction) *drops permanently* because such intellectual property or tangible assets (including assets in course of construction) have become unnecessary due to a change in the entrepreneurial activities, or cannot be used for the original purpose thereof as a consequence of damage or destruction, *or cannot be used at all*; (emphasis supplied by the Committee)

…"

"53(2) Depreciation as defined in Subsection (1) shall be carried out to an extent that the intangible assets, tangible assets and assets in course of construction be shown in the balance sheet at the known market value corresponding to the utility thereof, in effect on the balance sheet date. If an intangible or tangible asset, or an asset in the course of construction cannot be used for its intended purposes, or if its unusable, destroyed or is missing, it shall be removed from the list of intangible assets, tangible assets, or assets in course of construction after extraordinary depreciation is claimed and deducted. Any extraordinary depreciation on the basis of market value shall be claimed as on the balance sheet date; whereas extraordinary depreciation upon derecognition shall be accounted for as at the date when the asset is derecognized."

From the above, it is apparent that the extraordinary depreciation could have been provided only if the conditions prescribed as above in the law had been fulfilled, viz., *permanent* drop in the value of intangible asset because it could not be used at all or if the company could not use the intangible asset for its intended purposes, then it is to be removed from the asset register. Accordingly, the company had written off the development expenditure recognised as intangible asset in progress to zero. The Committee is of the view that writing off the intangible asset to zero itself indicates that at that point of time, intangible asset had neither value-in-use nor any disposal value. In other words, no future economic benefits were expected either from its use or disposal, which is also evident from the fact that at that point of time, neither of the conditions stated in paragraphs

44(d) and (e) of AS 26 were met, as stated by the querist in paragraph 1 above. In other words, the intangible asset had became virtually infructuous having no future economic benefit. Accordingly, in the view of the Committee, the said intangible asset should have been derecognised in accordance with paragraph 87 of AS 26 which is reproduced as below:

> ***"87. An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal."***

In view of the above, the question of charging of impairment loss on such intangible assets under Indian GAAPs or reversal thereof does not arise.

D. Opinion

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

(i) The capitalisation of development expenses as per the Hungarian Accounting Law is in line with Indian GAAPs assuming that the conditions of paragraph 44 of AS 26 as discussed in paragraph 7 above are fulfilled.

(ii) Since in the extant case, the company had no future use of that intangible asset resulting into any future economic benefits, the intangible asset (CWIP) recognised should have been derecognised rather than being considered as impairment loss in the consolidated financial statements as discussed in paragraph 8 above.

(iii) Since the answer to (ii) above is in the negative, the question of reversal of impairment does not arise.

Query No. 2

Subject: (i) Consolidation of ESOP Trust in the standalone financial statements.

(ii) Treatment of investment in own shares for EPS calculation in the standalone financial statements.

(iii) Treatment of ESOP Trust in the financial statements for tax audit Purposes.[1]

A. Facts of the Case

1. Company A (the 'company') is listed on stock exchanges in India and has a statutory year end of 31st December. In the year 2011, the company started new Employee Stock Option ('ESOP') scheme whereby the employees would be granted options (directly linked to individual, team and company performance) at an exercise price equal to the face value of the share (currently at INR 5). The company has created a Trust for this purpose, also referred to as the 'ESOP Trust' or 'ESOPT'. The ESOP Trust obtains its funds through a loan from the company, which it utilises for the purchase of the company's shares. It receives shares from the company by way of fresh allotment. The ESOP Trust then allocates shares to employees on exercise of their right in exchange of cash and repays its loans. The details of Trustees, Beneficiaries and Benefactor of the Trust are given below:

a. Trustees : Senior management employees of the company A

b. Beneficiaries : Company A Employees

c. Benefactor : Company A

The company records the charge (intrinsic value–grant price) in its own books.

2. The querist has drawn the attention of the Committee to paragraph 45 of the 'Guidance Note on Accounting for Employee Share-based Payments', (the Guidance Note') issued by the Institute of Chartered Accountants of India (the 'ICAI'), which reads as below:

> "45. For the purpose of preparation of consolidated financial statements as per Accounting Standard (AS) 21, 'Consolidated Financial

[1] Opinion finalised by the Committee on 5.4.2013 and 6.4.2013.

Statements', issued by the Institute of Chartered Accountants of India, the trust created for the purpose of administering employee share-based compensation, should not be considered. This is because the standard requires consolidation of only those controlled enterprises which provide economic benefits to the enterprise and, accordingly, consolidation of entities, such as, gratuity trust, provident fund trust, etc., is not required. The nature of a trust established for administering employee share-based compensation plan is similar to that of a gratuity trust or a provident fund trust as it does not provide any economic benefit to the enterprise in the form of, say, any return on investment."

3. The querist has also drawn the attention of the Committee to Clause 22A.1 of the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 (hereinafter referred to as 'the SEBI Guidelines'), dealing with accounting for employee stock option scheme ('ESOS') and employee stock purchase scheme ('ESPS') through Trust route, which reads as below:

> "In case of ESOS/ESPS administered through a Trust, the accounts of the Company shall be prepared as if the company itself is administering the ESOS/ESPS."

4. The querist has made an analysis evaluating whether the transactions of the ESOPT should be included in the standalone financial statements of the company. As per the querist, the following reasons suggest consolidation of ESOPT in the separate financial statements of the company:

(i) It is noted that the company, being a listed company, accounting by the company in respect of ESOP will have to be in accordance with the SEBI Guidelines on the matter.

(ii) Revised clause 22A.1 of the SEBI Guidelines reads as follows:

"In case of ESOS/ESPS administered through a Trust, the accounts of the company shall be prepared as if the Company itself is administering the ESOS/ESPS."

A plain reading of the above Clause shows that SEBI's intent is to make comparable the standalone financial statements of two companies - one which follows the Trust route and the other that issues shares directly to the employees concerned. The appropriate approach would, therefore, be that the accounts of the Trust should be included in the standalone financial statements of the company as if all the transactions of the Trust are those of the company. The standalone financial statements would, thus, be devoid of the effect of executing ESOP scheme through the Trust route. In substance, the activities of the Trust are being conducted on behalf of the company according to its specific business needs. The Trust should be seen as an extension of the company as a branch/agent and, therefore, it is appropriate to view actions that nominally are those of the Trust as actions of the company.

(iii) Since under the SEBI Guidelines, the ESOPT is to be viewed as a part of the company itself, it follows that the transactions between the two would not be reflected in the standalone financial statements of the company. Rather, the transactions between the ESOPT and third parties would be reflected in those financial statements as if these had been carried out by the company itself. This implies that the loan given by the company to ESOPT will not appear in the company's standalone financial statements.

5. The main issue arising from the above view is the manner of disclosure of the shares of the company held by ESOPT at the year end and the loan given by the company to ESOPT. As per the querist, as far as shares held by the Trust at the year end are concerned, these can be reflected in the standalone financial statements of the company. The face value of these shares should be shown as a deduction from share capital and the excess amount paid over and above the face value should be shown as deduction from securities premium with a detailed note explaining the facts. This is on the basis that to the extent own shares are purchased by the company from the market, the Shareholders' Funds stand reduced[2]. *In the books of account, these shares will continue to remain recorded in a separate account and, only for disclosure purposes, they would be shown as deduction from share capital/securities premium. There will not be an accounting entry made in the ledger debiting 'Share Capital/Securities Premium' and crediting 'Investment in Own shares'.* This is because, such an entry may be construed

[2] Acquisition of own shares of a company by employee welfare trusts (including ESOS/ESPS) from secondary market is no longer possible in view of the SEBI's Circular No. CIR/CFD/DIL/3/2013 dated January 17, 2013 which has amended 'SEBI Guidelines' and 'Equity Listing Agreement'.

as effecting a reduction of capital/utilisation of securities premium and, thus, giving rise to attendant legal issues. (Emphasis supplied by the querist.)

6. As per the querist, the ICAI's Guidance Note also recommends the above method of presentation in a situation where the enterprise provides finance to the ESOP Trust for subscription of shares issued by it (i.e., the enterprise) at the beginning of the plan. In case the enterprise provides finance to the Trust for purchasing shares from the market, ICAI's Guidance Note requires loan given to the Trust as asset in the enterprise's balance sheet. However, the genesis of this seems to be in the fact that unlike SEBI Guidelines, ICAI's Guidance Note treats the ESOP Trust as a separate entity. Accordingly, the activities of the trust are not reflected in standalone financial statements of the enterprise. Further, as per the Guidance Note, ESOP Trust is not consolidated.

7. However, the company's management is of the view that since both the SEBI Guidelines and the ICAI's Guidance Note require that as the Trust administers the plan on behalf of the company, the company will recognise any expense arising from the employee share-based payment plans as if the company itself is administering the plan. However, it should not incorporate any other balance of the ESOP in the standalone financial statements of the company. Thus, the loan from the company to ESOPT will not be eliminated and would appear in the standalone financial statements of the company. In view of paragraph 45 of the ICAI's Guidance Note, the Trust should not be consolidated for the purpose of Consolidated Financial Statements as per Indian Generally Accepted Accounting Principles (GAAPs).

8. Another issue which arises is how to consider investment in own shares in the standalone financial statements of company A for the purpose of calculating basic and diluted earnings per share. The querist has drawn attention of the Committee to paragraph 46 of the ICAI's Guidance Note on Accounting for Employee Share-based Payments, dealing with the issue of EPS, which reads as below:

> "46. For the purpose of calculating Basic Earnings Per Share as per Accounting Standard (AS) 20, 'Earnings Per Share', shares or stock options granted pursuant to an employee share-based payment plan, including shares or options issued to an ESOP trust, should not be included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, shares or stock options so granted

should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share. Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive."

As per the querist, the above seems to suggest that the shares purchased by the Trust from the market should be excluded in calculating weighted average number of outstanding shares for the purposes of basic EPS calculation. However, for purposes of diluted EPS computation, such shares would be considered as potential equity shares.

9. As per the querist, a note should be given in the notes to accounts, which should bring out the requirement of Clause 22A.1 of the SEBI Guidelines pointing out that pursuant to this requirement, the activities of the Trust have been deemed as those undertaken by the company and dealt with accordingly.

10. Considering the above analysis, another issue which requires deliberation is the accounting treatment to be followed in the financial statement prepared under Section 44 AB of the Income-tax Act, 1961 i.e., for the year ended 31st March. It is pertinent to note that these financial statements are prepared for a specific purpose for compliance with the Income-tax Act, 1961 and not for the purpose of compliance with any SEBI requirements.

11. The format of Form 3CB requires the tax auditor to state whether the financial statements of the company

"... give a true and fair view:-

(i) in the case of the balance sheet, of the state of affairs of the assessee as at 31 March,___ ; and

(ii) in the case of the profit and loss account/income and expenditure account of the profit/loss or surplus/deficit of the assessee for the year ended on that date."

12. The querist has drawn the attention of the Committee to the following extracts from the 'Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India:

"10.5 AS also apply in respect of financial statements audited under section 44AB of the Income-tax Act, 1961. *Accordingly, members should examine compliance with the mandatory accounting standards when conducting such audit."* [Emphasis added by the querist]

"10.7 The Companies Act, 1956, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 1956, or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view." (The querist has drawn the attention of the Committee to the fact that this has also been reiterated in paragraph 4.15 of the ICA1's 'Code of Ethics'-Eleventh Edition).

13. A question arises as to whether, for the purpose of compliance with the provisions of the Income-tax Act, 1961, the company, being a listed company, should comply with the SEBI Guidelines (as adhered to for the purposes of preparation of annual accounts) or the ICAI's Guidance Note while preparing its financials statements for the year ended 31st March. The querist has analysed this issue for the following two situations:

— Companies covered under the provisions of Minimum Alternate Tax ('MAT')

— Companies not covered under the provisions of MAT

Companies covered under the provisions of MAT

14. The querist has quoted the following portion of MAT provisions[3]:

"115JB. (1) Notwithstanding anything contained in any other provision of this Act, where in the case of an assessee, being a company, the income-tax, payable on the total income as computed under this Act in respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, 2010, is less than fifteen

[3] There are further amendments to MAT provisions quoted by the querist.

per cent of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of fifteen per cent.

(2) Every assessee, being a company, shall, *for the purposes of this section, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act, 1956 (1 of 1956):*

Provided that while preparing the annual accounts including profit and loss account,—

(i) the accounting policies;

(ii) the accounting standards adopted for preparing such accounts including profit and loss account;

(iii) the method and rates adopted for calculating the depreciation,

shall be the same as have been adopted for the purpose of preparing such accounts including profit and loss account and laid before the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956 (1 of 1956) :

Provided further that where the Company has adopted or adopts the financial year under the Companies Act, 1956 (1 of 1956), which is different from the previous year under this Act,—

(i) the accounting policies;

(ii) the accounting standards adopted for preparing such accounts including profit and loss account;

(iii) the method and rates adopted for calculating the depreciation,

shall correspond to the accounting policies, accounting standards and the method and rates for calculating the depreciation which have been adopted for preparing such accounts including profit and loss account for such financial year or part of such financial year falling within the relevant previous year.

…"

[Emphasis added by the querist].

As is evident from the extracts given above, for the purpose of section 115JB, the company is required to prepare profit and loss account as per the provisions of Parts II and III of the Schedule VI to the Companies Act, 1956 using the same accounting policies, accounting standards and the method and rates for calculating the depreciation which have been adopted for preparing such accounts including profit and loss account for such financial year or part of such financial year falling within the relevant previous year.

Companies not covered under the provisions of MAT

15. The next issue relates to the position where section 115JB is not applicable to a company. In this regard, the querist has made reference to paragraph 44 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the ICAI as per which "the benefits derived from information should exceed the cost of providing it". In the financial statements submitted under the Companies Act, 1956, certain information is disclosed to comply with the statutory requirements. As per the querist, such information may not have a bearing on the true and fair view of the financial statements prepared for tax purposes (Form 3CB). The stakeholders have access to the statutory financial statements. Further, as per the querist, the need of tax authorities seems to be met by the disclosures relevant for a true and fair view and, in this regard, the following portion of paragraph 10.7 of the Guidance Note on Tax Audit discussed in paragraph 12 above is relevant:

> "… However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 1956, or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view."

16. Accordingly, as per the querist, in the absence of any clear guidance, an assessee may elect to comply with the ICA1's Guidance Note for the purpose of preparation of accounts for the year ended 31st March whilst complying with the SEBI Guidelines for the purpose of preparation of annual accounts.

B. Query

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

(i) Whether, in the standalone financial statements of company A for the year ended 31st December, loan given by company A to ESOPT should be shown as 'Loans to ESOPT' under 'Assets' or operations of ESOPT should be included in the standalone financial statements of company A. If operations of ESOPT are included in standalone financial statements of the company, then, how to disclose shares of the company held by ESOPT?

(ii) In the standalone financial statements of company A, for the purpose of calculating basic and diluted earnings per share, how to consider investment in own shares?

(iii) Will the above treatment also be followed in the financial statements prepared under section 44AB of the Income-tax Act, 1961 i.e., for the year end 31st March, i.e., is the company required to follow the requirements of the ICAI's Guidance Note or the SEBI Guidelines?

C. Points considered by the Committee

18. The Committee notes that the basic issues raised by the querist relate to (i) inclusion of the operations of the ESOP Trust ('ESOPOT') in the standalone financial statements of the company, (ii) treatment of investment by ESOPT in the shares of the company for calculating basic and diluted earnings per share ('EPS') in the standalone financial statements of the company, and (iii) treatment in the financial statements prepared for tax audit purposes. The Committee has considered only these issues and has not examined any other issue that may be contained in the Facts of the Case. The Committee also notes that the charge on account of ESOP is stated by the querist as 'intrinsic value – grant price' in paragraph 1 above. It seems that the charge is intrinsic value i.e., 'market price – exercise price' (market price, for this purpose, is as defined in the 'SEBI Guidelines' and exercise price being equal to grant price, which in the extant case is face value of the share). However, this does not affect the opinion of the Committee. Also, the querist has not stated whether the company has allotted shares to ESOPT in respect of all the stock options granted or in respect of

expected number of vested options likely to be exercised by the employees. However, this does not affect the opinion of the Committee. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view and not from any legal point of view, such as, interpreting the provisions of the Income-tax Act, 1961, i.e., expressing any view on computation of income for the purpose of the Income-tax Act, 1961 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.

19. The Committee is of the view that, in case of listed companies, if there are certain differences between the 'Guidance Note' issued by the Institute of Chartered Accountants of India and the 'SEBI Guidelines' then to the extent the requirements of the SEBI Guidelines differ from the Guidance Note, the SEBI Guidelines will prevail.

20. The Committee notes Clause 22A.1 of the 'SEBI Guidelines' (also quoted by the querist in paragraph 3 above) which reads as below:

> "In case of ESOS/ESPS administered through a Trust, the accounts of the Company shall be prepared as if the company itself is administering the ESOS/ESPS."

Thus, though ESOPT itself may prepare its own financial statements, for example, to meet regulatory requirements, the standalone financial statements of the company should portray the picture as if the company itself is administering the ESOP Scheme. The Committee is of the view that this has two results viz., (i) the company should recognise any expense arising from the employee share-based payment plans, and (ii) the operations of ESOPT are included in standalone financial statements of the company insofar as the ESOP is concerned. In such a situation, in the standalone financial statements of the company, 'Loans to ESOPT' will not appear at all. Accordingly, the following adjustments are required:

(i) Loans to ESOPT in the books of company should be eliminated against loan from company as appearing in the books of Trust.

(ii) The amount representing the grant date intrinsic value of the options yet to be exercised by the employees (originally recorded as a debit on issue of shares to ESOPT even before the exercise of options by the employees) will be added to 'Investment in shares of the company' and the sum may be described as 'Shares held in trust for employees under ESOP Scheme'. This should be presented as a deduction from Share Capital to the extent of face value of the shares and Securities Premium to the extent of amount exceeding face value of shares. The company should give a suitable note in the Notes to Accounts to explain the nature of this deduction.

21. As regards the issue of calculation of earnings per share ('EPS') in the standalone financial statements of the company, the Committee notes that at present, AS 20, 'Earnings Per Share', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules') and the Guidance Note complement each other and, hence, both should be considered in a harmonious manner in addressing the issue on EPS calculation. The Committee notes that as per the Facts of the Case, the employees would be granted stock options which are directly linked to individual, team and company performance. The Committee is of the view that such performance-based employee stock options should be treated as contingently issuable equity shares under AS 20. Further, the Committee is of the view that the principles enunciated in AS 20 in respect of options and contingently issuable equity shares are equally applicable for shares allotted to ESOPT which, in turn, will be allotted in future to employees on exercise of their options. In reaching this conclusion, the Committee notes the expression '*shares or* stock options issued to an ESOP Trust' occurring in paragraph 46 of the Guidance Note, reproduced by the querist in paragraph 8 above. [Emphasis added by the Committee]. In the light of the above discussion, the Committee is of the following views:

(i) For the purpose of calculating basic EPS in the standalone financial statements of the company, shares allotted to the ESOPT should be included in the shares outstanding, only when the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. This is on the basis of paragraph 46 of the Guidance Note, reproduced by the querist in paragraph 8 above, which is also illustrated in Illustration 2 of Appendix VII to the Guidance Note. This is also in accordance with paragraph 34 of AS 20 dealing with contingently issuable shares with an added clarification that exercise of options is also required for inclusion of the shares in calculation of basic EPS.

(ii) The shares allotted to ESOPT are treated as potential equity shares for the whole or part of a particular reporting period depending on the conditions as prescribed in paragraph 34 of AS 20. In other words, even if the requisite vesting conditions are not fulfilled, shares allotted to ESOPT against granted options should be considered for calculating diluted earnings per share. However, it has to be examined whether they are dilutive and, if so, what should be the number of shares to be treated as dilutive potential equity shares. This should be determined in accordance with paragraphs 35-37 of AS 20. For this purpose, paragraph 47 of the Guidance Note, which supplements paragraph 35 of AS 20, should also be considered.

(iii) When the shares allotted to ESOPT are considered for calculation of basic and diluted EPS in accordance with principles stated in (i) and (ii) above, they are weighted in accordance with paragraph 43 of AS 20.

The Committee also notes that paragraph 46 of the Guidance Note quoted by the querist in paragraph 8 above deals, inter alia, with the situation where shares or options are 'issued' to the ESOPT and *not* with the situation where shares are purchased by ESOPT from the market. Consequently, the Committee does not agree with the querist's statement in paragraph 8 above that paragraph 46 of the Guidance Note seems to suggest that shares purchased by ESOPT from the market should be excluded in calculating the weighted average number of outstanding shares for purposes of basic EPS calculation, whereas, for purposes of diluted EPS computation, such shares would be considered as potential equity shares. In fact, Illustration 3 of Appendix VII to the Guidance Note clearly explains that when shares are purchased by the Trust from market, such shares represent the shares that have already been issued by the enterprise and the same should continue to be included in the shares outstanding for the purpose of calculating basic EPS as would have been done prior to the purchase of the shares by the Trust. Since the exercise of stock options granted under the plan does not result into any fresh issue of shares, the stock options granted would not be considered as potential equity shares for the purpose of calculating diluted EPS.

22. As regards the issue on audit under section 44AB of the Income-tax, 1961 (tax audit), the Committee notes section 115JB (2) of the Income-tax

Act, 1961, as reproduced in paragraph 14 above and is of the view that in the case of listed companies, the financial statements prepared for statutory audit are relevant for tax audit also, subject to the following:

(i) While the accounting year of the company in the extant case is calendar year, tax audit is for financial year. Hence, financial statements for the financial year should be prepared and subjected to tax audit. The said financial statements should be in accordance with Accounting Standards notified under the 'Rules' and SEBI Guidelines, while Guidance Note can be followed in respect of matters not addressed in the SEBI Guidelines, in a manner not inconsistent with the SEBI Guidelines.

(ii) The financial statements for audit under section 44AB of the Income-tax Act, 1961, should be prepared by following the same accounting policies and accounting standards, that have been adopted for preparing the annual accounts that were laid at the annual general meeting of the company in accordance with section 210 of the Companies Act, 1956.

D. Opinion

23. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 17 above:

(i) In the standalone financial statements of company A for the year ended 31st December, the loan given by company A to ESOPT will not appear at all. For presentation and disclosure of shares held by ESOPT, see paragraph 20(ii) above.

(ii) In the standalone financial statements of company A, the treatment of shares allotted to ESOPT for calculating basic and diluted EPS should be in the manner explained in paragraph 21 above.

(iii) See paragraph 22 above.

Query No. 3

Subject: Amortisation of Land Right of Way.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a Government company within the meaning of section 617 of the Companies Act, 1956. The shares of the company are listed with recognised stock exchanges. The company is engaged in the business of refining of crude oil and marketing of petroleum products. It has two refineries and lube blending/filling plants. The company also has depots, installation and LPG plants across India, besides having administrative offices at Delhi, Chennai, Kolkata, Mumbai and other major cities.

2. The company owns pipelines for movement of petroleum products from one location to another for the purpose of stock transfer/sale. These pipelines are underground pipelines having sectionalising valve stations/intermediate pigging stations/booster pumping stations in between. Products are pumped through these pipelines as and when movement of product is required and at any point of time, the pipeline is filled with the product. For the purpose of laying the pipelines, the company acquires 'right of way', i.e., right of use in land (ROU) under which such pipeline is to be laid. The right is acquired under the Petroleum and Minerals Pipelines (Acquisition of Right of User in Land) Act, 1962, and vests absolutely with the company free from all encumbrances.

3. Though the ownership of the land under which the pipeline is laid continues with the land owner, the pipeline remains the property of the company. The company also has perpetual and absolute right to enter the land under which pipeline has been laid for the purpose of maintaining, examining, repairing, altering or removing any such pipeline or for doing any other acts necessary for any of the aforesaid purposes or for the utilisation of such pipeline. This right enables the company to lay one or more pipelines. The land owner cannot construct any permanent structure or plant any tree having deep roots on this piece of land, though he can raise crops. According to the querist, the ROU is an independent fixed asset as this right is absolute and perpetual as per the Petroleum and Minerals Pipelines (Acquisition of Right of User in Land) Act, 1962. The Act provides provision for repair and replacement of the pipeline as and when necessary.

[1] Opinion finalised by the Committee on 5.4.2013 and 6.4.2013.

4. *Accounting treatment:*

(i) *Current accounting treatment:* In view of the above facts, the cost of ROU is capitalised as intangible asset, disclosed separately and not amortised. The accounting policy of the company on intangible assets also states that "cost of right of way that is perennial in nature is not amortised as no finite useful life can be identified for the same".

Paragraph 68 of Accounting Standard (AS) 26, 'Intangible Assets', which became effective from the accounting periods commencing on or after 1-04-2004, inter alia, states that "the useful life of an intangible asset may be very long but it is always finite." Further, paragraph 63 of AS 26 states that "there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use."

However, in the opinion of the company, AS 26 does not deal with an intangible asset of perennial in nature and hence, the company does not provide for amortisation on Land Right of Way.

(ii) *Expert Advisory Committee (EAC) Opinion*:

The above accounting treatment of not amortising the land right of way is in line with EAC Opinion dated 23.10.1999 (Query No. 31 of Volume XIX of the Compendium of Opinions). The opinion states that since right of way is perpetual in nature, it does not meet the definition of depreciable asset in terms of paragraph 3.2 of Accounting Standard (AS) 6, 'Depreciation Accounting' as it does not have a finite useful life. It may, however, be noted that the EAC Opinion was issued prior to introduction of AS 26.

(iii) *International Financial Reporting Standards (IFRS)*:

It may be noted that International Accounting Standard (IAS) 38, 'Intangible Assets' (paragraph 107) permits an intangible asset with an indefinite useful life not to be amortised. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity (paragraph 88 of IAS 38).

(iv) *Indian Accounting Standards (Ind AS)*:

Ind AS 38, 'Intangible Assets' (notified, but yet to be implemented) is also in line with IAS 38 (paragraph 105 of Ind AS 38).

It has also been observed that other companies having major pipelines do not amortise the right of way.

5. The Issue:

The statutory and government auditors have been raising the issue that the company should amortise the cost of right of way on the grounds that as per AS 26, the life of intangible assets is always finite and cost needs to be amortised over the same (paragraph 69 of AS 26).

B. Query

6. In view of the above, the querist has sought the opinion of the EAC on the following issues:

(i) Whether the current practice of the company not to amortise the land right of way as it is perennial in nature is correct.

(ii) In case it is not correct, what should be the useful life to be considered for computing the amortisation in view of the fact that the right of way is perennial in nature?

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to whether the land right of way, which, as per the querist, is perennial in nature, is eligible for amortisation as per AS 26. The Committee has, therefore, considered only this issue and has not touched upon any other issue arising from the Facts of the Case, such as, determination of depreciable amount for amortisation, if any, required, as per the discussion in the following paragraphs, etc. Further, the Committee wishes to point out that the issue has been examined in the context of the notified Accounting Standards only and not from the International Financial Reporting Standards (IFRS) and Indian Accounting Standards (Ind AS) perspective as referred to by the querist.

8. The Committee notes from the Facts of the Case and the Petroleum and Minerals Pipelines (Acquisition of Right of User in Land) Act, 1962

(paragraph 4) that the user's right is restrictive for laying down and maintaining the pipelines and not unlimited for any purpose. The Committee further notes the definition of the term 'useful life' as given in paragraph 6 of AS 26 and the following paragraphs of AS 26:

"6.9 <u>Useful life</u> 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."

"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.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise."

"66. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Standard adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

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 (see paragraph 94(a)).

…

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."

"70. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors."

"94. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

..."

9. On the basis of the above, the Committee is of the view that paragraphs 68 of AS 26 specifically envisages that the useful life of an intangible asset is always finite, howsoever long and indefinite it may be. AS 26 does not justify non-amortisation; it only requires disclosures where the useful life is considered more than 10 years. It stipulates that the life has to be determined on a prudent and rational basis. The Committee also does not agree with the view of the querist that the useful life of land right of way is infinite. In the view of the Committee, the useful life of the land right of way may be determined considering various technical, legal and economic factors, such as, useful life of petroleum reserves from which the petroleum products are being produced and then transported, technological changes in the transportation modes, alternative resources of energy, etc. The Committee is further of the view that, as per the Standard, the useful life of the land right of way may be indefinite but it is not infinite and, accordingly, the depreciable amount should be allocated on a systematic basis over the best estimate of its useful life. Therefore, the Committee is of the view that the current practice of the company not to amortise the land right of way is not correct. The Committee also wishes to point out that in case useful life of the intangible assets is determined to exceed more than 10 years, the company should provide reasons for such presumption as per the requirements of paragraph 94 of AS 26 reproduced above.

10. With regard to applicability of earlier opinion of the Committee dated 23.10.1999, as referred to by the querist in paragraph 4 above, the Committee

wishes to point out that the earlier opinion was based on AS 10 as at that time, AS 26 was not applicable. The Committee is of the view that after AS 26 coming into force, the requirements of AS 26 should be applied in the context of intangible assets dealt with by it as discussed above and AS 10 shall no longer be applicable to it.

D. Opinion

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

(i) No, the current practice of the company not to amortise the land right of way is not correct as discussed in paragraphs 8 and 9 above.

(ii) The useful life should be determined keeping in view the principles of AS 26, as discussed in paragraph 9 above.

Query No. 4

Subject: Presentation of interest expenses on advance received from customer.[1]

A. Facts of the Case

1. The querist is a defence public sector undertaking (hereinafter referred to as 'the company') under the Ministry of Defence and is engaged mainly in the construction of warships and submarines for Indian Navy. The company had entered into an agreement for design, construction and delivery of multi-purpose support vessels with an overseas customer. The agreement provided for payment of 20% on signing of the contract and 80% on delivery of the ship. The agreement also provided for refund of advance along with interest in case of cancellation of contract. The relevant clause reads as under:

[1] Opinion finalised by the Committee on 5.4.2013 and 6.4.2013.

> "The Contract shall allow a grace period for delay in delivery of forty days from the date of scheduled/ extended delivery without any Liquidated Damages payable by the Builder. For delivery after the grace period, Builder to pay Liquidated Damages @ US$ 18,000/- per day or prorate thereof, till the actual day of delivery. Buyers to have the right to cancel contract in case delivery is delayed (due to reasons excluding Force Majeure circumstances and delays due to Buyers' account) beyond four months from the delivery date. However, in case of delays due to Force Majeure circumstances within the Builder's Yard or at its Sub-contractor's yard, Buyers shall have right to cancel the contract for delay in delivery beyond six months from the Delivery Date. It is clearly understood and agreed by both parties that Buyers have the right to cancel contract for delay in delivery beyond six months from the Delivery Date, due to any reasons whatsoever, other than those delays due to Buyers' account.
>
> Upon such cancellation by the Buyer and upon the Buyer's Demand, the Builder shall within 10 (ten) days refund full amounts of total sums paid by the Buyer to the Builder in advance of delivery together with interest @ 7% p.a. from the day following the date of receipt by the Builder of the pre-delivery installment to the date of refund.
>
> It is clearly understood that in the event of any conflict between this Clause and any other Clause in the Contract, the terms in this Clause shall prevail."

During the financial year 2011-12, the overseas customer served the notice for termination of the agreements. The company had refunded the initial advance along with interest.

2. The company has been showing interest expenses in the accounts separately and not under 'Other Expenses'. Interest cost was disclosed under 'Finance Costs' as 'Interest Expenses – Project Related' in Note No 2.26 of the Notes to Accounts, as shown below:

		F. Y. 2011-12		F. Y. 2010-11
2.26 FINANCE COST				
Interest Expenses – Project Related	xx		xx	
Others	xx		xx	
		xx		xx

3. In view of the wide fluctuations in the expenses under the above category from year to year based on the stage of execution of the project, the company has been showing the expenses under two heads, viz., 'Other expenses – project related' and 'Other expenses', only to differentiate from the other expenses directly attributable to the project(s) as shown below as per the extracts of statement of profit and loss given in Note Nos. 2.27 and 2.28 of the Notes to Accounts:

2.27 OTHER EXPENSES – PROJECT RELATED

	F. Y. 2011-12	F. Y. 2010-11
Repairs & Maintenance	xx	xx
Technicians, Fees and Other Expenses	xx	xx
Service Tax Expenses	xx	xx
Technical Know How Expenses	xx	xx
Advising Team Fees and other Expenses	xx	xx
Licensing Fees	xx	xx
Facility Hire	xx	xx
Rent	xx	xx
Insurance	xx	xx
Bank Charges and Guarantee Commission	xx	xx
Travelling Expenses	xx	xx
Sea Trial, Launching and Commissioning Expenses	xx	xx
Legal, Professional and Consultant Fees	xx	xx
Miscellaneous Expenses	xx	xx

2.28 OTHER EXPENSES

	F. Y. 2011-12	F. Y. 2010-11
Repairs & Maintenance		
1. Buildings	xx	xx
2. Plant & Machinery	xx	xx
3. Steam Launches & Boats, Motor Cars, Lorries, etc.	xx	xx
4. Dredging	xx	xx

Less: Work done internally and other expenditure which has been included in other heads of expenses	xx	xx
Facility Hire	xx	xx
Water Expenses	xx	xx
Rent	xx	xx
Insurance	xx	xx
Rates and Taxes	xx	xx
Bank Charges and Guarantee Commission	xx	xx
Printing and Stationery	xx	xx
Travelling Expenses	xx	xx
Business Promotion Expenses	xx	xx
Sea Trial, Launching and Commissioning Expenses	xx	xx
Foreign Exchange Variation (Net) Expenditure Less: Income	xx	xx
Corporate Membership Expenses	xx	xx
Legal, Professional and Consultant Fees	xx	xx
Books and Periodicals	xx	xx
Postage, Telegrams and Phones	xx	xx
Training Expenses	xx	xx
CISF and Security Board Expenses	xx	xx
Advertising Expenses	xx	xx
Custom Office Establishment Expenses	xx	xx
Reduction in value of Materials	xx	xx
Loose Tools consumed	xx	xx
Directors Fees and Expenses	xx	xx
Consumption of Stores & Spares, etc.	xx	xx
Corporate Social Responsibility Expenses	xx	xx
	xx	xx

4. As per the querist, the Revised Schedule VI to the Companies Act, 1956 *per se* does not indicate any particular line item under which interest paid or payable is to be presented except under the head 'Finance Cost'.

5. The Government auditors has referred to paragraph 9.5.5 of the 'Guidance Note on the Revised Schedule VI to the Companies Act, 1956', issued by the Institute of Chartered Accountants of India and stated that the interest expenses under 'Finance Cost' include interest paid on borrowings from banks and others, on debentures, bonds or similar instruments etc. The interest paid on trade advances received from customer should not have been classified under 'Finance Cost' and should have been taken under 'Other Expenses', i.e., under Note No. 2.27 instead of 2.26.

6. The querist has drawn the attention of the Committee to Annexure C of the Guidance Note on the Revised Scheduled VI to the Companies Act, 1956 which gives a comparison of Old and Revised Schedule VI. Annexure C of the Guidance Note, inter alia, states that under Revised Schedule VI, finance cost is to be reported on 'aggregate basis'. Based on the statements in the Guidance Note, the company presented interest paid/payable to the overseas customer under 'Finance Cost (Interest Expenses – Project Related)'.

B. Query

7. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the presentation of interest paid/payable on advance received from the customer is appropriate.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to presentation of interest expenses on advance received from the customer on cancellation of the 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, detailed accounting aspects of effects of cancellation of the contract by the customer, classification and disclosure of other expenses related and not related to project, accounting for interest expenses for a period from cancellation of contract till its payment, etc.

9. The Committee notes that in the extant case, the advance received from the customer is not an interest-bearing liability during the existence of the contract. However, interest is payable if the contract is cancelled by the

customer due to reasons not attributable to the customer. The Committee is of the view that such interest is compensation payable to the customer. Under the terms of the contract, while the customer is entitled to refund of advance, the company is not compensated for any work done. Thus, in substance, the interest expense is a penalty levied on the company for failure to fulfil its contractual obligations within the time permitted under the contract. Accordingly, it should not be recognised as 'finance cost' in the financial statements and therefore, the presentation of interest expenses on advance received from the customer as 'finance cost' is not appropriate.

D. Opinion

10. On the basis of the above, the Committee is of the opinion on the issue raised by the querist in paragraph 7 above that the presentation of interest expenses on advance received from the customer as 'finance cost' is not appropriate as discussed in paragraph 9 above.

Query No. 5

Subject: Disclosure of items exceeding the quantitative threshold in the Notes to Accounts.[1]

A. Facts of the Case

1. The querist is a defence public sector undertaking (hereinafter referred to as 'the company') under the Ministry of Defence and is engaged mainly in the construction of warships and submarines for Indian Navy.

2. The company has been outsourcing some of the production processes of shipbuilding and has been accounting the expenses under line item 'Sub-contract'. Various outsourcing activities, such as, cleaning, insulation, machining, fittings and machine seats, pipe fitting / bending etc., are considered under natural head 'Sub-contract Expenses'. At times, out of these aforesaid activities, one or two activities may exceed one per cent of the revenue from the operations or Rs.1,00,000, whichever is higher.

[1]Opinion finalised by the Committee on 5.4.2013 and 6.4.2013

3 The company is following the practice of disclosing few categories of expenses towards sub-contracting/outsourcing, though the amount is more than one per cent of revenue from the operations, on the grounds of homogeneity and is clubbing the same as 'Sub-contract charge' and a separate line item has been inserted in the statement of profit and loss.

4. The Govt. Audit, while quoting the provisions of the Revised Schedule VI to the Companies Act, 1956, stated that any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000, whichever is higher, needs to be disclosed separately in the Notes to Accounts.

5. In reply to the observation of the Govt. Audit, the company has stated that the disclosure in respect of line items under Revised Schedule VI is by nature of expenditure. The value of individual sub-contract activity may not be relevant for the readers of the financial statements. Therefore, the disclosure of activity-wise expenditure under such category is not intended by the Revised Schedule VI.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to whether the disclosure of expenses towards sub-contracting/outsourcing on a homogenous group and reporting as sub-contracting expenses is appropriate.

C. Points considered by the Committee

7. The Committee notes that the basic issues raised by the querist relate to disclosure of expenses towards various sub-contracting/outsourcing activities as single separate line item, 'sub-contracting expenses' in the statement of profit and loss and separate disclosure of expenses in the Notes to Accounts, if the amounts of such expenses individually exceed the quantitative threshold prescribed in the Revised Schedule VI to the Companies Act, 1956. 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 Committee presumes that the relationship between the company and the sub-contractors is neither a principal-agent relationship nor a employer-employee relationship.

8. The Committee notes that the Form of the Statement of Profit and Loss prescribed under the Revised Schedule VI contains minimum line items,

which include some items of expenditure (classified by nature). The Revised Schedule VI also requires disclosure of some items of income and expenditure in the Notes to Accounts. The Instructions appearing above Part I of the Revised Schedule VI require that "line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance". The Committee notes that in the extant case, the company has been outsourcing some of the production processes of ship-building and is clubbing expenses on various outsourcing activities, such as, cleaning, insulation, machining, fittings and machine seats, pipe fitting / bending etc., and disclosing the same under the head 'Sub-contract Expenses', though, at times, expenditure on one or more activities may individually exceed one per cent of revenue from the operations or Rs.1,00,000, whichever is higher. This, as per the querist, is done on the grounds of homogeneity. The Committee further notes Clause (c) of Note 5(i) of the 'General Instructions for Preparation of Statement of Profit and Loss', 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:-
>
> (i) (a) ...
>
> (c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000, whichever is higher;"

The Committee also notes the Note appearing after the 'General Instructions for Preparation of Statement of Profit and Loss' to the Revised Schedule VI to the Companies Act, 1956, which states as follows:

> "**Note:- Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of Financial Statements."**

The question that arises is whether, for the purposes of above disclosure, various expenses which pertain to an item should be considered as separate items or can be aggregated as a single item even if such expenses individually exceed 1% of revenue or Rs. 1,00,000, whichever is higher. The

Committee is of the view that various expenses pertaining to an item can be aggregated as a single item, only if the expenses aggregated are of homogeneous/similar nature and the nature of the expenses covered by the item are clearly represented by the nomenclature used. In the extant case, the matter relates to 'sub-contracting expenses'. The Committee is of the view that the expenses aggregated under this head should relate to only 'sub-contracting' charges paid by the company for sub-contracting a part of the production process. If it includes any expense which is not in the nature of sub-contracting charges, such as, cost of raw material supplied to the sub-contractor to be machined by it then it cannot be included under the said head. Such raw materials are to be included under 'raw materials consumed' or any other appropriate head. The Committee is further of the view that the term 'sub-contracting expenses' does not clearly explain the nature of expenses aggregated under this head and therefore, is not an appropriate nomenclature. Thus, if the nature of sub-contracting expense can also be indicated by the nomenclature, viz., sub-contracting machining charges, sub-contracting cleaning charges, etc., it would be an appropriate presentation of such expenses.

As regards the separate disclosure of expenses so included if they individually exceed Rs. 1,00,000 or 1% of revenue, whichever is higher, the Committee is of the view that if the nature of all the charges included under the single head are being appropriately explained by the nomenclature used, these need not be disclosed as separate items in the statement of profit and loss or in the Notes to Accounts.

D. Opinion

9. On the basis of the above, the Committee is of the opinion on the issue raised by the querist in paragraph 6 above that the disclosure of expenses towards sub-contracting/outsourcing activities pertaining to a homogenous group and reporting as a single item would be appropriate, provided the expenses aggregated under this head relate to only sub-contracting charges paid by the company for sub-contracting a part of the production process. A proper nomenclature should be used for the head to explain clearly the nature of items aggregated under a particular head. The term 'sub-contracting expenses' is not an appropriate nomenclature as it does not clearly explain the nature of expenses aggregated. The Committee is also of the opinion that if the nomenclature used appropriately represents the nature of expenses clubbed therein, there would be no need for separate

disclosure of various sub-contracting expenses even if they individually exceed the threshold limit as prescribed under the Revised Schedule VI to the Companies Act, 1956.

Query No. 6

Subject: Capitalisation of expenditures in respect of projects under construction.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') has been created as an undertaking of a State Government for implementing the Metro Rail Project (hereinafter referred to as 'the project'). The company has entered into an agreement with A Ltd. for construction of phase IA of the project.

2. The querist has stated that for the construction of phase IA, A Ltd. has agreed to charge 6% on the total estimated value (as per Detailed Project Report (DPR)) of the works carried out by A Ltd. as overhead charges/fees to cover their establishment and administrative overheads. It is worth to note here that rate of fees normally charged on the deposit works is 12.5%. The company, during the preparation of books of account for the year ended on 31/03/2012, has charged the fees paid to A Ltd. to revenue instead of capitalising the same on the premise that A Ltd. is providing administrative/ management support to the company by undertaking on behalf of the company, the appointment of contractors and consultants and management thereof and procurement of equipments and installation thereof; virtually this is as an extension of the administrative wing of the company. If A Ltd. would not have agreed to do it, the company would have directly incurred the establishment cost. According to the querist, as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets' also, the cost which is not specifically attributable to a specific asset is not to be capitalised. The expression *"may be included as part of the cost of the construction"* has been used in

[1]Opinion finalised by the Committee on 5.4.2013 and 6.4.2013

paragraph 9.2 of AS 10, which indicates that those expenses which are not specifically attributable to specific fixed asset, may not be capitalised (emphasis supplied by the querist).

3. The querist has also stated that the administrative charges payable to A Ltd. are on the total cost even if the actual expenditure is lower. Further, it is not attributable to a specific asset group whereas the assets proposed to be created may fall under the following asset groups:

(i) Civil works (All building, depot, station etc.)

(ii) Plant & Machinery

(iii) Rolling stock

(iv) Power sub-station

(v) Other fixed assets

In view of this also, the capitalisation is not covered under the spirit of AS 10.

4. During the supplementary audit under section 619(3)(b) of the Companies Act, 1956, of the company's accounts for the year ending on 31/03/2012, the Principal Accountant General of the State, has stated this treatment to be in contravention to AS 10.

5. However, the company differs on this interpretation of AS 10 due to the fact that the spirit of AS 10 is not to ensure that all expenditure that may be classified as capital expenditure *must be* so classified. Instead, it is to ensure that no expenditure that may not be classified as capital expenditure *is not* so classified. This spirit of AS 10 has been followed by the company only to avoid unnecessary capitalisation of the expenses in question.

The querist has further mentioned that the establishment expenses incurred by the company on its employees including Chairman-cum-Managing Director (CMD), finance department, technical department and the administrative expenses incurred by the company have been accounted for as revenue expenses, the accounting of which has been duly accepted by the Comptroller and Accountant General (C&AG).

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on the application of AS 10 particularly paragraph 9, 'components of costs', of which sub-paragraph 9.2 clearly states that administrative and general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. Accordingly, whether the establishment and administrative overheads etc. paid by the company to A Ltd. is capital or revenue expenditure (allowable under the provisions of the Income-tax Act, 1961) and therefore, whether the treatment given in the accounts by the company is the violation of AS 10.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting treatment of fees paid to A Ltd. which is providing administrative and management support to the company relating to the appointment of contractors and consultants, procurement and installation of equipments for the construction of the project. The Committee has, therefore, considered only this issue and has not touched upon any other issue arising from the Facts of the Case, such as, correctness in the treatment of establishment expenses incurred by the company and other administrative expenses, which are accounted as revenue expenses and also accepted by the C&AG, etc. Further, the Committee has presumed that various assets under the project or the project itself are controlled by the company and have been appropriately capitalised in the books of the company. The Committee also wishes to point out that its opinion is expressed purely from accounting point of view and not from the angle of legal interpretation of any legal enactment, such as, Income-tax Act, 1961, i.e., whether any expense is allowable or disallowable under the Income-tax Act as the Committee is prohibited from answering such issues as per its Advisory Service Rules.

8. The Committee notes paragraphs 9.1, 9.2, 20 and 21 of AS 10 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:

(i) site preparation;

(ii) initial delivery and handling costs;

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

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

…"

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

"20. The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.

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

From the above paragraphs of AS 10, the Committee is of the view that the basic principle to be applied while capitalising an item of cost (including administration and other general overhead expenditure) to a fixed asset under construction is that it should be directly attributable to the construction of the 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 fixed asset could not have taken place and the asset could not be brought to its working condition, such as, site preparation costs, installation costs, professional fees, etc. The Committee is further of the view that the above principles of capitalisation relating to a fixed asset are equally applicable to a group of assets including a project.

9. The Committee notes that in the extant case the company has entered into the agreement with A Ltd. for the appointment of contractors and consultants and management thereof and for procurement and installation of equipments for the purpose of the construction of the project which the company has argued to be administrative overheads by nature. The Committee further notes from AS 10 that if expenses are directly attributable to the construction of a project or to the acquisition of any fixed asset or bringing it to its working condition, these may be included as part of the cost of the project or as a part of the cost of the fixed asset. The Committee is of the view that the fees paid to A Ltd. is being specifically incurred for the project and therefore, should be regarded as directly attributable to the project or fixed asset(s) constructed or acquired for the project and therefore should be capitalised in the cost of the project or fixed asset.

10. As regards the querist's argument in the context of phrase, 'may be included as part of the cost of the construction', used in paragraph 9.2 of AS 10, the Committee is of the view that paragraph 9.2 explains only the application of the 'Main Principles' as given in paragraph 20 of AS 10 (reproduced in paragraph 8 above), which states that the cost of fixed asset should comprise any attributable cost of bringing the asset to its working condition for its intended use. Accordingly, since the expenses incurred in the extant case are specifically incurred for the project and are directly attributable to it, these 'should be' capitalised as discussed in paragraph 9 above.

11. As regards the querist's argument that the principles of AS 10 is to avoid unnecessary capitalisation of the expenses, the Committee does not agree with the querist as there are specific principles for capitalising an expenditure as an asset or for expensing it as the decision to capitalise/ expense can have a material effect on the company's reported results.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the treatment made by the company on the expenses incurred as establishment and administrative expenses in the form of fees to A Ltd. as revenue expenditure is not in accordance with AS 10 and these should be capitalised to the project/asset(s) concerned as discussed in paragraphs 8 and 9 above.

Query No. 7

Subject: Accounting for moulds manufactured in-house which were charged to revenue in earlier years.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') engaged in manufacturing activity, in order to achieve the object of exhibiting true and fair value of its assets, has revalued and capitalised in the financial year 2011-12, moulds manufactured in-house till the year 2011. The out flow on such moulds was treated as a part of normal revenue expense and charged to the profit and loss account in each year during the financial years 2007-2011. This change as per the management is necessary, because cumulatively, the value of the moulds used as a part of the plant and machinery is on the rise and in fact qualifies to be separately reflected in the list of Fixed Assets Schedule. The corresponding amount in the financial year 2011-12 has been credited to revaluation reserve and the capitalised amount has been reflected in the Schedule of Fixed Assets under the head plant and machinery.

2. The querist has stated that the moulds are used in the process of manufacture. As per the querist, moulds meet the definition of fixed assets as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets' as follows:

(i) Fixed asset is an asset held for producing or providing goods and/or services and is not held for sale in the normal course of the business. Moulds capitalised are used for manufacture.

(ii) Self-constructed assets, viz., moulds have been capitalised at cost that is specifically related to these assets and which is allocable to the specific assets, viz., moulds.

(iii) Basis of revaluation is the estimated cost upto 1.4.2012 as per management analysis.

3. The querist has also clarified separately that there is no change in classification of moulds from one class of asset to another. Management has made a list of moulds having a useful life of six years as on 1.4.2011

[1] Opinion finalised by the Committee on 21.5.2013 and 22.5.2013.

and capitalised them in the financial year 2012-13. Board of Directors has annexed the following note to the Fixed Assets Schedule:

> "Fixed assets are stated at cost except item of moulds under plant and machinery which have been revalued as at 31.03.2012."

4. Value of capitalised moulds is Rs. 89,50,000. The revaluation was approved by the Board of Directors and is to be placed before shareholders for its adoption in the immediate ensuing Annual General Meeting. The following brief note has been appended to Notes to Accounts-

> "Moulds at Rs. 89,50,000/- has been revalued as on 31.03.2011."

5. Revaluation has been made by debiting the value of moulds capitalised under plant and machinery and crediting to revaluation reserve in the balance sheet.

B. Query

6. On the facts and circumstances stated above, opinion of the Expert Advisory Committee has been sought by the querist on the following issues:

(i) whether the procedure adopted by the company is in order.

(ii) accounting policy to be stated on revaluation/capitalisation as also policy to be followed henceforth. Further, the disclosure of the amount incurred in manufacturing the moulds because the management does not have the year-wise in-house cost incurred in its manufacture.

or

Any modification is required.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to recognition of moulds manufactured in-house which were charged to revenue in earlier years. 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, valuation of moulds, accounting treatment followed for expenditure incurred on moulds in earlier years, prior period item, if any, arising in the Facts of the Case, etc. The Committee wishes to point out

that at some places in the Facts of the Case, it has been stated that capitalisation of moulds was done in the financial year 2011-12 and at other places, capitalisation has been stated to be done in the financial year 2012-13. However, the Committee has not considered this aspect as this does not affect the issue raised. Further, the Committee has expressed its opinion purely from accounting perspective and not from the perspective of interpretation of any legal enactment, such as, Income-tax Act, 1961, etc.

8. The Committee notes paragraph 8.1 of AS 10, notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') which provide as follows:

> "8.1 The definition in paragraph 6.1 gives criteria for determining whether items are to be classified as fixed assets. Judgement is required in applying the criteria to specific circumstances or specific types of enterprises. It may be appropriate to aggregate individually insignificant items, and to apply the criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as fixed asset, because the amount of the expenditure is not material."

From the above, the Committee is of the view that an enterprise may decide to expense an item which could otherwise have been included as fixed asset, because the amount of the expenditure is not material. Judgement is required in applying the criteria to specific circumstances. The Committee notes from the Facts of the Case that as per the querist, moulds meet the definition of 'fixed asset' as per AS 10 and the company treats the moulds as fixed assets. The querist has also stated that there is also no change in classification of moulds from one category to another, for example, from 'inventory' to 'fixed assets'. From this, it appears that the company had also treated the moulds as fixed assets in earlier years, but on the consideration of materiality, the costs incurred for manufacturing the moulds were charged to the profit and loss account.

9. The Committee notes from the Facts of the Case that the company considers the aggregate value of moulds as held by it at the current reporting date as material and, therefore, it wishes to recognise them in its books of account as fixed asset. In this regard, the Committee notes the following paragraphs of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the 'Rules':

> **"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."***
>
> "30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.
>
> 31. The following are not changes in accounting policies:
>
> (a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and
>
> (b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial."

From the above, the Committee notes that in the extant case, on consideration of materiality, expenditure on moulds was considered immaterial depending on the circumstances prevailing at that point of time and accordingly, these were expensed off immediately. Subsequently, on account of change in circumstances, it is felt that the moulds have cumulatively become material, keeping in view the circumstances at the current reporting date. The Committee is of the view that consideration of materiality is to be applied at a particular point of time depending on the circumstances prevailing at that point of time. Any change in circumstances subsequently, does not warrant reversing an expense already charged off since those circumstances did not exist at the time of original accounting treatment. Accordingly, in the extant case, the moulds written off in the earlier years on account of immateriality cannot be brought back in the books of account even if these become material at a later date. Thus, the accounting policy to capitalise the moulds as fixed assets should be considered a new accounting policy, to be followed from the current reporting period when the moulds acquired are considered as 'material'. In view of the above aforesaid discussion, the question of revaluation does not arise. Thus, the procedure adopted by the company is not in order.

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, the accounting followed by the company is not in order, as discussed in paragraph 9 above.

(ii) The question of revaluation does not arise, as discussed in paragraph 9 above.

Query No. 8

Subject: Accounting treatment of government grant received from State Government for repayment of term loans/bonds.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company'), is incorporated under the Companies Act, 1956. The authorised share capital of the company is Rs. 12,000 crore. The subscribed and paid-up capital is Rs. 6,987.00 crore at 31.3.2012. The entire share capital is held by the State Government and the State Financial Corporation.

2. The querist has stated that the main objective of the company is execution of the Multipurpose Irrigation Project (hereinafter referred to as 'the project') together with rehabilitation and resettlement of the project affected people. The company was formed in the year 1994 and commenced its business with effect from 14.1.1995. The assets of the project which were then being implemented by the Water Resources Department of the State Government along with selected liabilities were transferred to the company on 14.11.1995. Further works were carried out by the company. The project is now substantially complete. The expenditures incurred on the project have been capitalised in the books of account of the company. The project cost has been partially funded by budgetary support from the State

[1]Opinion finalised by the Committee on 21.5.2013 and 22.5.2013

Government and partially by borrowed funds, i.e., bonds from investors and term loans from banks and financial institutions.

3. The querist has also stated that the company does not have operational income from the core assets. As such, as per the tripartite agreement entered into between the trustees to the bondholders, the company and the State Government, having guaranteed the repayment, the State Government has been funding the debt obligation through its budgetary support. The funds are released under the nomenclature 'for debt servicing' as per the actual requirement furnished to the Government with the break-up of principal and interest.

4. The money released towards payment of interest component of the repayment is recognised as income in the accounts and set off against the interest paid. Component of the grants received towards principal repayment is being accounted under the head 'Reserves & Surplus – capital reserves', keeping in view the provisions of Accounting Standard (AS) 12, 'Accounting for Government Grants'.

5. The accounting policy adopted by the company with regard to 'government grants' as related to debt servicing is reproduced below:

> "Government grants received for meeting specific debt obligation are bifurcated as grants for principal and interest. The grants for meeting principal repayment are treated as capital reserves. The grants for interest payments are accounted as income."

6. While conducting audit of the accounts of the company for the year ended 31.3.2011, the Comptroller Auditor and General (C&AG) had observed as follows:

> "The company has raised external borrowings from the market against the guarantee of the State Government. Out of these borrowings, the company created assets and the same had been capitalised in the books of account. However, in the absence of operational income from its core assets, the State Government has been servicing both the installment of principal and interest. While the repayment of interest installment is being recognised as income in the accounts and set off against the finance charges paid, the principal repayment is being treated as capital reserve. As a result, as on 31.3.2011, the company had accumulated capital reserve of Rs. 3,334.75 crore. As the loan

> was borrowed for creation of fixed assets, the amount should have been appropriated towards fixed assets as per AS 12. However, in the absence of identification of the amount received towards specific asset, the company did not appropriate the grant amount. As the policy is in contravention of AS 12, it is requested that the company should formulate a system to identify the assets created out of each borrowing so as to enable appropriation of the grant received from the State Government for servicing the loan against the assets created out of that loan amount. The policy may also be modified suitably to appropriate such unspecified capital grant/reserve in order to present a true and fair view of the accounts."

7. The company's justification for adopting the accounting policy indicated in paragraph 5 above is as follows:

> "7.1. The State Government was releasing funds to the company for works bills payment, debt servicing and other expenses till the year 2005-06 as contribution towards *'Share Capital'*(emphasis supplied by the querist). The company had allotted equity shares to the Government against the said releases. The company was preparing 'Expenditure During Construction Period (pending capitalisation) Account' up to the year 2006-07 as the project had not been substantially completed.
>
> 7.2. The company had borrowed funds through bonds and loans for project expenditure from the year 1995-96 onwards till the year 2006-07. From the year 2007-08, the Government is releasing funds for capital works as grants while earlier to this period the amount was being released as equity share capital and hence, accounted under advance against equity.
>
> 7.3. In the observations of the Accountant General, it is suggested to identify the assets created out of each borrowing and appropriate grant received from the Government for repayment of debts against each asset by deducting the same from the value of assets created. By doing so, the value of the fixed assets will become zero. There is also difference between the time of creation of assets and the repayment of the principal of the loan/Bonds. In view of the above, the company has accounted the funds received from Government for repayment of bonds and loans under capital reserve instead of advance against equity considering it as shareholders' funds. Further, it is not possible to identify assets created against each borrowings as borrowed funds are

pooled with other funds and released to project offices for payment of bills for creation of various assets and as such, the funds received from the Government for repayment of debts cannot be identified against specific assets, while the grants received for capital expenditure have been netted of against each asset.

7.4. Further, since the company is not earning any profits, the bonds/loans cannot be repaid out of own cash flows. In this scenario, the owners of the company, i.e., the State Government is replacing the debts from their own funds. Hence, the amount received from the State Government, being the promoters of the company, for repayment of principal loan amount is to be treated as contribution from the promoters. Therefore, it is rightly accounted under capital reserves, and reckoned as a part of the shareholder's funds. The grant received from Government is in the nature of promoters' contribution and treated as a part of shareholders' funds as per paragraph 16 of AS 12 which states as follows:

> *"**Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds."***

B. Query

8. In the above context, the querist has sought the opinion of the Expert Advisory Committee with regard to the following issues:

(i) Whether the money received from the Government for servicing the principal repayment be treated at par with promoters' contribution.

(ii) Whether the accounting policy adopted by the company, as stated in paragraph 5 above, is in violation of the provisions of AS 12.

(iii) If the above is so, what accounting policy should the company adopt for the financial year 2012-13 for accounting for grants received from the Government for repayment of principal debt?

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting treatment of grant received from the year 2007-08 onwards from

the State Government, which also holds majority shares in the company, for repayment of principal amount of term loans/bonds that were taken for the creation of fixed assets or construction of the project. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as, appropriateness of recognition of expenditure incurred on the project as well as that incurred on rehabilitation and resettlement of the project affected people as the cost of the project, appropriateness of preparation of 'Expenditure During Construction Period (pending capitalisation) Account' till the project had not been substantially completed, accounting for grant received for repayment of interest on term loans/bonds, recognition of borrowing costs, i.e., interest on term loans/ bonds borrowed for the project, etc.

10. As regards accounting for the grant/contribution received from the Government, the Committee notes that although the amount received has been described as grant but the Government holds majority of the shares of the company. Thus, the Committee is of the view that its accounting would depend on whether the amount received is in nature of grant or contribution as owner. In this context, the Committee notes paragraph 2 of Accounting Standard (AS) 12, 'Accounting for Government Grants', which provides the scope of AS 12 as follows:

> "2. This Standard does not deal with:
>
> (i) ...
>
> (ii) government assistance other than in the form of government grants;
>
> (iii) government participation in the ownership of the enterprise."

The Committee further notes clause 4.6 of the Tripartite Agreement between the company, the State government and the Trustees of the bondholders (provided separately by the querist for the perusal of the Committee), which provides as follows:

> "In the circumstances recited above, the company has requested the State Government to enter into this agreement with a view to provide for various matters and contractual obligations of the State Government to make available and to provide budgetary support to the company as may be required for the purpose of facilitating and enabling, if necessary, the company to make payments of principal, interest and

> other charges and expenses in relation to the said Bonds. *The State Government in its capacity as the majority shareholder of the company, and being the principal sponsoring party in relation to the Irrigation Projects executed, operated and maintained by the company, has agreed to enter into and execute this Agreement and has permitted the company to make certain representations in the Offer Documents*."

From the above, it is clear that the Government while giving guarantee to the bond holders for payment of interest and repayment of principal amount of the bond is acting in the capacity of the majority shareholder and principal sponsoring party for the Irrigation Project. In other words, the Government is providing financial support through budgetary allocation to the company for repayment of debt/bonds. Since the company has no operational income, the Government is contributing the money as the owner of the company. It is also evident from the Facts of the Case that the company is receiving non-refundable funds from its owner, i.e., State Government, without any consideration or reference to the total investment in the undertaking or towards total capital outlay as it generally happens when Government provides grants in the nature of promoter's contribution under AS 12. Further, such funds provided are also not meant for the acquisition/construction / creation of any specific fixed asset or infrastructure facility which is the case of grants related to specific fixed assets under AS 12. Thus, the Government, in the extant case, being owner, is coming to assist the company to avoid failure of repayment of its dues and obligations relating to loans. Accordingly, the Committee is of the view that though, the Government may term the funds given to the company as 'grant', in 'substance', these are owner's contribution. Hence, the funds given should not be recognised in accordance with AS 12. In this regard, the Committee notes that paragraph 17 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' recognises 'substance over form' as one of the major considerations governing the selection and application of accounting policies. The Standard describes 'substance over form' as follows:

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

From the above, the Committee is of the view that the accounting treatment should be governed by the substance of the transactions and events and not by their legal form. Accordingly, in the extant case, the funds provided by the Government should be accounted for as 'contribution from owners' and not as government grant.

11. For accounting treatment of contribution in the capacity of owners, the Committee notes paragraph 69(a) of the Framework for the Preparation and Presentation of Financial Statements (hereinafter referred to as the 'Framework', issued by the Institute of Chartered Accountants of India (ICAI) states as follows:

> "(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."

From the above, the Committee is of the view that funds provided by the Government, in the capacity of owners, is a contribution from an equity participant and accordingly it should not be accounted for as 'income' in the financial statements of the company. It should be accounted as equity only. However, the Committee notes from the Facts of the Case that against the funds provided by the Government, no shares have been issued to the Government and accordingly, these cannot be classified as 'Share Capital' of the company. The Committee also notes that these funds are receipts of the company which are to be utilised by the management as per the directions of the Government for a specific purpose, viz., repayment of debts. The Committee further notes the definitions of the terms, 'reserve' and 'capital reserve' as per the Guidance Note on Terms Used in Financial Statements as follows:

> *Guidance Note*
>
> "**14.04 Reserve**
>
> The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types: capital reserves and revenue reserves."
>
> "**3.10 Capital Reserve**
>
> A reserve of a corporate enterprise which is not available for distribution as dividend."

On the basis of the above and considering the Facts of the Case, the Committee is of the view that such funds are of the nature of 'reserve'. Since these receipts are used only for a specific purpose and are not available for distribution as dividend. Accordingly, these should be credited to 'capital reserve'.

D. Opinion

12. On the basis of the above, the Committee is of the opinion on the issues raised in paragraph 8 above as under:

(i) & (ii) The contribution made by the State Government is not a government grant as discussed in paragraph 10 above and accordingly, the provisions of AS 12 would not be applicable.

(iii) The funds provided by the Government are of the nature of owner's contribution and accordingly, these should be credited to 'capital reserve', as discussed in paragraph 11 above.

Query No. 9

Subject: Recognition of sale for despatches made to sub-contractors on partial completion of the product.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company'), which is a Government of India undertaking under the Ministry of Defence, manufactures a wide range of products like super alloys, titanium alloys, maraging steel, etc. for strategic sectors like Space, Defence, Nuclear power, etc. The products manufactured are sold in the form of ingots, forged billets, sheets, plates, strips, rods, rings, etc. To enable the supply of material in the form specified by the customers requiring special operations like machining, rolling, ring forming, etc. for which facilities are not available in-house, such jobs

[1] Opinion finalised by the Committee on 21.5.2013 and 22.5.2013.

are off-loaded to the sub-contractors in India. The company's turnover in the financial year 2011-12 was to the tune of Rs. 509 crore.

2. The querist has separately clarified that the company is getting orders for products viz., Maraging Steel Rings and Plates, meant for projects of national importance. These products are customised products which do not fall in the company's standard products, as the manufacturing process of rings and plates requires processing at external sources due to facility constraints. The time involved at each stage and production cycle time are given below. This schedule does not include raw material procurement time-

(A) Maraging steel rings (on availability of raw materials)

1.	Primary melting	— 1 day
2.	Conditioning of Ingot	— 5 days
3.	Secondary melting	— 5 days
4.	Forging to ring stock	— 7 days
5.	Forwarding of stock to subcontractor's work centre	— 30 days
6.	Ring Rolling	— 45 days
7.	Heat treatment	— 10 days
8.	Sample preparation and testing	— 30 days
9.	Machining of rings	— 30 days
10.	Inspection at subcontractor's place	— 15 days
11.	Clearance for dispatch by customer	— 20 days

Process stage from Sl no. 6 to 10 are being carried out at subcontractor's place.

(B) Maraging steel Plates (on availability of raw material)

1.	Primary melting	— 1 day
2.	Conditioning of Ingot	— 5 days

3.	Secondary melting	— 5 days
4.	Forging to slab stock	— 7 days
5.	Forwarding of stock to subcontractor's work centre	— 60 days
6.	Plate Rolling based on availability of slot	— 60-90 days
7.	Collection of plates	— 20 days
8.	Heat Treatment	— 7 days
9.	Testing and clearance of plates for grinding & polishing	— 10 days
10.	Grinding & polishing at subcontractor's place	— 60 days
11.	Inspection and Clearance for dispatch by customer	— 15-30 days

Process stage from Sl no. 6 & 10 are being carried out at subcontractor's place.

The customer gives his own specifications for the products to be delivered which are mutually discussed and agreed upon before accepting the order and before taking up manufacturing. These products are specific customised products and require special skills and facilities. The raw materials required for manufacturing these products are Nickel, Cobalt, Molybdenum, Pure Iron, etc., and are imported. Purchase orders/work orders are received before the commencement of production and the manufacturing is taken up only after the receipt of specification for the product. These products are complex in nature as processing of these products requires special skills, knowledge and facilities. These products are made of alloys which are vaccum melted and processed with controlled chemical composition using vacuum grade raw materials. These alloys find application in Indian strategic sectors, like, Indian Space programme-launch vehicles, Defence-Missile programme and nuclear application. According to the querist, the manufacturing activity of the products does not fall under construction activity but can be categorised as production activity. Since the activity does not fall under construction activity, the end product does not result into construction of any complex equipment. However, the products are used by the customer in manufacture/ assembling of Polar Launch Vehicle/ Geo Stationary Launch Vehicle.

3. The querist has stated that the company had referred a query in the year 1996-97 to the Expert Advisory Committee regarding accounting and recognition of deemed sale as per its accounting policy in respect of the contracts for supply of items requiring long production cycle time which involved intermediary/final operations outside the company. Till date, the company has been following the same accounting policy and has been accounting its revenue in line with Accounting Standard (AS) 7[2], Accounting for construction contracts, which was applicable for the long production cycle items as was opined by the Expert Advisory Committee in the year 1996-97 (published in the 'Compendium of Opinions'-Volume XVII as query no. 1.10). The company has been consistently following the above-mentioned practice of recognising sale and all along statutory auditors and C&AG auditors have accepted such practice. However, during audit of the accounts for the year 2011-12, the C&AG auditors have again re-looked at the accounting policy and raised query. The query of the C&AG auditors and the reply of the company are placed below:

> Query:
>
> "Statement of Profit and Loss – Revenue from operations – Rs. 49,630.51 lakh – (Note No.23) – Sale of manufacturing products – Rs. 48,122.36 lakh.
>
> This includes Rs. 11,603.67 lakh representing income from despatches to sub-contractors recognised as per significant accounting policy no.8.
>
> In respect of supply contracts, where production cycle exceeds one year and intermediary/final operations are required to be undertaken outside the company, materials are sent to sub-contractors. The company recognises a deemed income against these despatches, as per its accounting policy no.8 and reflects the same as accrued income (despatch with sub-contractors) in the balance sheet as a current asset. On return of materials from sub-contractors, deemed income (to the extent of value of materials returned) recognised earlier is reversed and accounted as sales adjustment.
>
> As at the end of financial year, the outstanding balance of materials with sub-contractors are reflected at net value under current assets after pro-rata adjustment of related advance received from customers.

[2] AS 7 (Issued 1983) was titled 'Accounting for Construction Contracts'. AS 7 (revised 2002) is titled as 'Construction Contracts'.

The above accounting treatment is claimed to have been followed as per Accounting Standard 7 (Construction Contracts) applicable where the accounting process involves measuring results of relatively long term events (more than one year) and allocating those results to relatively short term accounting periods.

It is observed that the revenue recognition of Rs.11,603.67 lakh is not in order and does not qualify for recognition as per AS 7, in view of the following:

AS 7 is primarily applicable to construction contracts specifically negotiated for construction of an asset or a combination of assets (i.e., tangible assets). The products despatched by the company to sub-contractors does not qualify for such classification.

Materials are being despatched for intermediary/final operations to sub-contractors (Vendors) and not customers. Hence, the processes involved are despatches to sub-contracting activities and not a sale. Accordingly, the gross value of accrued income reflected in balance sheet as current asset is the value of materials lying with sub-contractors.

As per paragraph 11 of AS 7, contract revenue is measured at the consideration received or receivable. Being a transaction with sub-contractors, receipt of consideration does not arise. Moreover, as stated by the company in response to an observation issued during Phase II of certification audit, since no sale takes place, income is not debited to sundry debtors (trade receivables). Instead, deemed income is initially treated as current asset on despatch and reversed on return of materials from sub-contractors thereby reducing sales revenue of respective year to that extent.

No disclosures are made regarding the amount of contract revenue recognised during the accounting period and methods used to determine the stage of completion of contract in progress. Further, necessary disclosures are not made regarding aggregate amount of costs incurred and recognised profits (less recognised losses) upto reporting period, the amount of advances received and amount of retentions.

Moreover, AS 7 does not provide for reversal of stage-wise sales recognised in earlier years upon completion of contract / construction of assets. The company had earlier agreed, during Phase II of certification audit, that there is no transfer of risks and rewards at the time of despatch to sub-contractors. Hence, the practice followed by the company did not comply with requirements of either Accounting Standard 7 or Accounting Standard (AS) 9, 'Revenue Recognition' to qualify for recognition of revenue.

Under the circumstances detailed above, considering the reversal of deemed income of Rs. 9,092.46 lakh from sales made in the books during the accounting period, the revenue from operations is overstated by Rs. 2,511.21 lakh.

In the absence of disclosure regarding aggregate amount of cost incurred, considering the margin of 23% indicated in working details furnished, the profit is overstated by Rs. 577.58 lakh."

Management Reply:

"Basically, the method of accounting to be followed is on accrual basis to maintain consistency in revenue recognition on going concern concept. Same issue was raised by audit in their Phase 2 audit vide Audit Enquiry No.12 dated 21/6/2012 and reply was submitted. As the issue is raised again, it is submitted as under referring to the Expert Advisory Opinion sought earlier:

Accounting Standard 7 is primarily applicable to construction contracts.

With regard to production cycle items taking more than a year to complete, in respect of which the company is recognising revenue before completion thereof, the Committee notes that AS 7 (issued 1983), on 'Accounting for Construction Contracts' states about the applicability of the Standard, inter alia, in paragraphs 2 and 3 thereof, as below:

> "2. ...The specific duration of the contract performance is not used as a distinguishing feature of a construction contract. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods."
>
> "9.2 The stage of completion used to determine revenue to be recognised in the financial statements is measured in an appropriate manner. For this purpose, no special weightage

> should be given to a single factor; instead all related factors should be taken into consideration; for example, the proportion that costs incurred to date bear to the estimated total costs of the contract, by surveys which measure work performed and completion of a physical proportion of the contract work."
>
> "17.1 ...The costs attributable to the contract can be clearly identified so that actual expenditure can be compared with prior estimates."

Thus, a matching concept of revenue recognition with respect to the expenditure incurred during the financial year is the basis of AS 7, which is adopted by the company. As otherwise, the expenses are incurred in one year or more than one year and revenue is to be recognised only on completion of the product ready for delivery, which distorts the total operating results of the organisation from year to year as most of the products are of long cycle in nature which is beyond 12 months.

Accounting Policy 8 clearly brought out the basis of recognition of revenue proportionately connected to each stage of completion. However, as explained to auditor during their third phase of audit, the issue is becoming a concern year by year and the same was placed before the Audit Committee for review and suggestion and the Audit Committee also, after going through in detail and taking into consideration the practical difficulties faced by the organisation in view of non-availability of facilities as well as dependence on few work centres for processing the product resulting in long cycle time, agreed to bear with the Accounting Policy No.8 for another year or two till in-house facilities come up so that the policy can be reviewed and suitable modification to the measure of accounting can be carried out.

In view of the above, the audit enquiry may please be dropped."

4. As per the querist, the basis for adopting AS 7 earlier was matching of expenditure and income in order to ensure that operating result of the company reflects the actual activity as well as income, failing which it may distort the results in any year and abnormally boost the results in another year.

5. The querist has explained the accounting entries involved. The following accounting entry is passed when the material is sent for job work.

Code of Account	Accounting Entry	Dr./ Cr.	Debit Amount	Credit Amount
	Despatches with Sub-contractors (Current Asset)	Dr.	1,20,000	
	To Despatches to Sub-contractors (Income-P&L)	Cr.		1,20,000

When the material is received back by the company from the sub-contractor, the income recognised on those despatches (to the extent of the materials received back) is reversed in the books. The following accounting entry is passed in the books of account.

Code of Account	Accounting Entry	Dr./ Cr.	Debit Amount	Credit Amount
	Sale adjustments against despatches with sub-contractors (Deduction from Income-P&L)	Dr.	1,20,000	
	To Despatches with sub-contractors (Current Asset)	Cr.		1,20,000

When the finished product is sent to the customer, the following entry is passed:

Code of Account	Accounting Entry	Dr./ Cr.	Debit Amount	Credit Amount
	Sundry Debtors (Current Asset)	Dr.	1,40,000	
	Sales (Regular) (Income-P&L)	Cr.		1,40,000

At the year-end, the outstanding balance in the 'Despatches with sub-contractors' is disclosed as 'Accrued Income' (under 'Current Assets'). The company pays to the sub-contractor for the services rendered on the goods as the job is completed by the sub-contractor and material is received back by the company.

6. Last five years' position regarding above transactions are summarised below:

Rs. in crore

Year	Total	Income recognised during the year as despatches to sub-contractors (Income-P&L) Turnover	Income reversed which was recognised in earlier years, during the year on despatch of the final product (Deduction from Income-P&L)	Net impact as income in P&L Account during current year
2011-12	509.01	116.04	90.92	25.12
2010-11	417.87	87.25	59.49	27.76
2009-10	371.21	56.38	35.46	20.92
2008-09	309.11	37.68	33.14	4.54
2007-08	255.01	23.89	22.85	1.04

7. As per the C&AG auditors, the system of accounting deemed income, which the company claims to be in line with AS 7, is not correct and needs a re-look in view of the fact that invoices are not raised and no consideration is received from the sub-contractor, as the sub-contractor is not the customer of the company. Material issued to sub-contractors cannot be recognised as revenue either under AS 9 or AS 7 and, hence, the system followed needs to be reviewed.

8. In view of the long production cycle time that takes for the final product to be manufactured which spans over more than twelve months of time, the querist has sought the opinion of the Expert Advisory Committee (EAC) regarding its Accounting Policy No. 8, which is as under:

> *"In respect of the contracts for supply of items requiring long production cycle time which involve intermediary/final operations outside the company, income is recognised proportionately as under:*

(a) *Where prices are available for each stage of completion: The price appropriate to the stage of completion.*

(b) *Where prices are not available for each stage of completion:*

–90% as the case may be, of the final contract value for the item less estimated cost to be incurred for completing the item.

-Balance is recognised as income on completion / acceptance and despatch of the item."

B. Query

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

(a) Whether the accounting policy of the company with regard to setting up of sales based on the semi-finished products sent to sub-contractors for further processing without invoices being raised on the final customers is in line with AS 9, 'Revenue Recognition'.

(b) Whether the accounting policy according to which the company is taking into books, the value of despatches to sub-contractors upto the stage of completion as income where production operations are spread over more than one financial year is in line with AS 7, 'Construction Contracts'.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised by the querist relate to recognition of sales in respect of semi-finished products sent to sub-contractors for further processing and considering value of despatches to sub-contractors upto the stage of completion as income when production operations are spread over more than one financial year, in the context of two specific end products viz., Maraging Steel Rings and Maraging Steel Plates. The Committee has, therefore, considered only these issues and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting entries passed at various stages, exhibition of value of materials with sub-contractors as accrued income after pro-rata adjustment of related advance received from customers under 'Current Assets' in the balance sheet, treatment in respect of any other end-product,

etc. The Committee presumes that the C&AG auditors' query and management's reply reproduced in paragraph 3 above are in respect of the two specific end-products mentioned above. The Committee also notes that as per data provided by the querist, the production cycle time in respect of these products have reduced to 198 days in case of Maraging Steel Rings and to 250-295 days in case of Maraging Steel Plates, which is different from the facts of earlier query where the products had involved long production cycle time, viz., more than a year. Thus, although the querist states to have applied the earlier opinion of EAC but the Committee notes that the facts of the extant case, as provided, do not seem to be on par with the facts given in the year 1996-97. Moreover, the Committee notes that the production cycle of the said products is prolonged mainly due to dependence on few work centres for their processing (refer Management Reply in paragraph 3 above) and thus, the products manufactured per-se cannot be considered to have a long production cycle.

11. The Committee notes that the two specific end-products, viz., Maraging Steel Rings and Maraging Steel Plates are customised. They are used by the customer in the manufacture/assembling of Polar Launch Vehicle/ Geo Stationary Launch Vehicle. The Committee notes that AS 7 is applicable only in case of *construction of an asset or a combination of assets* in accordance with a contract *specifically negotiated for construction* of the same or when there is any rendering of services which are closely related to the construction of the asset. In this connection, the Committee notes the following extracts from AS 7, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> ***"2.1 A <u>construction contract</u> 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) ...”

The Committee notes from the above that there should essentially be a ‘construction of asset’, in order to become AS 7 applicable. The Committee further notes that the querist has clarified in paragraph 2 above that the manufacturing activity in respect of the two specific end-products does not fall under construction activity but can be categorised as production activity and that while the manufacturing process may be complex, the two specific end-products are not complex pieces of equipment. The Committee also notes that manufacture/assembling of Polar Launch Vehicle/ Geo Stationary Launch Vehicle, done by the customer of the company and not by the company itself, may be considered as a complex piece of plant or equipment as contemplated under paragraph 3 of AS 7. However, manufacture of their parts, which is being done by the company cannot be considered as complex pieces of equipment. Accordingly, considering the nature of products being manufactured, the Committee is of the view that AS 7 is not applicable for revenue recognition in respect of the two specific end products. Only AS 9, ‘Revenue Recognition’, is applicable for revenue recognition in respect of the same. In this regard, the Committee also wishes to point out that AS 7 also does not envisage recognition of revenue on despatch to the sub-contractors, rather requires recognition of revenue by reference to the stage of completion of the contract activity at the reporting date.

12. The Committee notes that AS 9, notified under the Rules, prescribes the following criteria for revenue recognition:

> “6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the

fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes."

"10. Revenue from sales or service transactions should be recognised 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.

Explanation :

..."

"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

13. From the Facts of the Case, the Committee notes that there is no transfer of significant risks and rewards of ownership when the semi-finished products are despatched to the sub-contractors for further processing. (Refer C&AG Auditors' Query reproduced in paragraph 3 above). In other words, there is no sale to the sub-contractors. In fact, as stated in paragraph 5 above, the company pays to the sub-contractor for the services rendered on the goods by them. Further, the Committee also notes that at the time of despatch to sub-contractors, there is no transfer of significant risks and rewards of ownership of semi-finished products to the final customers, since, only finished products are delivered to them. Thus, the criterion of transfer of significant risks and rewards of ownership prescribed in paragraph 11(i) of AS 9, reproduced in paragraph 12 above, has not been met in the extant

case in respect of semi-finished products despatched to the sub-contractors. Accordingly, the Committee is of the view that no revenue from sales should be recognised on despatch of semi-finished products to the sub-contractors for further processing. Incidentally, the Committee wishes to point out that mere raising invoice on the customer cannot be considered as a criterion to recognise revenue under AS 9 and the other conditions of revenue recognition relating to transfer of significant risks and rewards of ownership, etc. as per AS 9 need to be met.

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) The accounting policy of the company with regard to setting up of sales based on the semi-finished products sent to sub-contractors for further processing is not in line with AS 9, 'Revenue Recognition' in the context of the two specific end products viz., Maraging Steel Rings and Maraging Steel Plates. Raising invoices on the final customers is not relevant for revenue recognition under AS 9.

(b) AS 7, 'Construction Contracts', is not applicable for revenue recognition in respect of production items viz., Maraging Steel Plates and Maraging Steel Rings, as mentioned above.

Query No. 10

Subject: Recognition of distribution network acquired in a business acquisition as an intangible asset.[1]

A. Facts of the Case

1. Company X (hereinafter referred to as the 'company') was incorporated

[1]Opinion finalised by the Committee on 21.5.2013 and 22.5.2013

in February 2011 as a wholly owned subsidiary of company Y. During the year 1st April, 2011 to 31st March, 2012, company X acquired a business from company Z, an unrelated party, on a slump sale basis for an arm's length consideration. Company Z is a leading manufacturer of kitchen appliances. The acquisition of business has led to company X becoming a leading player in this segment. As part of the acquisition, company X has acquired a large network of distributors, service centres, service points, retailers and manufacturing points.

2. The company operates through different channels, such as, the distributors, retailers, direct dealers, etc. More than 80% of the sales in the past were effected through the network of distributors (hereinafter referred to as 'the distribution network').

3. The management of company X engaged a valuer to carry out the purchase price allocation. The intangible assets identified by the valuer for the purchase price allocation included brands and the distribution network. As per the valuation report, the distribution network was identified as an intangible asset based on the following assumptions:

(a) Around 80% of the revenues in the financial year 2011-12 will be derived through the distribution network and that contribution of current and new distributors would reduce from 80% to 70% over the 10 year explicit forecast period in a linear fashion. For valuing distribution network, only projected revenues from existing distributors were considered.

(b) The knowledge and relationships of the distributors matter significantly in the industry and a new market entrant may not be able to replicate the same easily. In this aspect, the distribution network seemed to have a distinct advantage over those of other market intermediaries. Considering the time period over which the current distributors are expected to contribute to the revenues of company X, the economic life of the distribution network was considered to be indefinite.

4. The following are the key terms of the distributor agreement:

(a) The agreement appointing the distributor is valid till 31st March, 2012 and is renewable on mutual terms. Thus, if not renewed, the distributor agreement will apply for company X from the date of acquisition of business until 31st March, 2012.

(b) The authorised distributor cannot market or deal with any other similar product directly or indirectly (either imported or indigenous).

(c) If the distributor owns/operates any retail counters, such retail counters shall deal only with the company's brand at least in MG (a particular type of product) category. The distributor will take the company's prior written approval before dealing in the products of any other brand.

(d) In keeping with the company's plans for expansion in other product categories, it is expected that the distributor will assign the inputs and focus as directed by the company to these products in their respective markets' retail counters.

(e) The appointment of distributorship can be terminated by either party on 30 days' written notice without assigning any reason. In the event of unsatisfactory performance, misconduct, misbehavior or negligence or loss to the company, or any material breach of any of the terms of this agreement by the distributor, as may be opined and determined solely by the company at its discretion, the appointment may be terminated by the company forthwith.

(f) The appointment granted herein to the distributor is entirely personal and non-assignable by the distributor. The distributor shall not be entitled or permitted to transfer the appointment for authorised re-distribution of the company's products to any other person, party or company in any manner whatsoever, without the express consent of the company as received in writing.

(g) In order to maintain the company's brand value and goodwill, the company's suggested pricing while making supplies by the distributor to its sub-dealers, should be maintained in order to avoid underselling, which will lead to erosion of margins, brand image and sales. The company shall have the right to terminate this agreement in the event of violation of this clause.

(h) A distributor is appointed for a specified district only. Infringement by way of supplying to any other territory will lead to termination of appointment with immediate effect.

(i) The company at its discretion may effect direct supplies to the existing network of dealers or new dealers in the above area.

5. As per the querist, each year there is movement in the number of distributors covered under the network, but the distributors terminated are replaced by new distributors in their respective regions besides distributors being appointed for new regions. Thus, the turnover foregone because of the decrease in the number of the distributors is effectively replaced by appointment of new distributors who are also subject to the same terms and conditions. It is reiterated that purchase price allocation done by the valuer is only for existing distributors.

6. The following facts are also relevant:

— During the period ended 31st March, 2012, sales made through the distributors were 85% of total sales.

— The percentage of distributors appointed during the past three years is around 24% and that of terminated is around 11%. The loss of revenue caused due to termination is 0.32% of total gross turnover, while the revenue generated by new distributors is 8%.

— In most cases, the termination of distributors is on account of their financial disability or due to dispute in their organisational structures.

7. The querist has separately informed that total number of authorised re-distributors was 105 as at 31st March, 2012 and, subsequently, there were 6 additions and 6 discontinuances till October 2012. Thus, the probable rate of discontinuance is around 6%. However, equal number of authorised re-distributors have been appointed during the period from April 2012 till October 2012.

8. The brand has been in existence for more than 10 years which gives added advantage over the other competitors and, thus, makes it highly unlikely for the distributors to quit the dealership of the company.

9. The accounting issue that arises is whether the existing distribution network can be recognised as an intangible asset when accounting for acquisition of company Z's kitchen appliances business by the company X.

10. The querist has drawn the attention of the Committee to the following paragraphs of Accounting Standard (AS) 26, 'Intangible Assets':

"6.1 An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or

supply of goods or services, for rental to others, or for administrative purposes.

6.2 An <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.”

“Identifiability

11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

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.

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality."

"17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. ...

20. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

22. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost."

11. As per the querist, the extracts from AS 26 reproduced in paragraph 10 above show that an intangible asset should have the following characteristics:

- Identifiability - an asset should be separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability;
- Control over the resource - in order to demonstrate control, an entity must have the power to obtain the future economic benefits arising from the item and be able to restrict the access of others to those benefits;
- Existence of future economic benefits – an intangible asset should be expected to give rise to future economic benefits, e.g., in the form of revenue from the use of the asset;
- No physical substance; and
- Non-monetary.

12. The fact whether distribution network acquired in the present case pursuant to business acquisition can be recognised as an intangible asset

by the buyer should be determined by applying the above principles. As per the querist, this involves determining whether the distribution network meets the criteria of identifiability, control and future economic benefits such that it qualifies for recognition as an intangible asset. Further, as per the querist, the following points are noteworthy in this regard:

- The relationship between the company and distributors is governed by an agreement with each distributor which clearly spells out the rights and obligations of each party.
- The distributor cannot market or deal with any other similar product directly or indirectly.
- The pricing suggested by the company should be followed while making supplies to the sub-dealers. In case of violation, the company has the right to terminate the agreement.
- The appointment granted to the distributor is specific and non-assignable by the distributor.
- The retail counters of the distributor shall deal only with the company's brand at least in MG category. Prior written approval of the company is required before dealing in the products of any other brand.
- The distributor is expected to assign the inputs and focus as directed by the company to these products in its respective retail counters.

13. As per the querist, considering the above, it can be concluded that the criteria of identifiability and future economic benefits are met. The question, then, is whether the control criterion is met. On this issue, there can be the following two views:

View 1

One view can be that the agreements with distributors provide control over the distribution network only for a very limited period of time. This view is based on the reasoning that–

- the agreement appointing each distributor was valid only till 31 March, 2012 and it was renewable only with mutual consent and not unilaterally by the company;

- the agreement can be terminated by either party on 30 days' written notice without assigning any reason. Thus, beyond this notice period, neither party has any legal rights or remedies against the other party.

The above aspects of the agreement indicate that at the time of acquisition of relevant business from company Z, company X acquired 'control' over the distribution network only for the non-cancellable period of distributor agreements, i.e., for a period of 30 days only. The continuance of the distributorship beyond this period was at the discretion of the distributors and, hence, was not within the control of the company. Consequently, the value to be placed on the distribution network should be with reference to this period. Given that the period is very small, it seems that distribution network will not have any significant value. The valuer has taken the useful life of distribution network as indefinite and on this basis ascribed a significant value to the distribution network. However, in the absence of any legal right, the company does not have any control over the network beyond the non-cancellable period of 30 days. The mere fact that historically, only a small percentage of distributors has exited does not mean that the company has control over the distributors – each of whom is free to leave after 30 days. Hence, only a very small value (corresponding to non-cancellable period) can be ascribed to distribution network as a separate intangible asset.

View 2

A contrary view can be that where an entity acquires any right from another party in an arm's length transaction, it is implicit that the entity expects future economic benefits to arise from the right and it pays for the same on the basis that it has implicit control to ensure that those benefits flow to it. To conclude that control does not exist unless contractual or legal rights are present would not reflect the substance of the situation. If control in some way was not present, the purchase of the right would just not make commercial sense. This position is clearly recognised in paragraph 16 of International Accounting Standard (IAS) 38, 'Intangible Assets', as below:

> "16. ... In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the

customer relationships are separable, those customer relationships meet the definition of an intangible asset."

In this regard, it may be noted that the concept of what constitutes 'control' is the same under both IAS 38 and AS 26 as is evident from the following extracts from these standards:

Extract from IAS 38

"13. An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity 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 because an entity may be able to control the future economic benefits in some other way."

Extract from AS 26

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

The portion of paragraph 16 of IAS 38 reproduced above was included in the revised version of IAS 38 and, as per the Basis for Conclusions on IAS 38, this inclusion is intended to 'clarify' the position. AS 26 is based on pre-revised IAS 38 and, hence, it does not contain this portion.

Extracts from Basis for Conclusions on IAS 38

"BC13 The Board observed that exchange transactions for the same or similar non-contractual customer relationships provide evidence not only that the item is separable, but also that the entity is able to control the expected future economic benefits flowing from that relationship. Similarly, if an entity separately acquires a non-contractual customer relationship, the existence of an exchange transaction for that relationship provides evidence both that the item is separable, and that the entity is able to control the expected future economic benefits flowing from the relationship. Therefore, the relationship would meet the intangible asset definition and be recognised as such. However, in the absence of exchange transactions for the same or similar non-contractual customer relationships, such relationships acquired in a business combination would not normally meet the definition of an 'intangible asset'—they would not be separable, nor would the entity be able to demonstrate that it controls the expected future economic benefits flowing from that relationship.

BC14 Therefore, the Board decided to clarify in paragraph 16 of IAS 38 that in the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset."

Besides having the same concept of 'control', both AS 26 and IAS 38 also explicitly recognise that legal rights are not the only way of acquiring control and that an enterprise may be able to control the future economic benefits in some other way also. Based on a combined reading of AS 26 and IAS 38, it can be argued that the explicit assertion in IAS 38 that standalone exchange transactions of non-contractual customer relationships provide evidence of control is a clarification of what, in the absence of legal rights, the other ways of controlling future economic benefits can be. On this basis, it can be argued that the distribution network can be recognised as an intangible asset, if there are exchange transactions for such networks (other than as part of business combinations). The querist has separately informed that the distributors who left the company would probably join other competitors for their products but the querist is not aware of any specific market where distribution network is exchanged.

B. Query

14. The querist has sought the opinion of the Expert Advisory Committee as to whether the distribution network acquired as part of the business acquisition in the extant case qualifies for recognition as an intangible asset as per AS 26.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised by the querist relates to initial recognition of the distribution network acquired as part of the business acquisition as an intangible asset as per Accounting Standard (AS) 26, 'Intangible Assets'. 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, valuation of the distribution network, subsequent recognition of 'distribution network' as an asset once the contract with the distributor expires on March 31, 2012, detailed aspects of initial accounting of the business acquisition, recognition of other assets and liabilities acquired as a part of business acquisition, treatment of expenditure, if any, incurred on addition of new distributors to the acquired distribution network, etc. Incidentally, the Committee notes that the 'economic life' of the distribution network is assumed to be indefinite as per valuation report (see paragraph 3(b) above), whereas, the querist has stated in paragraph 13 (see View 1) that the valuer has taken the 'useful life' of distribution network as indefinite. The Committee wishes to point out that terms 'economic life' and 'useful life' are different, though, as a matter of coincidence, the economic life and useful life of an asset may be same in some situations. Further, as a passing reference, the Committee wishes to point out that for *accounting* purposes, the concept of intangible assets with indefinite life is found in IAS 38 and not in AS 26. However, these matters do not affect the opinion of the Committee.

16. The Committee notes that in the extant case, distribution network is acquired as a part of acquisition of kitchen appliances business. The Committee notes paragraph 31(a) of AS 26 as given below:

> "(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor;..."

In view of the above, the Committee is of the view that for recognition, an intangible asset, even if acquired as part of a business purchase, should meet both the definition and recognition criteria specified in AS 26, reproduced by the querist in paragraph 10 above. The Committee notes from the Facts of the Case that the distribution network, being an arrangement for the marketing of the company's product, is a non-monetary item without physical substance held for the purpose of supply of goods. Further, it appears from the Facts of the Case, that the existence of the distribution network is a factor for the acquisition of the business. Also, while allocating the purchase consideration, the valuer is able to identify the distribution network separately and also assign a value to it. This indicates that (i) the distribution network is identifiable; (ii) it is probable that future economic benefits attributable to the distribution network will flow to the company; and (iii) the cost of acquisition of the distribution network can be measured reliably. Further, as regards 'control', the Committee notes paragraphs 14 and 17 of AS 26 as reproduced below:

> "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."

> "17 An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets."

The Committee is of the view that the key terms of the distribution agreement mentioned by the querist in paragraph 4 above indicate that the distribution network is controlled by the company at the time when it acquires the business. However, the Committee also notes that the distribution agreement is valid only upto 31st March, 2012 and as stated by the querist, the exchange (market) transactions for the same or similar distribution network are not available. In other words, there does not appear to be any control on distribution network either through legally enforceable rights or in any other way beyond March 31, 2012. Accordingly, the Committee is of the view that the company has control over the distribution network upto the validity of the distribution agreement, i.e. upto March 31, 2012. Hence, the distribution network acquired as part of the business acquisition meets both the definition and recognition criteria (although for short period of time), as specified in AS 26, reproduced by the querist in paragraph 10 above.

Incidentally, the Committee wishes to mention that for initial recognition of distribution network it is not necessary to examine the relevance of clarificatory amendment to paragraph 16 of IAS 38 mentioned by the querist in paragraph 13 above, especially, when that amendment is applicable in the context of absence of legal rights, whereas, in the extant case, there is transfer of legal rights arising from the distributor agreement in favour of the company. Further, the Committee notes that the querist's view mentioned in paragraph 11 above gives an impression that identifiability criterion is met only if the intangible asset is separable. This is not correct, since, as per paragraph 13 of AS 26 reproduced by the querist in paragraph 10 above, separability is not a necessary condition for identifiability.

17. The Committee is further of the view that if, after applying an appropriate valuation technique, distribution network is not considered as a 'material' item, the company may choose either to recognise the distribution network as an intangible asset at an immaterial value or not to recognise it as an intangible asset. This is because 'materiality' is one of the considerations in selection of accounting policies as per paragraph 17 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'. Further, as per paragraph 4.3 of 'Preface to the Statements of Accounting Standards' issued by the Institute of Chartered Accountants of India, Accounting Standards are intended to apply only to items, which are material. A material item is described as an item, the knowledge of which might influence the decisions of the user of the financial statements (see paragraph 17(c) of AS 1).

D. Opinion

18. On the basis of the above, the Committee is of the opinion that the distribution network acquired as part of the business acquisition in the extant case qualifies for recognition as an intangible asset as per AS 26 only upto March 31, 2012, as discussed in paragraph 16 above. As regards materiality considerations, see paragraph 17 above.

Query No. 11

Subject: Accounting treatment of share application money pending for allotment invested by holding company in subsidiaries.[1]

A. Facts of the Case

1. Consequent to State Electricity Reforms Transfer Scheme 2000, the erstwhile State Electricity Board (SEB) was reorganised into three corporations namely State Power Corporation Ltd. (SPCL), State Vidyut Utpadan Nigam Ltd. and State Jal Vidyut Nigam Ltd. w. e. f. January 14, 2000. The City Electricity Supply Area was separated as a subsidiary company of SPCL and christened as the City Electricity Supply Company Limited (CESCO) vide State Transfer of K Zone Electricity Distribution Undertaking Scheme, 2000.

The State Power Corporation Ltd. (hereinafter referred to as 'the company') is dealing with bulk purchase and sale of electrical power in the State and had a turnover of Rs. 12,197.66 crore in the financial year (F.Y.) 2007-08. It purchases electricity from central generation utilities, state power generation utilities, independent power producers and also from private traders through bilateral purchases, etc. Further, it sells the electrical power to its wholly owned subsidiary companies holding distribution license under the Electricity Act, 2003. These distribution companies were created pursuant to the Transfer Scheme Notification passed by the State Government on August 12, 2003, wherein the distribution business of the company was vested in them.

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[1]Opinion finalised by the Committee on 21.5.2013 and 22.5.2013.

2. The company is a Government company within the meaning of section 617 of the Companies Act, 1956 and is holding 100% shares in its subsidiaries, which are also Government companies (within the meaning of section 617 of the Companies Act, 1956), as 'Investments'. The company's 100% shareholding is with the Governor of the State.

3. The State Government infuses funds by way of equity contribution in the holding company, i.e., the company. These funds are used by the company as per the instructions of the State Government for investing in the shares of its subsidiary distribution companies for creation of capital assets, etc.

4. The funds received from the State Government are invested by the company in the subsidiary distribution companies as 'share application money'. The allotment process from share application money to share capital rests with the respective subsidiary distribution companies. Pending allotment of share application money, these subsidiary distribution companies have utilised such amounts in the creation of capital assets.

5. The auditors in the course of the audit observed that the subsidiary distribution companies have negative net worth and, accordingly, advised the company to make suitable provisions in the annual accounts for diminution in the value of investments in accordance with Accounting Standard (AS) 13, 'Accounting for Investments', considering that such investments in subsidiary distribution companies was made as long-term investment.

6. As per the advice of the auditors, the company made a provision for diminution in the value of investment upto the level of equity shares actually allotted by the subsidiary distribution companies subsequent to the close of the financial year till the date of approval of the accounts of the holding company.

7. The querist has stated that considering that till such time the allotment is made, the contract of contribution to share capital is not complete and the application money is therefore only a liability in the books of subsidiary companies, the provision for diminution in the value of investments has not been made for the amount invested in subsidiary distribution companies which has not been allotted by the subsidiaries as equity in the name of the company till the date of approval of accounts.

8. The querist has also stated that the allotment of share application money by the subsidiary companies is pending as their accounts are in arrears and are yet to be audited.

9. At the time of organisation of the SEB in January, 2000 and then at the time of creation of successor distribution companies in August, 2003, the capital assets were allocated on historical cost basis. Such assets of subsidiary distribution companies have not been revalued since their inception. The company and the subsidiary distribution companies have undertaken the revaluation of their assets and this exercise is in progress.

10. According to the querist, considering that the revaluation of assets was in progress till the date of approval of accounts, the fair value of assets of the subsidiaries cannot be determined until and unless the revaluation process is completed and restated balance sheet is prepared. It was contended that since the real value of assets of subsidiary distribution companies is much higher than the book value, the diminution can be worked out only after a fair valuation of shares of distribution companies.

11. In view of the foregoing contentions, the company has made a provision for diminution in the value of investments made in subsidiary distribution companies upto the level of equity allotted by the subsidiary companies.

12. The company's accounting policy discloses the accounting treatment of investment as under:

> "Investments:
>
> 4. Long-term investments in subsidiaries are valued at cost and provision is made for diminution, other than temporary, in the value of such investments."

13. *In the above context, Accountant General, the State under his Review Audit for the F.Y. 2007-08, has commented that the company should consider the amount of share application money (which has not been allotted till the approval of accounts of the company) also while making provisions for diminution in the value of investments.* (Emphasis supplied by the querist.)

B. Query

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

(i) Whether share application money is to be considered for making provision for diminution in the value of investments even though the shares for the same are yet to be allotted.

(ii) Whether share application money, in respect of which shares are allotted subsequent to the end of the financial year but before the adoption of accounts of the company, should be considered as share capital for the purpose of making the provision for diminution in the value of investments.

(iii) For making provision for diminution in the value of investments, whether the company can consider the fact that the revaluation of assets is under progress and that the fair market value of assets would be higher than the historical value/cost of assets?

C. Points considered by the Committee

15. The Committee, while answering the query, has considered only the issues raised in paragraph 14 above and has not examined any other issue that may arise from the Facts of the Case, such as, recognition of share application money pending allotment in the financial statements of subsidiary companies, etc. Further, the Committee has presumed that the money has been given to the subsidiary companies as equity contribution and not as grant.

16. The Committee notes that the erstwhile SEB was restructured into three corporations one of which is the company. Further, its electricity distribution business has been divested to wholly owned subsidiary companies of the company. The company as well as its subsidiary companies are Government companies. The State Government infuses funds in the company, which the company uses as per the instructions of the State Government for investing in the shares of subsidiaries. Accordingly, the company has invested the funds received from the State Government as share application money in subsidiary companies some of which is pending for allotment. In this regard, the issue raised is that whether the provision for diminution in the value of investments should be made against the share application money even though the shares for the same are yet to be allotted as on the balance sheet date. The Committee notes the definition of the term ‘Investments’ as defined in AS 13, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’) and ‘Advance’ as defined in the ‘Guidance Note on Terms Used in Financial

Statements', issued by the Institute of Chartered Accountants of India, as below:

> ***AS 13***
>
> ***"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'."***
>
> *Guidance Note on Terms Used in Financial Statements*
>
> **"1.17 Advance**
>
> Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services."

From the above, the Committee is of the view that although the share application money pending for allotment may not give any benefits to the company (neither dividend, interest, rentals nor capital appreciation) till shares are allotted against it to the company, however, since in the extant case, the money has been given to the subsidiary companies, this application money for shares may be considered to be held 'for other benefits'. Further, the Committee notes that the money so provided has been utilised by the companies for acquisition of capital assets and all the companies being State Government companies operate as per the instructions of the State Government. Also, paragraph 7 above indicates existence of a 'contract of contribution to share capital' against which shares have been allotted after the balance sheet date but before the approval of accounts. The Committee is of the view that all this indicates that irrespective of the fact that whether shares are allotted to the company or not, the money given as share application money would not be refundable to the company. Therefore, considering 'substance over form', the Committee is of the view that these are of the nature of long-term investments. Accordingly, provision for diminution in the value of investments other than temporary should be considered against the same. Further, the Committee is the view that it should be disclosed in the financial statements with an appropriate nomenclature and notes to accounts so as to give the correct picture of the situation, viz., shares are yet to be allotted against these investments. The Committee is also of the view that even if shares are allotted against such application money after the balance sheet date, but before the adoption of accounts, there is no need for disclosing it as 'shares' till the date of allotment, as it is taking place in the subsequent year. However, additional disclosures regarding allotment (which takes place in subsequent year before adoption of accounts) may be made in the financial statements. The Committee is further of the view that had the subsidiary companies reserved the right to simply refund the money without allotting the shares then it should have been treated as an 'advance' rather than 'investment' till such shares are allotted to the company. The Committee is of the view that in that case also, the company should examine the recoverability of the said advance and, accordingly, an appropriate provision should be made against such advance as per the Generally Accepted Accounting Principles.

17. As regards making provision for diminution in the value of investments, the Committee notes paragraphs 17 and 32 of Accounting Standard (AS) 13, 'Accounting for Investments', notified under the Rules, as reproduced below:

> "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."
>
> ***"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."***

On the basis of the above, the Committee is of the view that in the case of long-term investments, only where there is a decline, other than temporary, in the value of investments, the carrying amount is reduced to recognise the decline. The Committee is further of the view that to determine whether there is a decline other than temporary, in the value of investments, an assessment should be made keeping in view the value of the assets of the subsidiaries, its results, the expected cash flows from the investment, etc. Such an assessment should be made on an individual investment basis. In determining the value of investment, fair value of the underlying assets of the subsidiaries may also be considered.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 14 above:

(i) Yes, in the extant case, as discussed in paragraph 16 above, since the money would not be refundable to the company, share application money pending for allotment should be considered as long-term investment while making provision for diminution in the value of investments. Even if the share application money would have been refundable and as such, shown as 'advances', an appropriate provision should be made based on their recoverability as discussed in paragraph 16 above.

(ii) and (iii) Refer to paragraphs 16 and 17 above.

Query No. 12

Subject: Recognition of free of cost equipment provided by a contractee to the contract.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a defence public sector undertaking under the Ministry of Defence and is engaged in the construction of Warships and Submarines. For a particular class of ship construction, the company entered into an agreement with the buyer for the construction and delivery of 3 ships.

2. The company has agreed for construction of 3 ships on 'Fixed Price' basis with variable component in respect to certain items.

[1] Opinion finalised by the Committee on 21.5.2013 and 22.5.2013

(i) The break-up of the contract price is as under:

Sr. No.	Cost Element	1st ship	2nd ship	3rd ship	Total
1	Material	xx	xx	xx	xxx
2	Yard efforts	xx	xx	xx	xxx
(A)	Fixed cost element on not exceeding basis (1+2)	xxx	xxx	xxx	xxx
(B)	Variable cost items on not exceeding basis	xxx	xxx	xxx	xxxx
(C)	Base and Depot (B & D) spares (Budgetary) (With FE Content xx crore) on not exceeding basis				xxxx
(D)	Grand Total (a+b+c)				xxxxx

Note: The above cost is exclusive of duties and other statutory levies applicable at the time of delivery of the vessel(s) and will be paid at actual.

(ii) Payment Terms:

(a) Fixed price element:

The payment will be made by the buyer against the completion of particular stage.

(b) Variable price element:

The payment will be made at actual with % of profit against the documentary evidence.

3. Base and depot (B&D) spares for all 3 ships of this class shall be procured through the company and X % remuneration will be paid on the cost of the item.

4. The contract states that variable cost items indicated as a part of contract price are budgetary and will be paid based on finalised specifications and source of supply nominated by the buyer at actual. Later, the buyer

intimated to the querist that certain equipments out of variable cost items, will be supplied by him at 'free of cost' for installation on board of ship. It is, therefore, to be noted that the variable cost items mentioned at paragraph 2(i) (B) in the table above consists of 2 parts as under:

(i) The purchase orders of some equipments are placed by the company in the presence of the buyer's representative for technical scrutiny as well as negotiating the prices. The vendors of the equipment are paid by the company. The cost of the equipment alongwith the cost of installation and profit thereon is claimed and reimbursed by the buyer to the company.

(ii) There are certain equipments for which orders are directly placed and also paid by the buyer. These equipments are known as 'Buyer Furnished Equipment (BFE)' and are delivered to the company 'free of cost' for installing in the ship. The labour cost of installation is included in the fixed price component of the contract.

5. Sale on delivery of the ship to customer is reflected in that financial year. During the construction period, work-in-progress (WIP) is valued as under:

a. Where profits can be reliably measured:

"At costs incurred upto the reporting date plus profits recognised under the percentage of completion method in the proportion of the actual costs incurred bear to the estimated total cost to completion as on that date."

b. Where loss is anticipated:

"When it is probable that total contract costs will exceed the total contract revenue, the expected loss is fully recognised as an expense immediately, irrespective of physical progress achieved on the reporting date."

(A copy of annual accounts for the financial year (F.Y) 2011-12 has been supplied by the querist for the perusal of the Committee.)

B. Query

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

(i) Whether the Buyer Furnished Equipment's (BFE's) cost can be considered as inventory (simultaneously creating liability to the buyer) and then on issue to ship can be taken in WIP, so that accretion to WIP will be recognised as revenue.

(ii) Whether BFE's value can be considered as a part of sale value in the year of delivery.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to whether the Buyer Furnished Equipment (BFE) can be considered as inventory/WIP by the contractor and whether that value can be considered as part of sales value in the year of delivery. 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 treatment of equipments purchased by the company whose value is reimbursed by the buyer, accounting treatment of installation cost on BFE, recognition of contract costs and revenue, method of valuing work-in-progress during the construction period, etc. Further, it is also presumed by the Committee that the risks and rewards of ownership relating to BFEs do not vest with the company.

8. The Committee notes that before any item can be recognised as an inventory, it should meet the definition of 'asset' as given in paragraph 49 of the Framework for the Preparation and Presentation of Financial Statements (hereinafter referred to as 'the Framework'), issued by the Institute of Chartered Accountants of India as follows:

"(a) 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 that orders in respect of BFEs are directly placed by the buyer and also payment in respect of them is made by the buyer. These are then supplied to the company for installing in the ship and the buyer pays installation charges which are included in the contract price. Thus, the company has neither incurred any cost on BFEs nor any amount is recoverable on account of such equipments except installation charges. Accordingly, the Committee is of the view that such equipments are not 'assets' that may be a considered as a part of its contract work-in progress. In fact, after installation in the ship, BFEs are returned to the buyer after completion of the ship. Thus, these are only held by the company in the capacity of a bailee. Since, these cannot be considered as 'asset', therefore, these can neither be considered as 'inventory' nor as work-in-progress.

Accordingly, these cannot also be considered as a part of sale value or revenue of the company as no consideration would be receivable in respect of the cost of such equipments.

D. Opinion

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

(i) No, the BFEs cannot be considered as inventories/WIP, as discussed in paragraph 8 above.

(ii) No, the BFE's cost cannot be considered as part of sales value/ contract revenue, as discussed in paragraph 8 above.

Query No. 13

Subject: Capitalisation of borrowing costs for Tunnel Boring Machine in accordance with AS 16.[1]

A. Facts of the Case

1. A construction company (hereinafter referred to as 'the company') engaged in construction of bridges, roads, jetties, tunnelling etc., is executing

[1]Opinion finalised by the Committee on 21.5.2013 and 22.5.2013.

Metro Projects involving boring of underground tunnels. For the tunnelling activity, it has imported specialised Tunnel Boring Machines (hereinafter referred to as 'TBM'), which are funded through borrowings. The TBM is a machine, which has revolutionised the tunnelling industry both making tunnelling a safer, more economic solution for creating underground space and opening the possibility of creating tunnels where it was not feasible earlier.

2. TBM is used to excavate tunnels with a circular cross section through a variety of soil and rock strata. It can bore through anything from hard rock to sand. TBMs are used as an alternative to drilling and blasting. Modern TBMs typically consist of rotating cutting wheel, called a cutter head, followed by a main bearing, a thrust system and trailing support mechanisms. Support mechanisms located on the back-up includes conveyor or other systems for muck removal, slurry pipelines, control room, electrical systems, dust removal, ventilation and mechanisms for transport of precast segments. It is in the nature of a self reliant processing plant.

3. The querist has stated that once the characteristics of the required TBM have been defined, the period of time needed to manufacture the machine can take upto eight months. It is to be noted that every TBM is customised to suit the geo-physical condition of the strata where it will work. Hence, these machines are not available off the shelf. It is always manufactured against order and the manufacturing process typically takes anywhere between 8 to 12 months. Considering huge cost involvement, advances are to be paid to the manufacturer during different stages of manufacturing.

4. Tunnel Boring Machine is not a single set of machine, which operates on its own but requires several ancillary equipments and fittings to make it operable. End-to-end length of Main TBM and ancillaries ranges anywhere between 70-80 metres and weighs around 750 to 900 tonnes. The consignment arrives at nearest port in several pieces in containers, which have to be lifted by cranes and loaded in heavy trucks. After the containers reach the construction site, the assembly process which includes continuous and sequential assembly of all separate parts starts and the said process till final commissioning is also time consuming and takes around 6-8 months. Date-wise sequence of the activities performed by the company for one of the TBM is given below:

Activity	Date
Request for Quotes floated	18-03-2011
Letter of Intent issued to party	24-04-2011
Delivery of consignment to the port	06-12-2011
Transported to the construction site	22-12-2011
Final commissioning and ready for intended use	22-11-2012

Assembly operations must be carried out under the supervision of skilled technicians including those from the supplier of the machines. Some of the activities and approximate time involved in the commissioning of TBM are given by the querist as below:

(i) Construction of launching shaft: It is a box like structure where the TBM is to be lowered. (approx. 30-40 days)

(ii) Installation of EOT Gantry girder and crane and other preparatory work for lowering of TBM. (approx. 45-55 days)

(iii) Lowering and fixing of Cradle. (approx. 2-3 days)

(iv) Lowering of TBM: This is done with the help of 2 heavy cranes and other various lifting. (approx. 4-5 days)

(v) Installation of Reaction Frame. (approx. 7 days)

(vi) Pushing of TBM and Cradle for clear space between D'wall and Cradle for Cutter Head Lowering. (approx. 15-20 days)

(vii) Lowering and fixing of Cutter Head and fitting to Front Shield. (approx. 5-7 days)

(viii) Lowering of TBM Accessories: Rest of the accessories/equipments are lowered in the following sequence : (approx. 7-10 days)

(a) Assembly of Conveyor line

(b) Segment Cars

(c) Man riders

(d) Muck Cars

(e) Grout Car

(f) Locomotives etc.

(ix) Pushing the TBM and Cradle for clear space between D'wall and cradle for Screw conveyor fixing. (approx. 12-15 days)

(x) Removal of Reaction Frame. (approx. 5-7 days)

(xi) Fixing of Sleepers / Rails in base slab area. (approx. 20-25 days)

(xii) Connections between Hydraulic and Electrical Circuit. (approx. 20-25 days)

(xiii) Testing and Commissioning of TBM (approx. 45-55 days): Once the assembly is over, the TBM breaks through the wall of the launching shaft and gradually moves forward. This initial drive is for the alignment / adjustment of the cutter head. This testing and initial drive are normally carried out over a length of 50 or 100 metres under the supervision of supplier's engineers. Once the TBM along with the backup Gantry is fully into the tunnel, the initial drive is stated to be over and the TBM is fully commissioned and ready for operations.

5. The querist has reproduced paragraph 6 and explanation to paragraph 3.2 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), as follows:

"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."***

"3.2. ...

Explanation:

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."*** (Emphasis supplied by the querist.)

6. The querist has further reproduced relevant extracts from the erstwhile Accounting Standards Interpretation (ASI) 1, 'Substantial Period of Time', which was subsequently withdrawn and included as an Explanation to paragraph 3.2 of AS 16 as below:

> "2. The issue is what is the meaning of the expression 'substantial period of time' for the purpose of this definition.
>
> **CONSENSUS**
>
> 3. The issue as to 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 should be considered.
>
> 4. The following assets ordinarily take twelve months or more to get ready for intended use or sale unless the contrary can be proved by the enterprise:
>
> (i) assets that are constructed or otherwise produced for an enterprise's own use, e.g., assets constructed under major capital expansions.
>
> (ii) assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example, ships or real estate developments)."

B. Query

7. On the basis of the above and considering the fact that Tunnel Boring Machine is not a general bought-out machinery and requires substantial

time and efforts right from the time of identification of manufacturer, studying the geological data of the strata it is going to operate, manufacturing, shipping, custom clearance, ferrying from sea port to construction site, and final assembly before it becomes ready for its intended use, the querist has sought the opinion of the Expert Advisory Committee as to whether interest on borrowings incurred for the acquisition of Tunnel Boring Machines can be capitalised till the machine commences operation.

C. Points Considered by the Committee

8. The Committee notes that the query relates to accounting treatment of borrowing costs incurred on acquisition of Tunnel Boring Machines from the date of identification of manufacturer till it commences operation. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case including capitalisation in parts/phases, nature of financing arrangements, accounting treatment of borrowing costs incurred on funds utilised for making prepayments towards acquisition of TBM, etc. The Committee notes that at some places, the querist has stated the time needed to manufacture the TBM as 8 months and at other places, it is stated to be 8 to 12 months, which seems to be an apparent contradiction, however, it does not affect the opinion expressed hereinafter, which lays down the broad principles to be considered while capitalising borrowing costs.

9. The Committee notes from the Facts of the Case that the company has imported specialised TBM to be used in the boring of underground tunnels. The Committee further notes that TBMs are specifically manufactured against the order to suit the geo-physical conditions and later assembled at the construction site. The querist has stated that import of TBM is funded through borrowings though it is not clearly evident from the Facts of the Case as to when the borrowings are taken, viz., before identifying the manufacturer or when the order is placed. Further, it is also not clear whether the assembly activities at the construction site are also funded from borrowings. The Committee has therefore assumed that the entire project including construction / final assembly is funded through borrowings and that such funds have been borrowed specifically to acquire the TBM and its related activities.

10. The Committee further notes the definition of the term ‘qualifying asset’ and paragraph 5 of Accounting Standard (AS) 16, notified under the ‘Rules’, which are reproduced below:

"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.

Explanation:

> ***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."***

"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."

The Committee notes from paragraph 3.2 of AS 16 that ordinarily twelve months is considered as substantial time, however, a shorter or longer period can be justified considering the peculiarities of the facts and circumstances of each case. The Committee notes that the querist has stated that the time required to manufacture the TBM is minimum of 8 months and further 8 months are required for getting it ready for its intended use. Accordingly, the time required to construct the TBM and getting ready for its intended use is in aggregate more than twelve months. Therefore, based on the facts given, the Committee presumes that TBM is a qualifying asset.

11. The next issue that the Committee has examined is the nature of activities undertaken for acquisition and for commencement of operation through TBM, which are financed through borrowed funds, so as to determine whether the borrowing cost incurred in relation to them can be capitalised. In this regard, the Committee further notes the following paragraphs of AS 16, notified under the 'Rules':

> ***"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 notes from the Facts of the Case that various activities are performed before the asset is placed into operation. The activities include identification of manufacturer, studying the geological data of the strata, manufacturing, shipping, custom clearance, ferrying from sea port to construction site and final assembly. The Committee also notes that the manufacture / construction of the asset was performed by the vendor before it is commissioned at the construction site. The conditions for commencement of capitalisation are clearly laid down in paragraph 14 of AS 16. The Committee is of the view that though there are no restrictions for capitalising the borrowing costs incurred on assets manufactured at a vendor site, all the conditions of paragraph 14 above should be satisfied for capitalisation of borrowing costs. The expenditure on the qualifying asset and payment of borrowing costs are not sufficient enough to capitalise the borrowing costs. The activities that are necessary to prepare the asset for its intended use or sale should also be in progress so as to satisfy the conditions for capitalisation.

12. The activities necessary to prepare the asset for its intended use or sale can vary depending on facts and circumstances of each case. The Committee notes that activities such as, identification of manufacturer and studying the geological data of strata are performed by the company even before placing the order. Therefore, these activities cannot be deemed to be 'activities necessary to prepare the asset for its intended use or sale' as these activities do not add any value to the asset and no activity was in progress to prepare the asset for intended use. In fact, at that point of time, neither the manufacturer was identified nor the design of the TBM was certain. In other words, such activities were not leading to any change in the asset's condition. The Committee is further of the view that manufacturing at the vendor's site, shipping, custom clearance, ferrying from sea port to construction site and final assembly can be considered for capitalisation as the activities necessary to prepare the asset for intended use are in progress. The Committee also wishes to emphasise that the borrowing costs should be capitalised upto the period of completion of all the activities necessary for preparing the asset for its intended use or sale and not upto the period of actual commencement of operation.

D. Opinion

13. On the basis of the above, the Committee is of the view that no borrowing costs can be considered for capitalisation which have been incurred during the period of identification of manufacturer and studying the geological data of strata; however borrowing costs incurred during manufacturing at the vendor site, shipping, custom clearance, ferrying from sea port to construction site and final assembly can be capitalised in accordance with paragraphs 14 and 16 of AS 16. The Committee also wishes to emphasise that the borrowing costs should be capitalised upto the period of completion of all the activities necessary for preparing the asset for its intended use or sale and not upto the period of actual commencement of operation.

Query No. 14

Subject: Treatment of disputed elements of cost in valuation of inventory of raw material.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'A Refinery Ltd.' or 'A Ltd.'), a Government of India undertaking, is engaged in refining of crude oil having a refining capacity of 3 MMTPA. A Ltd. is jointly-owned by other public sector undertakings and a State Government (SG). It is engaged in production of petroleum products, i.e., high speed diesel, motor spirit, aviation turbine fuel, superior kerosene oil, liquified petroleum gas, naphtha, sulfur, raw petroleum coke and calcined petroleum coke. The refinery is the fourth refinery in the State.

2. A Ltd. has stated that it shares transportation cost on crude with X Refinery and Petrochemicals Limited (hereinafter referred to as 'X Refinery Ltd.' or 'X Ltd.') and certain elements of this transportation cost are disputed. The company has accounted for these disputed elements as a part of its raw material cost and considers the same also for closing inventory valuation. There is a difference of opinion on the present accounting treatment as to whether such disputed elements should be considered for inventory valuation or not.

3. There are four refineries located in the North East (NE) having an overall refining capacity of 7 MMTPA as detailed below:

Refinery	Company	Refinery Capacity
B Refinery	Z Ltd.	0.65 MMT per annum
C Refinery	Z Ltd.	1.00 MMT per annum
X Refinery	Z Ltd.	2.35 MMT per annum
A Refinery	A Refinery Ltd.	3.00 MMT per annum

Against crude oil refining capacity of 7 MMTPA, crude oil availability in the State is only around 4.50 MMTPA which is delivered to the 4 NE Refineries from the crude oil fields owned by Z Ltd./D Ltd. in the State. In view of low

[1] Opinion finalised by the Committee on 21.5.2013 and 22.5.2013

availability of State crude at 4.50 MMTPA, the overall refining capacity of the North East is not fully utilised and, therefore, with a view of optimising the refining capacity in the North East, the Ministry of Petroleum & Natural Gas (hereinafter referred to as MOP&NG or 'the Ministry') allocated 1.5 MMTPA of Ravva PSC crude effective from 1st April, 2003 to X Refinery Ltd. MOP&NG vide letter reference no. P-20029/67/02 – PP dated 18th February, 2003 stated that consequent upon the allocation of 1.5 MMTPA of Ravva PSC crude oil to X Refinery Ltd., the total crude oil availability for the North East refineries for the financial year 2003-04 would go up by 1.5 MMTPA over and above the State crude oil quantity. This additional 1.5 MMTPA Ravva crude along with the State crude would be re-apportioned among the four North East refineries in proportion to their installed capacities and in case of X Refinery Ltd., quantity re-apportioned above would comprise of 1.5 MMTPA of Ravva crude oil and the balance quantity would be made up by the State crude oil. It was also decided that the additional transportation cost of Ravva crude over the State crude would be shared by all the North East refineries in the proportion in which crude availability to the North East refineries is individually augmented on account of the enhanced reallocation.

4. Thus, crude oil transported in two sectors is as follows:

(a) Haldia to Barauni through pipeline owned by Z Ltd.

(b) Barauni to X Refinery through pipeline owned by another company, E Limited.

As per MOP&NG instructions, the additional transportation cost of Ravva crude over the State crude would be shared by all the North East refineries in the proportion in which crude availability to the North East refineries is individually augmented. This additional transportation cost is to be shared by the 4 NE Refineries, as transportation cost of Ravva crude is higher than the transportation cost of the State crude which is available locally and X Refinery Ltd. is foregoing its share of the State crude to the other 3 NE Refineries as it processes both Ravva crude (1.50 MTPA) and balance State crude.

5. The querist has further stated that X Refinery Ltd. is debiting the additional transportation cost incurred for Ravva crude to the other 3 NE Refineries on a year to year basis from the financial year 2003-04 on the quantity of augmented crude received by each refinery. Transportation cost consists of elements like service tax, entry tax, terminalling charges, marine

insurance, agency fee, etc. As the MOP&NG instructions did not indicate the elements of additional transportation cost, the same was discussed with X Refinery Ltd. and certain elements were agreed to between the two main parties i.e., X Refinery Ltd. and A Refinery Ltd. Although A Refinery Ltd. is not agreeable to some of the elements of this additional transportation cost debited by X Refinery Ltd., provisions are being made in the books of account based on the debits raised by X Refinery Ltd.; however, payments have been released only for the agreed items. The elements of additional transportation cost agreed and not agreed to by A Refinery Ltd. are as under:

6. Elements of additional transportation cost agreed to by A Refinery Ltd. for which payments are regularly made to X Refinery Ltd.:

(a) Ocean freight, bunker charges, insurance upto port and other import related costs,

(b) Pipeline freight for movement from port to X Refinery Ltd.,

(c) Pipeline consumption and ocean loss,

(d) Entry tax payable on the additional transportation cost on entry of Ravva crude into the State.

7. However, some elements of additional transportation cost debited by X Refinery Ltd. have not been agreed to by A Refinery Ltd. and the same are currently under dispute as detailed below:

(a) The State Freight Savings adjustment - All the 4 NE refineries have to pay crude oil pipeline transportation cost to Z Ltd./D Ltd. on the State crude oil received at each refinery. As the other 3 NE refineries are receiving higher quantity of the State crude through this exercise, they have already incurred the State crude transportation cost and this cost should be reduced from the additional transportation cost of Ravva augmented crude to be borne by each refinery. The calculation methodology of this State freight savings is under dispute.

(b) Entry Tax element - Further, on account of the difference in opinion of the State freight savings, A Refinery Ltd. is also settling the entry tax on a lower net transportation cost.

(c) Other issues – Disputes are also towards quantity of loss on elements such as ocean loss, pipeline loss incurred on Ravva crude transportation.

8. The differential on account of the above differences, i.e., difference in opinion on the State Freight Savings cost and the entry tax on the same, and high element of ocean and transportation loss on Ravva crude movement through ship and pipeline, is accounted for as a liability in A Refinery Ltd.'s books of account and debited to raw material cost, i.e., part of the crude cost, though no payment is being made to X Refinery Ltd. for these differentials. Further, as these items are being accounted for as a part of the raw material cost, the same are also considered for the purpose of closing inventory valuation. Though the amount is disputed, negotiations are going on against the disputed elements.

9. A Refinery Ltd. is considering all the elements as part of inventory cost in line with paragraph 6 of Accounting Standard (AS) 2, 'Valuation of Inventories', which states, ***"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."***

10. A Refinery Ltd. has included the disputed amount of Ravva crude transportation cost as a part of crude oil cost and the closing inventory valuation of crude oil and provision for the same has been made in the books of account following a conservative approach. The querist has separately clarified that the disputed amount has been provided for as a liability and disclosed in its balance sheet under 'sundry creditors' and not as a provision.

11. A Refinery Ltd.'s auditors, during the audit for the financial year 2011-12, have raised an objection for inclusion of disputed amount of Ravva crude transportation cost in crude inventory valuation. In the opinion of the auditors, as per AS 2, no abnormal (disputed) amount should be considered for valuation of closing stock. Thus, inclusion of disputed amount of liability has resulted in inflation of closing stock with corresponding overstatement of profit.

12. A Refinery Ltd. is of the view that amount that is disputed by it is not an abnormal item but a difference in calculating the net amount (rate) payable on account of Ravva crude transportation. Again, as per paragraph 13 of AS 2, following costs are to be excluded:

"(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.)

As disputed amounts are not abnormal items and the disputes are purely commercial in nature, A Refinery Ltd. has been considering the same as part of inventory cost.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the procedure followed by A Refinery Ltd. for valuation of inventory with inclusion of disputed items of additional transportation cost for which no agreement has yet been reached between two parties as a part of cost of crude oil is correct or not.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised in the query relates to the inclusion of additional transportation cost which is under dispute in the aggregate cost of inventory. 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, appropriateness of inclusion of various components of the additional transportation costs in the cost of inventories, appropriateness of creation of liability/provision in respect of transportation cost which is under dispute, etc. Further, the opinion expressed hereinafter is purely on the accounting issue raised in the query and not on the legal issues involved.

15. The Committee notes from the Facts of the Case that A Ltd. has recognised transportation cost which is under dispute in the cost of inventories and, therefore, the Committee has presumed from the Facts of the Case that these are the costs necessary for bringing the inventories to their present location and condition. Accordingly, the issue that arises is that only because these are 'disputed', whether these should be considered

as 'abnormal' and excluded from the cost of inventories, as contemplated under paragraph 13 of AS 2, as follows:

> "13. In determining *the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain cos*ts 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;
>
> ..."
>
> (Emphasis supplied by the Committee.)

The Committee is of the view from the above that costs that are excluded from the cost of inventories are abnormal wasted materials, labour or other production costs, etc. The Committee is of the view that just because a cost is under dispute does not make it wasted materials, labour, or other production cost and, therefore, it cannot be considered as an abnormal cost.

D. Opinion

16. On the basis of the above, and subject to the presumptions stated in paragraph 15 above, the Committee is of the view that the procedure followed by 'A' Refinery Ltd. for valuation of inventory with inclusion of additional transportation cost which is under dispute as a part of cost of crude oil is correct.

Query No. 15

Subject: Applicability of AS 11 to certain transactions pertaining to recoveries of claims settled by the corporation against its credit insurance covers.[1]

A. Facts of the Case

1. A corporation is an export credit insurer. The corporation provides insurance cover to the Indian exporters against the risk of overseas buyer's failure to pay and/or failure by the buyer's banks to externalize the payments to India.

2. The corporation is registered with the Insurance Regulatory and Development Authority (IRDA) as non-life insurer. The corporation follows IRDA guidelines for general insurers in preparing the financial statements.

3. The corporation charges a premium from the policy holders in Indian rupees (INR) based on the value of the shipments made / exposure accepted by the corporation. The policy holders prepare the invoices and export documents in the specified currency as per the commercial agreements entered into with the overseas buyers. The policy holders declare the value of the shipments to the corporation in Indian Rupees (INR) by applying the appropriate exchange rate (bank rate / reference rates as the case may be) to convert the invoice value and pay the premium thereon to the corporation in INR.

4. The querist has stated that in case the policy holders fail to receive their dues from the foreign buyers / buyer's country, they lodge a claim with the corporation. As per the terms of the covers, the corporation covers the losses in INR. The corporation calls for the bank certified exchange rate on the date of shipment to confirm the true value of the loss suffered. The claim is considered on the lower of (a) value on which premium is paid or (b) the bank certified value. The above practice is followed, as conceptually, under an insurance contract, the insured is not supposed to gain from a misfortune suffered and on the same count, the cover offered is that which is paid for (i.e., the value on which the premium is paid). The claims thus settled are expensed out in the books of the corporation. According to the querist, as the claims are computed in INR on the basis of the shipments made, there are no foreign exchange losses or gains arising on account of payment of claims. Losses, if any, caused due to exchange rate fluctuation by default are not hedged by a foreign exchange contract.

[1] Opinion finalised by the Committee on 16.07.2013.

5. As per policy terms, if subsequently, a recovery is made by the insured, he is obliged to share the recovery net of recovery expenses, in the same proportion in which the total loss was initially shared by the corporation at the time of claim settlement in INR. The querist has separately informed that the corporation's insurance policy bond (a copy of which has been provided by the querist for the perusal of the Committee) states as under:

> "Upon payment of a claim under this policy by the Corporation, the insured shall take all steps which may be necessary or expedient or which the Corporation may at any time require to effect recoveries whether from the buyer or from any other person from whom such recoveries may be made including (if so required) through institution of legal or other proceedings and upon being so advised by the Corporation, shall—
>
> (a) assign and transfer to the Corporation his rights under the relevant contract in respect of which the loss occurred and such claim payment was made, including his right to receive any monies payable under such contract or his right to damages for any breach thereof;
>
> (b) deliver up to the Corporation any goods in respect of which such payment has been made and any documents relating thereto and assign and transfer to the Corporation his right and interest in any such goods and documents; and
>
> (c) assign, deliver or otherwise transfer to the Corporation any negotiable instruments, guarantees or other securities relating to such goods or contracts."

The querist has also informed that, although the corporation has subrogation rights, it exercises those rights sparingly and currently, the corporation is not exercising its right of subrogation in respect of commercial claims paid to Indian exporters and is relying on action taken by exporters for recovery.

6. The querist has further stated that as there is generally, a time gap between the date when the shipment takes place and the time when the recovery is actually effected, recovery is realised in INR at a different exchange rate, a portion of which is shared with the corporation. As the corporation issues the policy in INR, collects premium in INR and settles claims in INR, it also adjusts the total amount realised in INR as recoveries

against the claim settled. The corporation's view is that the exchange gain or loss is that of the exporters and not of the corporation. However, the joint statutory auditors of the corporation opine that the element of surplus/ deficit in recoveries due to exchange rate fluctuation should be treated as exchange gain/loss by the corporation as per Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'.

7. The querist has also separately informed that a recovery provision is created in respect of a paid claim at the end of each year. The estimated recoveries in respect of all the paid claims are computed and accounted for on the basis of assessment of each individual claim case at the end of each financial year, which as per the querist, is made independent of foreign exchange fluctuations. However, the recoveries in respect of claims paid and outstanding for recovery for more than three years as on the balance sheet date are estimated at Rs.100/- per claim case even if higher recovery provision is permissible on such assessments. The estimated recoveries on account of transfer delay claim, paid or provided for, is accounted for on the basis of the corporation's current perceptions based on the available information and past experience. This has been documented in the 'Significant Accounting Policies' of the company. At the commencement of the next accounting period, the corporation reverses those recovery provisions created at the end of the preceding accounting period. At the end of the financial year, estimation of each individual claim is undertaken again. Where there is no probability of recovery, the corporation ceases to make provision for recovery on the said case thereby closing the case. According to the querist, IRDA has not prescribed any regulation in this regard. In fact, the practice of making provision for recovery is prevalent only in the export credit insurance sector under the non-life insurance category. The recovery provision has two parts. The income part is shown as a reduction in the claim provisions in Schedule 2 (Claims Incurred) to the accounts. The asset part is shown as a part of other assets in Schedule 12 (Advances and Other Assets) to the accounts. As far as accounting for claims and recovery in the books of Policy Holder (PH) is concerned, the querist has stated that generally, the PH accounts for the net loss in the transaction after adjustment of claim amount settled by the corporation. Whenever the dues from the buyer are recovered, the PH would show the same as bad debt recovery and the gain/loss due to exchange rate fluctuation is required to be accounted for by the PH accordingly. The PH is further required to share the recovery proceeds {gross remittance to India less recovery expenses incurred (net

recovery), if any} in the same ratio in which claim was paid by the corporation to PH.

8. According to the querist, after a claim is paid, though it is expensed out in financial statements, record is maintained showing the amount as outstanding claim till the amount is either fully recovered or partly recovered and balance written off or fully written off as per the extant guidelines.

9. The querist has reproduced the following extracts from AS 11:

> **“Objective**
>
> An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise’s reporting currency and the financial statements of foreign operations must be translated into the enterprise’s reporting currency.
>
> The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.
>
> **Scope**
>
> *1. This Standard should be applied:*
>
> *(a) in accounting for transactions in foreign currencies; and*
>
> *(b) in translating the financial statements of foreign operations.*
>
> (Emphasis supplied by the querist.)
>
> 2. This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.”

10. The corporation is of the view that the premiums are collected in INR, claims are settled in INR and recovery is realised in INR and there is no foreign currency element in the books of account of the corporation during the entire transaction cycle. Hence, it is considered that AS 11 is not applicable to the corporation’s recovery transactions under the policies issued to the exporters.

11. The joint statutory auditors are of the view that since the recovery of claims by the exporter is denominated in foreign currency, each instalment of recovery by the corporation has to be bifurcated into actual recovery and recovery due to exchange rate fluctuation and the amount attributable to exchange gain/ loss should be reflected accordingly. There is a possibility that, at times, the corporation may be able to recover an amount more than the claim paid amount. The surplus/deficit has to be recognised as forex gain/loss and even when total recovery is not adequate to adjust the outstanding claim, the part of outstanding claims after adjustment of recovery not due to exchange gain/ loss should continue to be shown as outstanding claim or written off as per the extant guidelines.

12. The querist has provided the following illustrations of adjustment of recovery in different scenarios which clearly bring out the difference between joint statutory auditors' view and the corporation's view:

Illustration 1

Assumptions:

1. Exporter's Invoice Value USD 10,00,000 (1 USD = Rs. 45)	Rs. 4,50,00,000
2. Claim settled by the corporation for USD 10,00,000 (1USD = Rs. 45) - 90% cover	Rs. 4,05,00,000
3. Total amount received by exporter USD 6,00,000 (1USD = Rs. 55)	Rs. 3,30,00,000
Corporation 's share of recovery at 90%	Rs. 2,97,00,000
(a) Corporation's view: To be adjusted against outstanding claims	Rs. 2,97,00,000
Balance claim outstanding	Rs. 1,08,00,000

(b) Joint statutory auditors' view:

To be adjusted against outstanding claims (6,00,000 x 45 x 90%)	Rs. 2,43,00,000

To be booked as forex gain (2,97,00,000 – 2,43,00,000)	Rs. 54,00,000
Balance claim outstanding (4,00,000 x 45 x 90%) or (4,05,00,000 – 2,43,00,000)	Rs. 1,62,00,000

Illustration 2:

Assumptions:

1. Exporter's Invoice Value USD 10,00,000 (1USD = Rs. 45)	Rs. 4,50,00,000
2. Claim settled by the corporation for USD 10,00,000 (1USD = Rs. 45) - 90% cover	Rs. 4,05,00,000
Total amount received by exporter USD 10,00,000 (1USD =Rs. 40)	Rs. 4,00,00,000
Corporation's share of recovery (90%)	Rs. 3,60,00,000
(a) Corporation's view:To be adjusted against outstanding claim	Rs. 3,60,00,000
Balance outstanding claim	Rs. 45,00,000

(b) Joint statutory auditors' view:

To adjust against outstanding claim	Rs. 4,05,00,000
Book as forex loss	Rs. 45,00,000
Balance outstanding claim	NIL

Illustration 3:

Assumptions:

1. Exporter's Invoice Value USD 10,00,000 (1USD = Rs.45)	Rs.4,50,00,000
2. Claim settled by the Corporation for USD 10,00,000 (1USD= Rs.45) - 90% cover	Rs 4,05,00,000

Total amount received by exporter USD 9,50,000 (1USD =Rs 55)	Rs.5,22,50,000
Corporation's share of recovery (90% of Rs. 5,22,50,000)	Rs. 4,70,25,000

13. The corporation is of the view that the method of accounting for recovery as per the auditor's view in the illustrations above totally distorts the actual recovery effected by the corporation and consequently, the 'incurred claim' of the corporation which is one of the major items in the revenue account of the corporation will be distorted.

14. The joint statutory auditors are of the view that in the illustration 2 above, the corporation should book forex loss and treat the claim as fully recovered and not continue to show the recovery outstanding.

The corporation's view

15. As per the querist, as mentioned in paragraph 9 above, AS 11 is applicable to foreign transactions and foreign operations. The corporation's credit insurance policies issued in INR cannot be construed as forex transactions just because the quantum of recoveries is affected by exchange rate fluctuations. The corporation is of the opinion that the basic transaction in foreign currency is of the exporter only and any such exchange gain/loss is to be recognised only in its books of account as per AS 11.

16. The querist has also stated that as there are not many organisations, undertaking similar business of significant volume, common accounting procedure at industry level is not available.

B. Query

17. The querist has sought the opinion of the Expert Advisory Committee on the appropriateness of the method of accounting for recovery, currently followed by the corporation.

C. Points considered by the Committee

18. The Committee notes that the basic issue raised in the query relates to whether the accounting treatment followed by the corporation of not recognising any foreign exchange gains / losses on the amount recovered

from the third party to the contract of insurance is correct or not. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, including disclosures of risks, accounting for transactions in the books of the insured/ policy holder, accounting for insurance premium, measurement of provision for recoveries or any asset arising therefrom, recognising foreign exchange gain/loss on estimated recoveries, adjustment of recoveries against claim settled, etc. Further, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective, for example, from the perspective of examining the legal relationship between the corporation and the insured, etc.

19. The Committee notes from the Facts of the Case (paragraph 5 above) that the corporation has the right of subrogation, although it is relying on action taken by exporters for recovery. The Committee is of the view that once the claim is settled by the enterprise, it steps into the position of insured against the third party who may have caused the damage. Thus, even though the exporter recovers the amount but it is done on behalf of the corporation and primarily the right to recover remains with the corporation. Moreover, as per clause 25 of the Insurance Policy (reproduce below), the Committee notes that the corporation has a right to recover greater sum than the amount of claim paid by it.

> "25. Any sums recovered by the Insured or by the Corporation after the date at which the loss is ascertained, from the buyer or from any other source shall be divided between the Corporation and the Insured in the proportion in which the amount of loss was borne by each of them respectively according to the terms of this Policy, whether or not such division results in the retention by the Corporation of a greater or lesser sum than the amount paid by the Corporation under this policy in connection with the amount of loss, whatever be the cause, circumstance or reason for such retention. The Insured shall pay to the Corporation all sums so recovered forthwith upon being received by him or by any person on his behalf, the Insured hereby acknowledges and declaring that until such payment is made to the Corporation he receives and holds such sums in trust for the Corporation."

Thus, in the view of the Committee, on payment of claim, the right to recover gives rise to a resource controlled by the corporation from which future economic benefits are expected to flow, which is an 'asset' as per paragraph

49(a) of the Framework for Preparation and Presentation of Financial Statements as reproduced below:

> "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."

20. The Committee further notes paragraph 8 of AS 11, which provides as follows:

> "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) ...
>
> (d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency."

From the above, the Committee is of the view that on payment of claim, the corporation acquires an asset, viz, right to recover from the foreign buyer which is denominated in foreign currency. This acquisition of asset is a foreign currency transaction as per AS 11. Thus, the Committee is of the view that although, in the extant case, the premiums collected and claims settled are denominated in INRs but the asset acquired for recovery (viz., right to recover from the foreign buyer) is denominated in foreign currency which involves foreign currency risk as is also clear from the Illustration provided by the querist. Accordingly, the Committee is of the view that the company should recognise the exchange gain or loss, if any, thereon due to foreign currency fluctuations as foreign exchange gain or loss and therefore, the contentions of the company in this regard are not correct.

D. Opinion

21. On the basis of the above, the Committee is of the view that the accounting treatment followed by the corporation of not recognising foreign currency gains/losses on the amount recoverable from the third party to the contract of insurance is not correct.

Query No. 16

Subject: ***Accounting for the cost incurred on acquisition of land including the buildings situated thereon and demolished immediately thereafter for the purposes of mining and payment of compensation claim for rehabilitation to the owners of land as per the approved scheme.***[1]

A. Facts of the Case

1. A company is a wholly owned State Government company. It is the only integrated titanium dioxide pigment plant in the world. The turnover of the company during the financial year 2011-12 was Rs. 613 crore with a profit of Rs. 150 crore (provisional). Presently, the company has the following three units:

(i) Mineral separation unit – engaged in the separation of valuable mineral like ilmanite, rutile, ziron and siliminite from beach sand.

(ii) Titanium pigment unit – manufacture of titanium dioxide pigment.

(iii) Titanium sponge unit – A unit established with the financial/ technical assistance of ISRO/DRDO for the manufacture of titanium sponge. With the commissioning of the plant, India became the 7th country in the world possessing this technology.

2. The querist has stated that the company has incurred heavy cost in the acquisition of land including building situated thereon through negotiated settlement process from a large number of parties for the purposes of extraction of heavy minerals as a part of its regular mining activities for manufacture and production of titanium dioxide in its plant. The minerals so extracted constitute one of the principal raw materials for the production of titanium dioxide and for comfortable survival and existence of the company, it is essential to acquire and own sufficient and adequate mineral deposits. Hence, the acquisition of land is wholly and exclusively intended to provide uninterrupted supply of scarce minerals for manufacturing operations. The purchase price of land is based on the current market value of land only and price paid has no relationship with the mineral deposits embedded or available on such land. The mineral deposits are being collected by the

[1] Opinion finalised by the Committee on 16.7.2013.

company through sea harvesting by removing sand deposited by the waves and to a limited extent, land mining has also been started in the recent past as the concentration in sand collected through sea harvesting has been depleted. After the extraction of the minerals as above, the land is filled with the tailing sand and restored to the original position and hence, according to the querist, there is no depletion in the value of land acquired except on account of sea erosion and in fact after filling and restoration to its original position, the market value of the land only increases over a period of time on account of the inflationary trend in the real estate market. Further, the sea harvesting can be continued for long after completing the land mining.

3. The querist has further stated that in respect of the cost incurred for acquisition of land as also the cost paid for the building situated on the land acquired from various parties (and demolished before commencement of mining activities), consideration is stated separately in the document of purchase (title deeds of land). The cost of building as per the document is substantially higher as compared to the cost of land. The total cost incurred for land and building upto 31-03-12 is Rs. 116.65 crore and more than 60 % of the same is the cost of building. The company accounts for the cost paid for acquisition of land under 'Land Account' under fixed assets as a tangible asset having an enduring value is acquired. The company has to pay royalty to the State Government for extraction of minerals through mining activities as per the Mines and Minerals Development and Regulation Act, 1957 as the title of ownership of the minerals embedded in the land vests in the Central Government and extraction and use of such minerals is regulated by the above statute. As regards the cost incurred for acquisition of building, the company has no intention of utilising the building for its business activities and the building is demolished immediately or at the time of the commencement of mining. The vendors / occupants are allowed to demolish the building by payment of 5% of the value of the building as stated in the document to the company. Therefore, the objective / intention of the company is to acquire land for undertaking mining activities only and the break-up details of price of land and building are separately stated in the purchase documents as per the insistence of the sellers of such land.

Accounting treatment presently followed:

4. In view of the fact that the land is used essentially for sea-harvesting as above, the company follows the accounting policy of booking the cost incurred on acquisition of the land under 'Land Account' under fixed assets

and it is the stand of the company that a considerable portion of land is acquired as a reserve for facilitating the sea harvesting which is a continuous process and the land adjacent to sea shore is required. In view of this, the company is of the opinion that the land is held as a fixed asset and cannot be treated as a current asset. Since the ownership of minerals embedded on such land, under law, vests with the Government, the company can sell/ transfer the mineral deposits only after paying the royalty to the State Government, as stated above. For these reasons, it was considered not appropriate to account for the land as a current asset purely based on the mineral deposits available in such land. Being predominantly a unit of chemical industry, the company wants to convert these lands after mining as a buffer zone as a part of the initiative towards environment and social responsibilities.

5. The querist has also stated that the company does not account for the cost of the building acquired and demolished separately under 'Buildings' under 'Fixed Assets' and the entire cost of the land and building is accounted for under 'Land Account'. 5% of the value recovered from the vendors / occupants on demolishing the building is credited to the cost of land as the salvage value recovered as a part of the acquisition process considering that the predominant objective was only to acquire such land for mining activities.

6. The company has received audit query from the statutory auditors and the Comptroller and Auditor General (C&AG) stating that the cost of land, which has to be taken to represent the mineral deposits included / embedded in the land has to be accounted for as a current asset and not under 'Fixed Assets'. Moreover, the cost of building has to be shown separately under fixed assets and as and when the same is demolished, the cost of building has to be written off to the statement of profit and loss. In this regard, the querist has stated that in case the entire cost of building is to be written off to the statement of profit and loss in the financial year 2012-13, this will seriously erode the financial position of the company since the aggregate cost incurred upto 31.03.2012 is quite high.

7. During the financial year 2011-12, rehabilitation compensation @ Rs. 3 lakh has been paid to owners of land and building as per the minutes of the meeting held in the presence of the District Collector, in cases where the owners have not opted for the offer of the company to provide equivalent extent of land in another locality adjacent to the company's premises.

Wherever, such option has been exercised by the owners of the land, the company has entered into an agreement with such parties to provide them the ownership title on equivalent extent of land within a period of three years plus a reduced rehabilitation compensation of Rs. 75,000. The querist has argued that since the company enters into a legal obligation to provide equivalent extent of land plus reduced cash compensation of Rs.75,000, provision has to be, in any way, made in the accounts in the year of acquisition of such land. The cash compensation of Rs. 3 lakh paid during the year 2011-12 and the obligation incurred for providing equivalent extent of land plus cash compensation of Rs. 75,000 during the year 2011-12 amounts to around Rs. 475 lakh and Rs. 10 lakh respectively.

B. Query

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

(i) The correctness of the policy followed for accounting for the cost of the land under 'Fixed Assets' and not under 'Current Assets' based on the reasoning as above and the correctness of accounting for the cost incurred on building acquired and demolished as reduced by 5% of the sale price received under cost of land on the argument that such cost is incurred solely and exclusively for the purpose of acquisition of land. In case the Committee is of the opinion that the cost incurred on the building demolished is to be written off as a revenue expenditure, whether it would be in order to amortise the cost of building, carried forward in the books upto 31.03.2012 under 'Land Account' over a suitable number of years on the ground that the company acquires title over the mineral deposits which could be construed as an intangible asset as per Accounting Standard (AS) 26, 'Intangible Assets'.

(ii) The accounting procedure to be followed in respect of rehabilitation compensation of Rs. 3 lakh paid to sellers of land who have not exercised the option for alternative land, i.e., whether the expenditure is to be treated as revenue expenditure or to be capitalised under cost of land.

(iii) The accounting policy and procedure to be followed for the liability incurred at the time of acquisition of land and entering into agreement for provision of alternative land plus reduced cash compensation of Rs. 75,000 considering that at the point of acquisition, the company is not able to ascertain which land would be given in exchange to the parties involving equivalent area and hence, the cost thereof is not correctly ascertainable.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting for the land and buildings acquired for the purposes of sea harvesting and land mining and accounting for rehabilitation expenditure incurred on acquisition of land. 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 the royalty paid to the Government on sale or transfer of minerals, accounting for the costs incurred, if any, for acquiring mining rights, accounting for sea harvesting and land mining activities and the minerals developed out of these activities, accounting for site restoration costs, etc. The Committee notes from the Facts of the Case that in case where land owners have opted for the offer of equivalent extent of land along with reduced rehabilitation compensation, it is stated that the company is not able to ascertain which land would be given in exchange to the parties involving equivalent area and hence, the cost thereof is not ascertainable. Accordingly, the Committee has presumed that the land is not to be given to the parties by the company out of its owned lands. Further, the opinion of the Committee is purely from the accounting point of view and not from the angle of interpretation of any legal enactments, such as, Income-tax Act, 1961, etc. as in view of Rule 2 of the Advisory Service Rules of the Committee, it is prohibited from doing so.

10. As regards accounting for the land and buildings acquired, the Committee notes the definition of the term, 'fixed asset' as per paragraph 6.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') which provides as follows:

> ***"6.l <u>Fixed asset</u> is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business."***

The Committee also notes the definition of the term 'Current Assets' as per paragraph 3.34 of the Guidance Note on Terms Used in Financial Statements as follows:

> ***"3.34 Current Assets***
>
> Cash and other *assets* that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business."

From the above, the Committee is of the view that in the extant case, although the land has been acquired for extracting mineral deposits, it is the minerals extracted which will be sold in the normal course of business. Land will be held by the company till all the mineral deposits are exhausted and will also continued to be held thereafter. In other words, land is not being consumed in the normal course of business rather it is held for the purpose of extraction of mineral deposits through sea harvesting or land mining. Accordingly, the Committee is of the view that it is not appropriate to consider land as a current asset just because it will be used to extract mineral deposits available under such land, rather the land should be treated as fixed asset. In this regard, the Committee also wishes to point out that mineral deposits is a separate asset which should be recognised separately.

11. As regards accounting for buildings situated on the land acquired for sea harvesting and land mining, the Committee notes that although a separate price is stated in the purchase documents in respect of buildings, the company has no intention of utilising the buildings for its business activities. In other words, these buildings are unusable for the purpose of the business and are demolished either immediately on acquisition or at the time of commencement of mining. Even the vendors are allowed to demolish the building by payment of 5% of the building value to the company. Thus, although the company may have acquired both land as well as buildings, the sole purpose of acquiring them is mining and sea harvesting on the acquired land and accordingly, the Committee is of the view that the amount paid for buildings should be included in the cost of acquisition of land. The value received from the vendors on account of demolition of buildings should be deducted from the cost of acquisition as it is incidental to the acquisition only.

12. As far as accounting for rehabilitation compensation paid to sellers of land who have not exercised the option for alternative land is concerned,

the Committee is of the view that this expenditure is directly attributable to the acquisition of land and accordingly, following the principles of AS 10, it should be included as a part of cost of land. In this regard, the relevant paragraph of AS 10, notified under the 'Rules' is reproduced below:

> ***"20. The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use."***

With regard to accounting for rehabilitation compensation paid in the form of alternative land plus reduced compensation, the Committee notes that at the point of acquisition, the company is not able to ascertain the land that would be given in exchange to the parties and accordingly, its cost is not correctly ascertainable. The Committee notes the following paragraphs of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the 'Rules' 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."***
>
> ***"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."

"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. The amount of a provision should not be discounted to its present value."

From the above, the Committee is of the view that acquisition of land in the extant case creates an obligation on the enterprise to pay the rehabilitation expenditure either through outright compensation of Rs. 3 lakh or through exchange of another piece of land plus reduced compensation. Thus, even though the alternative land may not have been identified, the company has an obligation to settle it which cannot be avoided. Thus, the company has incurred a liability. However, since the value of alternative land can be measured using a substantial degree of estimation, the Committee is of the view that the company should recognise a provision in respect of its liability at the best estimate of the expenditure required to settle the obligation at the reporting date as per paragraph 35 of AS 29, reproduced above, which should be included as part of the cost of the land. In this regard, the Committee is also of the view that Rs. 3 lakh can be taken as a basis for reasonable estimation of the liability.

D. Opinion

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

(i) The accounting policy followed by the company for accounting the cost of land under fixed assets and not under current assets is correct, as discussed in paragraph 10 above. The accounting for cost incurred on building acquired and demolished subsequently under cost of land is also correct as discussed in paragraph 11 above.

(ii) The rehabilitation compensation paid to sellers of land should be capitalised as part of the cost of land, as discussed in paragraph 12 above.

(iii) The liability in respect of alternative land should be recognised as provision at the best estimate of the expenditure required to settle the obligation at the reporting date, as discussed in paragraph 12 above.

Query No. 17

Subject: Revenue recognition in case of project managers.[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. In addition to construction and operation of Hydro Electric Power Projects, being a central public sector undertaking, the company is also engaged in project management/ consultancy and other construction contracts on behalf of other agencies on *deposit work basis* generally not on profit and loss basis. These assignments are either related to own projects of the company or work has been entrusted to the company by the Government of India (GoI). *None of the assignments as aforesaid is taken up by the company by bidding like a contractor* (emphasis provided by the querist). For carrying out these assignments, the company acts as an agent of the agency on whose behalf said deposit work is done and there is no principal to principal relation between the company and the said agency. One of such assignments is for formulation and implementation of Rajiv Gandhi Gramin Vidyutikaran Yojna (hereinafter referred to as the 'RGGVY'). The company is carrying out these assignments in a number of states on behalf of respective states. The brief background

[1] Opinion finalised by the Committee on 16.7.2013.

as well as the modus operandi for carrying out these assignments are as under:

- Under the Bharat Nirman programme of the Government of India, the Ministry of Power (MoP) has been entrusted with the formulation and implementation of the RGGVY. The RGGVY aimed at electrifying all villages and habitations and providing access to electricity to all rural households of the country through Central Public Sector Undertakings (CPSUs), since the CPSUs have the technical and professional competence and expertise to implement such a scheme on a massive scale.

- A Memorandum of Understanding (MoU) was signed on 14th July, 2004 between a funding company and the company with the objective to be associated in the formulation and implementation of projects under the programme in association with the concerned State Government/power utility. In accordance with the said MOU, the company entered into agreements with the GoI, State Governments and State Power Utilities (SPUs) for implementation of projects in those states on behalf of the State Governments/ SPUs. Under the said MOU, the funds required for the execution of the project are released directly to the company by the GoI through the funding company including 12% service charges. The company is responsible for selecting executing agencies (contractors) through open tenders. Project-wise separate contracts namely 'Supply Contracts' and 'Erection Contracts' are entered into between the company and the selected contractors, for execution of the work. At no point of time, GoI, State Government or SPU enters into any kind of contract with the contractors. The contractor company furnishes a performance bank guarantee in favour of the company for executing the work. Further, the responsibility of levying and collecting the liquidated damages, if any, from the contractors is that of the company and, the amount so recovered will be adjusted in the project cost. Relevant extracts of MOU entered between funding company and the company are given hereinbelow by the querist for ready reference:

"Clause 4: Role of the company:

4.1

(a) The company shall undertake these projects on deposit work basis (in suitable installments) on behalf of the borrower/owner of the project after a separate multilateral agreement is entered into as stated hereinabove.

(b) The company shall be responsible for formulation, development and implementation of the projects in the identified area involving system planning, design, engineering (in accordance with the GoI's guidelines, specifications and construction standards, wherever applicable) and procurement in accordance with agreed competitive bidding procedures.

(c) The projects shall be implemented by the company in a time bound manner as scheduled in the approved projects and projects so implemented by the company will be taken over immediately after their completion by the concerned State Government/State Power Utility, who will be responsible for proper operation and maintenance thereafter.

(d) If the State Government/State Power Utility so desires, the company may consider taking up operation and maintenance of the completed projects on mutually agreed terms and conditions under a separate agreement with that State Government/State Power Utility.

4.2 If the State Government/State Power Utility so desires, the role of the company may be limited to:

(a) Project monitoring and supervision of quality of works during construction, or

(b) Formulation and preparation of project reports based on the details provided by the concerned State Government/State Power Utility, arranging project approvals, providing advisory support during procurement, if required, and project monitoring and supervision of quality of works during construction. ..."

Clause 5: Project Execution and Development Expenditure

5.1

(a) The projects to be implemented by the company under this agreement shall be funded by the GoI from the funds sanctioned to the State Government/ State Power Utility under Accelerated Electrification of Villages and Households Programme.

(b) The funds for the execution of the projects shall be released by the GoI directly to the company, including service charges as per agreement to be executed with the borrower/owner of the project under suitable multilateral arrangements, which shall be legally enforceable.

(c) Separate accounts for development and implementation of such GoI funded projects shall be maintained by the company.

(d) the company shall be entitled to service charges of 12% of project cost on pro-rata basis and the same may be included in the project cost. Further, additional statutory taxes payable by the company shall also be reimbursed.

5.2 Service charges payable to the company shall be 2% and 5% of the project cost on pro-rata basis for the scope of services as defined against clauses 4.2 (a) and 4.2 (b) respectively and the same may be included in the project's cost. Further, additional statutory taxes payable by the company shall be reimbursed. ...”

Relevant extracts of Agreement between the funding company, State Government, SPU and the company entered separately for each state have been provided by the querist as under:

“3.0 Construction / Implementation

3.1 The company shall make all possible efforts to complete the project(s) within the approved time frame starting from the date of release of the first installment of funds by the GoI.

3.2 The company shall specify quarterly milestones, and progress shall be reviewed with reference to these milestones jointly by the GoI, authorised representative of State Government, State Electricity Board and the company in quarterly Performance Review Meetings.

3.3 The company shall suitably incorporate the provisions towards levy of liquidated damages in their agreements with contractors for delay in completion of the project(s) and also other relevant contractual provisions pertaining to the procurement of goods and works. Declaration in this regard shall be furnished by the company before setting the actual expenditure on the project in line with the provisions under clause 1.3 (g) of this agreement. All amounts towards liquidated damages, if any, as may be recovered by the company under this provision, shall be suitably adjusted in the project cost.

3.4 (a) The company shall ensure that its own quality control systems and inspection are adopted in the implementation of these projects.

(b) The best cost control measures shall be enforced by the company during implementation through appropriate management and control systems.

(c) On behalf of the project authority (State Government and SEB), the company shall ensure that the equipment & material specifications and construction practices & standards are as those approved/stipulated by the Funding Company. ...”

2. Accounting treatment being followed by the company in respect of the above type of work is described as under:

- The company is recognising revenue in the statement of profit and loss to the extent of agency fees proportionate to the work executed in the year and establishment and administration expenses actually incurred are charged to the statement of profit and loss. The direct work cost (executed by the contractor) is directly adjusted against the advance / funds received from the funding company on behalf of the State Power Utilities / State Government. Accounting on net basis is being done because of the following:

  - ❏ As per the MOU, it is clear that the ownership of the entire work shall vest with the various State Governments/State Power Utilities. The company works only as an agent on their behalf and the funds are provided by the Government of India under a fiduciary relationship of principal and agent. This definition of ownership is contained in clause 1.0 of

'Funding Company Guidelines for procurement of goods and services' under the chapter 'Invitation to Bids', which is reproduced below:

*"______ *** has been entrusted by ____** with the concurrence of Government of ____* for execution of XYZ Ltd. for electrification of villages and rural households in the _______ district(s) of ______*. The execution of the project shall be funded out of the proceeds of the financial assistance to be received by Government of ___* from XYZ Ltd. and all eligible payments for the execution of the project under the intended contract shall be made by the _____*** under suitable arrangement with ___**. The ownership of the project shall remain vested with ___**."*

*(*** stands for 'the company', ** stands for 'name of SPU' and * stands for 'the State Government'.)*

❑ The company is to utilise the funds as per the terms and conditions of the MOU and after meeting the actual expenses on the work, the balance is to be refunded.

❑ The statutory deduction of taxes and duties at source related to these works shall be done by the company on behalf of the State Power Utilities and TDS so deducted shall be deposited with the relevant tax authorities on their behalf. TDS certificates shall also be issued on their behalf by utilising PAN/TAN/TIN of the State Power Utilities.

❑ All invoices under the construction contracts, awarded by the company, shall be raised by the contractor on "State Power Utilities acting through the company" and all payments shall be made to the contractor by the company on behalf of State Power Utilities.

❑ The way-bills/road-permits are also being issued by the owner, i.e., the State Power Utilities.

❑ Liquidated damages recovered by the company from contracting company, to whom the work has been awarded by the company on behalf of SPU, is also to be passed on to the respective SPU/State Government.

- ❑ The company works as agent on behalf of the concerned SPU / State Government, thereby having no risk and reward of its own, so far as direct work cost on the assignment is concerned. The company's reward is only to the extent of its agency fees and only risk associated in this assignment is incurring of loss in case expenditure incurred on establishment and administration (indirect expenditure) happens to be more than the agency fees. It clearly shows that the company acts as an agent of the State Government and is not a contractor.

- As such, the company is performing these services as an implementing agency on nomination basis and not as a contractor as ownership of the assets always vests with the State Power Utilities. Therefore, Accounting Standard (AS) 7, 'Construction Contracts', is not applicable. However, for the purpose of measurement of revenue as aforesaid, proportionate completion method as stipulated in Accounting Standard (AS) 9, 'Revenue Recognition'/AS 7 is being followed. Disclosure as regard to advance received, work done and revenue earned during the reporting period is given in the financial statements.

3. The querist has stated that the above accounting treatment is in conformity to the recent opinion of Expert Advisory Committee (EAC) (published as Query No. 19 of Volume XXXI of the Compendium of Opinions) given in respect of one of the subsidiaries of a power sector company executing the rural electrification work under RGGVY. The querist has also provided the relevant extracts of the opinion referred to by it.

4. Significant accounting policy of the company in respect of accounting of aforesaid assignment is reproduced below:

> "10.2 In respect of Project Management/Consultancy Contracts/Cost plus Contract, revenue is recognised based on the terms of agreement and the quantum of work done under the contract."

5. For such assignments, revenue recognition principle i.e., proportionate completion method as enunciated in AS 9 / AS 7 is being followed for the computation of revenue only. However, other disclosures warranted by AS 7 were not given in the financial statements *in view of the explanation given*

in paragraph 2 above read with the EAC opinion referred in paragraph 3 above (emphasis supplied by the querist).

6. During the audit of accounts for the financial year (F.Y.) 2011-12 of the company, the Government auditor had raised an observation on the accounting treatment being followed by the company in respect of aforesaid assignment. The observation of the audit is reproduced below:

> *"In terms of the Accounting Policy No. 10.2 in respect of revenue, the Company has recognized the revenue in respect of Project Management / Consultancy / Construction Contracts on the basis of Contract Agreement and quantum of work done under the contract. During review of the Profit & Loss Account, it has been observed that the company has recognized the revenue of Rs. 131.42 crore on account of Rural Electrification / Construction Contracts and other different works assigned by different agencies having long terms cycle contracts falling under the category of Accounting Standard 7 in terms of different opinions of Expert Advisory Committee of the ICAI. As such, the provisions of the Accounting Standard 7, i.e., Construction Contracts should have been followed and accordingly, an accounting policy with other treatment as required in compliance of AS 7 should have been followed with following disclosures at the reporting date:*
>
> 1. *the amount of contract revenue recognised as revenue in the period;*
> 2. *the methods used to determine the contract revenue recognised in the period;*
> 3. *the method used to determine the stage of completion of contract in progress;*
> 4. *the aggregate amount of cost incurred and recognised profits (less recognised losses) upto the reporting date;*
> 5. *the amount of advances received and*
> 6. *the amount of retentions.*
>
> *As such, accounts are deficient to that extent and needs to revisit the treatment given in the Profit and Loss Account and Balance Sheet."*

However, after referring to the aforesaid opinion of EAC, the auditors did not press further the observation as far as recognition of revenue is concerned. But they insisted on the following disclosures in the accounts:

(a) Accounting policy of the company should be modified so as to disclose that revenue is being recognised on proportionate completion method and the method used to determine the stage of completion;

(b) Disclosure as required in AS 7 should invariably be given in respect of all the assignments.

In view of the above audit observation, Accounting Policy No.10.2 of the company has been re-worded during F.Y. 2012-13 as under:

> *"Revenue on Project Management/Construction Contracts/consultancy assignments is recognised on percentage of completion method. The percentage of completion is determined as proportion of "cost incurred up to reporting date" to "estimated cost to complete the concerned Project Management/Construction Contracts and consultancy assignment".*

B. Query

7. On the basis of the above, it is contended by the company that AS 7 is not applicable in case of such assignments, though the revenue is being recognised on proportionate completion method. The company is of the view that the recent EAC opinion referred to above is quite clear and supports the accounting treatment of the company in respect of such assignments. However, since the above referred EAC opinion is silent on the issue of disclosure requirements as per AS 7, which has been pointed out by the Government auditors at paragraph 6 above, opinion of EAC has been sought by the querist on the following issues:

(i) Whether AS 7 is attracted to such assignment.

(ii) In case AS 7 is attracted, whether its application is limited to recognition of revenue only, as opined by EAC in its above referred opinion, or all disclosures as given in AS 7 are also warranted.

(iii) In case disclosures are to be given, whether disclosure related to aggregate amount of cost incurred and recognised profit (less recognised losses) upto the reporting date should be given for the entire project cost i.e., (sum of direct work cost and establishment & administrative cost) or the cost relating to agency fees, i.e., establishment & administrative cost only.

C. Points considered by the Committee

8. The Committee notes that the basic issues raised by the querist are related to applicability of AS 7 in the extant case in relation to recognition of revenue in the context of RGGVY assignment undertaken by the company and its disclosure requirements. Therefore, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, revenue recognition policy to be followed for other projects viz., owned projects and other construction contracts, accounting policy to be followed for operation and maintenance of the project after its implementation, propriety of arrangement for compliance of provisions of income-tax/deduction of TDS on payments as per the provisions of Income-tax Act, 1961, or interpretation of the terms of the agreements or MoUs entered into with the State Government or State Power Utilities, or sub-contractors or funding company, treatment of establishment and administrative expenses incurred by the company as direct or indirect cost in the books of the company, etc. Further, the Committee wishes to point out that its opinion is expressed purely from the accounting point of view. The Committee notes that while various sub-clauses of clause 4 of MoU between the funding company and the company indicate that SPU is one of the project authority, clauses 3.2 and 3.4 (c) of the Agreement between funding company, State Government, SPUs and the company indicate SEB to be the project authority. Accordingly, the Committee presumes that SPUs and/or SEBs are project authorities along with the State Government.

9. With regard to recognition of revenue, the Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), 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."

In view of the above, the transactions and events are accounted for and presented in accordance with their substance, i.e., the economic reality of events and transactions, and not merely in accordance with their legal form. In other words, it is the 'economic reality' that is important in accounting and not only the 'legal reality'. In the extant case, the Committee notes from the Facts of the Case that while the company is responsible for formulation and implementation of the projects in accordance with the agreed procedures, the actual execution is being done through other agencies/parties. Further, the Committee notes that while the legal form is that all the documents, such as, bidding documents, notification to executing agencies, contract and letter of award or even the guarantees given by the executing agencies etc., are in the name of the company, the substance of the transaction is that the company is acting only as an agent of the State Government/SPU/SEB as significant risks and rewards related to the project vest with the State Government/SPU/SEB which is clear from the following facts:

(a) It has been specifically stated in clause 4.1 (a) of MOU between the funding company and the company that the company shall undertake these projects on deposit work basis on behalf of the borrower/ owner of the project.

(b) Clause 3.4 of Agreement between the funding company, State Government, SPU and the company clearly reflects that the company is just acting under the instructions/ specifications of the funding company, the nodal agency appointed by the Government of India.

(c) It is clearly stated that the State Governments / SPUs would be the owner of the project.

(d) It is stated that the company gets only a fixed percentage of income as service charges depending on the nature of contract awarded to it and the only risk associated in this assignment is incurring of loss in case expenditure incurred on establishment and administration happens to be more than the agency fee. From this, it appears that the company is not incurring any cost directly related to the project.

(e) Although the company has the right to recover liquidated damages from the executing agencies but the same are adjustable against the project cost. Thus, neither such cost is borne by the company nor such recovery benefits the company. In other words, all significant risks and rewards related to the business are assumed either by the owner (State Government/SPU/SEB) or executing agencies.

10. On the basis of the above, the Committee is of the view that since the significant risks and rewards related to the ownership of project do not vest with the company, the costs and revenues related to the construction of the project and the procurement of products as per the project should not be recognised in the books of account of the company. The Committee is further of the view that as the company is merely providing services in relation to construction/procurement to the State Governments/ SPUs for which it is receiving fixed service charges, keeping in view the consideration of substance over form as explained above, the company should recognise only the service charges received in consideration of its services as its revenue. In this regard, the Committee also notes paragraphs 10 and 11 of Accounting Standard (AS) 7, 'Construction Contracts', notified under the 'Rules', which provide as follows:

"10. Contract revenue should comprise:

(a) the initial amount of revenue agreed in the contract; and

..."

"11. Contract revenue is measured at the consideration received or receivable. ..."

On the basis of the above, the Committee is of the view that since the consideration being received by the company out of its contract for rendering of services is a fixed percentage of the project cost, the same should be considered as contract revenue of the company in the extant case.

11. As regards application of AS 7 in the extract case, the Committee notes that for execution of the projects, the company enters into 'supply' and 'erection' contracts with the selected contracting companies (sub-contractors/executing agencies). Thus, the company is rendering services directly related to the construction as in case of *project managers* and accordingly, AS 7 is applicable in the extant case. In this connection, the Committee notes paragraph 4 of AS 7, notified under the 'Rules', which is reproduced below:

"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) ..."

Accordingly, the Committee is of the view that the principles of AS 7 should be applied while recognising revenue (viz., service charges) from the services rendered as well as while considering disclosures as per AS 7. The Committee is further of the view that since, in the extant case, contract revenue is the service charges, same should be considered while providing disclosures as per AS 7. Similarly, contract cost would be restricted to the cost incurred in relation to its service contract, as per the principles of AS 7.

D. Opinion

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

(i) AS 7 is applicable to the assignments in the extant case, as discussed in paragraph 11 above.

(ii) Application of AS 7 is not limited to recognition of revenue only and accordingly, all disclosures as per AS 7 are also warranted.

(iii) Since, in the extant case, contract revenue is the service charges, same should be considered while providing disclosures as per AS 7. Similarly, contract cost would be restricted to the cost incurred in relation to its service contract, as per the principles of AS 7.

Query No. 19

Subject: Accounting Treatment of Status Holder Incentive Scheme (SHIS) Scrips.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a private limited non-listed company established in the year 2006. The company is engaged in the business of manufacturing yarn.

2. The querist has stated that the Central Government has announced its Foreign Trade Policy (FTP) for 27.08.2009 to 31.03.2014 on 27.08.2009. Latest amendment to the policy was made on 05.06.2012. The Policy describes 'Promotion measures' in Chapter 3. Status Holders Incentive Scheme (hereinafter referred as the 'Scheme') is one of the promotional measures given in the Chapter 3 of the Policy. Paragraph 3.16 of the FTP deals with the provisions of the Scheme. Provisions of the Scheme have been reproduced by the querist as follows:

"3.16 Status Holders Incentive Scrip (SHIS)

3.16.1 (a) Objective of SHIS is to promote investment in upgradation of technology.

(b) Status Holders of sectors specified in Para 3.16.4 below, shall be entitled to a Duty Credit Scrip @1% of FOB value of exports made during 2009-10, 2010-11, 2011-12 and 2012-13.

(c) Status Holders of additional sectors listed in Para 3.10.8 of HBPv1[2] 2009-14 (RE-2010) shall also be eligible for this Status Holders Incentive Scrip on exports made during 2010-11, 2011-12 and 2012-13.

(d) This shall be over and above any Duty Credit Scrip claimed/ availed under this chapter.

3.16.2 Status Holders availing Technology Upgradation Fund Scheme (TUFS) benefits (administered by Ministry of Textiles) during a

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[1] Opinion finalised by the Committee on 16.7.2013.

[2] HBPv1 stands for Hanbook of Procedures Volume 1

particular year shall not be eligible for Status Holders Incentive Scrip for exports of that year.

3.16.3 The Status Holders Incentive Scrip will be subject to actual user condition. However transferability will be permitted amongst status holders subject to the condition that the transferee status holder is a manufacturer. Status Holder Incentive Scrip shall be used for import of capital goods (as defined in FTP) relating to sectors specified in Para 3.16.4 below and para 3.10.8 of HBP. Only in respect of CG[3] imported earlier, upto 10% value of the Duty Credit Scrip can be used for import of components, spares/ parts of such CG.

3.16.4 Status Holders of the following Sectors shall be eligible for the Status Holders Incentive Scrip:

(i) Leather Sector (excluding finished leather);

(ii) Textiles and Jute Sector;

(iii) Handicrafts;

(iv) Engineering Sector (excluding Iron & Steel,..)

…"

3. The querist has further stated that as the company deals in textile sector, it is eligible for SHIS scrip as per paragraph 3.16.4 (ii). However, due to lack of clarity in respect of the company's eligibility under this scheme, the company could not apply for SHIS scrips during 2009-10 to 2011-12 and pursuant to a recent clarification, the company has applied for SHIS scrips for financial years 2009-10 and 2010-11 during the current financial year 2012-13. The company did not apply for SHIS scrips for the financial year 2011-12 as the company had availed TUF benefit during this year. The company has also received SHIS scrip from the Director General of Foreign Trade (DGFT) during the current financial year 2012-13.

4. The querist has reproduced the following paragraphs of Accounting Standard (AS) 12, 'Accounting for Government Grants', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

[3] CG stands for Capital Goods

"1. This Standard deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc."

"3.2 *Government grants* are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. ..."

"5.2 ...

(ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs."

"5.4 It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants."

"10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income."

Company's view

5. Looking to the above objective and provisions, the querist is of the view that SHIS scrips are capital incentive from the Government, hence the same should be credited to capital reserve at the time of its utilisation.

6. The querist has also provided the following accounting entries:

a. On accrual:

SHIS receivable A/c	Dr.	With face value
To SHIS capital reserve A/c		With face value

b. On utilisation in import of capital items / spare parts:

Asset / Mill Store A/c	Dr.	With invoice value
Cenvat receivable A/c	Dr.	With duty amount
To sundry creditors A/c		With Invoice value
To SHIS receivable A/c		With duty amount

c. On sale of scrips:

Sundry debtors A/c	Dr.	With Invoice value
To SHIS Receivable A/c		With sale value
To Vat payable A/c		With VAT amount
SHIS capital reserve A/c	Dr.	With discount value
To SHIS receivable		With discount value

B. Query

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

(i) Whether SHIS scrip falls under the definition of 'government grant' or these should be considered as 'incentive income'.

(ii) Considering the objective and conditional use for capital goods only, whether it would be correct to treat the SHIS scrip as a capital grant in the nature of 'promoters contribution'.

(iii) Whether this scrip should be credited directly in capital reserve or as deferred income or current income.

(iv) Whether it will affect accounting treatment if scrip is sold in the market instead of self-use.

(v) What would be accounting treatment if market value of the scrip is 30% at the time of receipt and will be 25% at the balance sheet date?

(vi) Whether receipt of earlier year's SHIS scrip will be treated as 'prior period income' during current financial year 2012-2013.

C. Points considered by Committee

8. The Committee notes that the basic issue raised in the query relates to accounting for SHIS scrips received under the Scheme of the Foreign Trade Policy. Therefore, the Committee has considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, presentation and disclosure of SHIS scrips in the financial statements, treatment of amount received by the company on utilisation/ sale of SHIS scrips, accounting for imported capital goods or spares/ components against which scrpis would be utilised, timing of recognition of the scrips entitlement, etc.

9. With regard to the issue raised by the querist as to whether SHIS scrips fall under the definition of the term, 'government grant', the Committee notes paragraph 3.2 of Accounting Standard (AS) 12, 'Accounting for Government Grants', notified under the 'Rules' as follows:

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

From the Facts of the Case, the Committee notes that SHIS scrips are assistance in kind by the Government as the company receives scrips that may be either adjusted against import of capital goods or their spare parts/ components or can be sold to another status holder subject to certain conditions. Further, these are awarded on the basis of pre-specified percentage of exports made by the company and accordingly, the value placed upon them is reasonably determinable. Therefore, these are of the nature of government grant.

10. With regard to nature of grant obtained, the Committee notes paragraphs 8.1 and 10.1 of AS 12 which provide as below:

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

> "10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income."

The Committee notes that as per the Foreign Trade Policy, the SHIS scrips are granted to the exporters with the objective to promote investment in upgradation of technology. However, the grant is awarded with reference to exports made by the company and not with reference to total investment in an undertaking or by way of contribution towards its capital outlay. Accordingly, the Committee is of the view that it would not be appropriate to treat the SHIS scrips as 'promoters' contribution'. Further, the Committee is of the view that the scrips granted cannot be considered as a grant related to specific fixed assets as at the time of awarding such scrips, no specific asset has been identified for its utilisation. The Committee notes that such scrips can be utilised not only for payment of duty on import of capital goods but also for their spare parts or components which can be revenue in nature. Moreover, it is not necessary under the policy that its recipient should utilise the scrips for technology upgradation only. The recipient may transfer it to another status holder subject to certain conditions resulting into an income for him. Thus, the award of SHIS scrips should be considered to be generating income to the company. Accordingly, the Committee is of the view that as per the principles of AS 12, the scrips granted should be treated as a grant related to revenue.

11. With regard to measurement of government grant, the Committee is of the view that basis of measurement depends on its intended use. The Committee notes that there could be two intended uses of these scrips, i.e., these can either be utilised against the purchase of capital goods and spares in accordance with the Policy or can be held for sale. In case the company intends to utilise these scrips against the import of capital goods and spares, these should be recognised at the value of the scrips granted as these would be utilised at the same value against the settlement of import duty. However, in case the company intends to sell these scrips, these should be valued at the lower of the original value of the scrip or its estimated net realisable value.

12. As regards the situation where the company was entitled to SHIS scrips in earlier years but same was not claimed by the company, the Committee is of the view that it is not an error or omission in the preparation of the financial statements. The company has not claimed the SHIS scrips due to lack of clarity on its eligibility and has applied for it pursuant to 'recent clarifications'. Accordingly, the Committee is of the view that it would not be appropriate to recognise receipt of the SHIS scrips for earlier years as prior period income. In this regard, the Committee notes the definition of the term 'prior period items' 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' as follows:

> **"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."**

D. Opinion

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

(i) SHIS scrips fall under the definition of 'government grant', as discussed in paragraph 9 above.

(ii) No, it would not be correct to treat the SHIS scrip as a capital grant in the nature of 'promoters' contribution', as discussed in paragraph 10 above.

(iii) The scrips should not be credited directly in capital reserve or treated as deferred income, rather these should be recognised as grants related to revenue as per the principles of AS 12, as discussed in paragraph 10 above.

(iv) It is the valuation and not recognition of scrip which may be affected by the fact that the scrip is intended to be sold in the market or is intended to be used internally against import of capital goods and spares/components, as discussed in paragraph 11 above.

(v) If the scrips are intended to be sold in the market, then these should be valued at lower of original scrip value or estimated net realisable value. In other cases, it will not affect the valuation of scrips.

(vi) In a situation when the company was entitled to SHIS scrips in earlier years but same was not claimed by the company, it would not be appropriate to treat the receipt of SHIS scrips as prior period income, as discussed in paragraph 12 above.

Query No. 19

Subject: Exempt Provident Fund-disclosure and valuation as per Accounting Standard (AS) 15, 'Employee Benefits.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') has an Exempt Provident Fund Trust (hereinafter referred to as 'the Trust') to manage the contributions of its members. Contributions are made to the Trust as per the rules and the Provident Fund Scheme. The Exempt Provident Fund Trust invests the contributions in securities as prescribed by the Employees Provident Fund Organisation. The Trust has not sold any of its security since inception. The querist has stated that the Trust is restricted by the Employees Provident Fund Organisation in general from selling its investments. All the investments of the Trust are, therefore, 'Held to Maturity' investments as per paragraph A40 of Accounting Standard (AS) 31, 'Financial Instruments: Presentation' (the reference seems to be to paragraph A40 of Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement'), and paragraph AG20 of Indian Accounting Standard (Ind AS) 39, 'Financial Instruments: Recognition and Measurement'[2].

2. The querist has stated that an Exempt Provident Fund Trust has the obligation to its members to declare the interest rate announced by the

[1] Opinion finalised by the Committee on 16.7.2013.
[2] Subsequently, Ind AS 109, 'Financial Instruments', was issued vide MCA Notification dated 16th February, 2015, in place of Ind AS 39.

Employees' Provident Fund Organisation **(**EPFO). Hence, there is an interest rate guarantee for the interest given by such Exempt Provident Fund.

3. The Institute of Actuaries of India (IOAI) issued Guidance Note 29 (GN 29) on 'Valuation of Interest Rate Guarantees on Exempt Provident Funds under AS 15 (Revised)' in the year 2011, effective from 1st April, 2011.

4. The querist has stated that after the issuance of GN 29 by IOAI, the interest rate guarantee portion of the Exempt Provident Fund Trust takes the characteristic of a defined benefit. However, as per the querist, contributions made to the Exempt Provident Fund Trust continue to have the substance of a defined contribution plan.

5. As per the querist, Accounting Standard (AS) 15, 'Employee Benefits', does not have any specific guideline on how to value and disclose liability towards Exempt Provident Fund Trust where the interest portion is a defined benefit and the contribution made is having the characteristic of a defined contribution plan. Under AS 15, the disclosure and valuation requirements for defined benefit plans are significantly different from those of defined contribution plans.

6. The querist has also informed that post issuance of GN 29, and in the absence of any specific guidelines on valuation and disclosure of liability for Exempt Provident Fund, the company has been asked to follow the valuation and presentation guidelines similar to defined benefit plans. Accordingly, as per the querist, all the 'Held to Maturity' investments of the Exempt Provident Fund Trust are fair valued at their market price. Fair valuation of the 'Held to Maturity' investments leads to gain or loss. Such gain or loss is notional only since the Exempt Provident Fund Trust is restricted to sell its investments by the Employees' Provident Fund Organisation in general. Such notional gain/loss on the investments is passed through the statement of profit and loss of the company.

7. As per the querist, the company has been following the accounting policies consistently and these policies are in line with the Accounting Standards pronounced by the Institute of Chartered Accountants of India (ICAI). With regard to the employee benefits, AS 15 is followed by the company. Till the financial year 2010-11, provident fund was considered by the company as defined contribution plan and interest rate guarantee valuation was followed as per the industry practice.

8. The company has disclosed the following in its notes forming part of its financial statements for the year 2011-12:

> "AS 15, 'Employee Benefits' requires fair valuation of the Planned Assets on the balance sheet date for all defined benefit plans. However, AS 15 does not specifically detail any prescriptive method for fair valuation of investments held by Exempted PF Trust which have a unique investment objective. The investments of Exempted Provident Fund are normally held to maturity as mandated by Employees Provident Fund and Miscellaneous Provisions Act, 1952. The Exempted Trust Fund is expressly prohibited from selling these securities except under exceptional conditions and only with specific permission of EPFO. Accordingly, market prices are not good reflectors of fair value for such held to maturity investments. The company has therefore followed the valuation principle envisaged in AS 30: Financial Instruments – Recognition and Measurement and Ind AS 39: Financial Instruments – Recognition and Measurement which specifically stipulate that for held to maturity investments face value must be used and market prices may not be a good indicator.
>
> The company, in compliance with AS 15 and further with AS 30 and/or Ind AS 39 has valued the investments at their fair value which is based on the face value of the investments. The exempted trust has demonstrated a positive intent to hold the security until maturity by not making any sales since inception of the trust and has further adhered to the PF rules which prohibit it from selling any such securities. The face value of the investments is higher than the liability by ... on the balance sheet date and since such excess belongs to the Exempt Trust, the same is not recognised in the books of the company."

9. The statutory auditors of the company have drawn attention to the note referred above in their report to members stating that "…the valuation of plan assets of the provident fund administered by a Trust set up by the company (a defined benefit plan) at the face value instead of using the fair value, which in our view is not in compliance with Accounting Standard (AS) 15, Employee Benefits". Accordingly, they have qualified their opinion in this regard.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee as to whether an Exempt Provident Fund is to be disclosed as a defined benefit plan, defined contribution plan or both and whether the basis of valuation of the investments held by the Exempt Provident Fund Trust as 'Held To Maturity' should be at the market value or the face value.

C. Points considered by the Committee

11. The Committee restricts itself to the issues raised by the querist in paragraph 10 above regarding the nature and disclosure of 'Exempt' Provident Fund Scheme as defined benefit plan or defined contribution plan under AS 15 as well as the valuation of the investments held by Exempt Provident Fund Trust under the 'held to maturity' category, for the purpose of its presentation in the financial statements of the company. The Committee has, therefore, considered only these issues and has not touched upon any other issue that may arise from the Facts of the Case, such as, valuation of the investments in the financial statements of the Trust, accounting treatment followed by the company prior to the issuance of GN 29 by the IOAI, correctness of the company's accounting policy, etc.

12. The Committee notes the definitions of the terms 'defined contribution plans' and 'defined benefit plans' as contained in paragraphs 7.5 and 7.6 of AS 15, reproduced as below:

> ***'"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."***
>
> ***"7.6 <u>Defined benefit plans</u> are post-employment benefit plans other than defined contribution plans."***

From the above, the Committee notes that a post-employment benefit plan has to be treated either as a defined contribution plan or as a defined benefit plan. AS 15 does not contemplate any other category of post-employment plan.

13. The Committee notes that section 17 of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (EPFMPA) empowers the Government to exempt any enterprise from the provisions of the EPFMPA provided the rules of the provident fund set up by the enterprise are not less favourable than those specified in section 6 of the EPFMPA and the employees are also in enjoyment of other provident fund benefits which on the whole are not less favourable to the employees than the benefits provided under the EPFMPA.

14. The Committee further notes that the Employees' Provident Fund Scheme, 1952 issued under the EPFMPA requires in Appendix A (clause 7) to clause 27AA of the said Scheme that "Any deficiency in the interest declared by the Board of Trustees is to be made good by the employer to bring it up the statutory limit". Therefore, such exempt provident funds carry an embedded interest rate guarantee.

15. The Committee notes from the definition of defined contribution plan given in paragraph 12 above that in a defined contribution plan, the liability of an enterprise is restricted only to the amount it contributes to a separate fund for the benefit of its employees. As stated in paragraph 14 above, in the case of an Exempt Provident Fund, the liability of the enterprise is not restricted to the contribution it makes to the separate fund but also extends to any deficiency in the rate of interest earned by the separate fund as compared to the rate declared by the Government under clause 60 of the Employees' Provident Fund Scheme, 1952.

16. The Committee further notes that as per paragraph 26 of AS 15, "Examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through: ... (b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions ...". Hence, the obligation referred to in paragraph 16 above clearly falls within the definition given in paragraph 26(b) of AS 15. As per paragraph 27 of AS 15, "Under defined benefit plans: (a) the enterprise's obligation is to provide the agreed benefits to current and former employees ...". Accordingly, the Exempt Provident Fund set up by the company is a defined benefit plan under AS 15. This has also been confirmed in paragraph 9 of 'ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)', issued by the Accounting Standards Board of the ICAI, which states that "…provident funds set up by employers which require interest shortfall to be met by the employer would be in effect

defined benefit plans in accordance with the requirements of paragraph 26(b) of AS 15". Further, since an exempt provident fund is a defined benefit obligation, the Committee is of the opinion that an enterprise is required to make the disclosures in terms of paragraph 120 of AS 15.

17. With regard to basis of valuation of the investments held by the Exempt Provident Fund Trust, as per paragraph 55 of AS 15, in determining the defined benefit liability, "(c) …the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly" has to be taken into account.

18. The Committee notes that AS 15 deals with the fair value of plan assets in paragraphs 100 – 102. Paragraph 100 of AS 15 provides as below:

> "100. The fair value of any plan assets is deducted in determining the amount recognised in the balance sheet under paragraph 55. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation)."

Therefore, the Committee is of the view that AS 15 explicitly requires all investments to be fair valued (irrespective of the period for which it is held) to determine the defined benefit liability after taking into account the factors mentioned in the above-reproduced paragraph. The Committee further notes from the Facts of the Case that the querist has stated that since AS 15 does not specially detail any prescriptive method for fair valuation of investments held by Trust, the company has followed the valuation principle as prescribed under AS 30 and Ind AS 39 for 'held to maturity' investment. In this regard, the Committee notes that paragraph 2 of AS 30, while stating the scope of the Standard, explicitly scopes out the financial instruments held by employer under AS 15 by stating as follows:

> ***"2. This Standard should be applied by all entities to all types of financial instruments except:***
>
> ***…***

> ***(c) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies."***

On the basis of the above, the Committee is of the view that while determining the defined benefit obligation, for valuation of the investments held by the Trusts, only the principles of AS 15 should be followed.

D. Opinion

19. On the basis of the above, the Committee is of the opinion that an Exempt Provident Fund Scheme is a defined benefit plan in terms of paragraph 7.6 of AS 15, the accounting for which has to be done on an actuarial basis. Since an exempt provident fund is a defined benefit obligation, the Committee is further of the opinion that an enterprise is required to make the disclosures in terms of paragraph 120 of AS 15. The plan assets held by the Trust should be valued at fair value as per the principles of AS 15, as discussed in paragraph 18 above.

Query No. 20

Subject: Accounting treatment of subsequent expenditure on technological upgradation/ improvements on capital assets.[1]

A. Facts of the Case

1. A company is a wholly owned Government of India enterprise incorporated in the year 1965 with the main objective of setting up cement plants in deficit areas to cater to the needs of that area and other neighbouring States. Indian cement industry being the second largest producer of cement in the world after China, is comparable with any advanced country in terms of technology involved in cement manufacture. With the best energy efficient practices and environment friendly equipments, Indian

[1] Opinion finalised by the Committee on 16.7.2013

cement industry is the most competitive globally. International trends in technology, like latest grinding systems, advanced material handling systems, automation in process control, high efficiency particle separation, clinker cooling, quality monitoring and control, etc. have been adopted by Indian cement industry.

2. The querist has stated that though the company is the only Government of India enterprise in the country in cement sector, its market share is less than 1% of the total market share in the country thereby leading to severe competition from private entrepreneurs in the market. The company has one of its cement factories in one of the districts of Andhra Pradesh. It was commissioned in the year 1987. The plant has been in operation for more than 25 years after its commissioning and most of its major equipments have outlived their lives.

3. The querist has further stated that cement industry is a process industry and functions of various departments are inter-dependent. The process starts from extracting and crushing of limestone, making it raw meal and then feeding into the kiln where burning takes place at a temperature of 1300 degrees C with the help of coal and its output is clinker. Grinding of clinker takes place in the cement mill by adding certain additives to make it cement, the final product, before the same is packed and despatched by rail/road.

4. Due to company having been declared sick by Hon'ble Board for Industrial and Financial Reconstruction (BIFR) in the year 1996 due to erosion of its net worth, no technological upgradation/modernisation could take place, as was called for in the cement industry due to fast technological changes. However, normal maintenance was carried out to keep the plant running. As many new cement plants with higher capacity and latest technology have been set up by private entrepreneurs in the vicinity of the plant of the company in Andhra Pradesh and Karnataka, the company had been facing severe competition from private entrepreneurs in the industry and the company is finding difficulty to operate the plant economically without modernisation/ technology upgradation. Therefore, in place of changing the vital equipments with latest technology which entails substantial investment, the company made an endeavour to upgrade/ improve its certain equipments with certain amount of expenditure with a view to increase the standard efficiency of the vital equipments, increase its useful life and to reduce the

operating cost to the extent possible. The modernisation programme was planned for a period of around 3 months by engaging best consultants in the industry and all the activities involved were meticulously worked out and taken up for implementation. The company has, therefore, undertaken modernisation/upgradation of vital equipments, keeping energy efficiency and environment friendly technology in mind, to increase their standard performance with increase in overall productivity and standard operating efficiency of the plant. Major jobs involved and gist of results envisaged are as follows:

Jobs involved:

1. Modernisation of kiln with grate cooler.
2. Upgradation of Vertical Roller Mill (VRM) and VRM fan assembly.
3. Upgradation of Electrostatic Precipitator (ESP) for VRM/Kiln.
4. Renovation of blending system of raw mill silo.
5. Upgradation of cement mill.
6. Upgradation of coal mill.
7. Upgradation of limestone crusher.

Results:

1. Increased kiln output rate.
2. Considerable effect on output rate of cement mill, raw mill, coal mill, etc.
3. Better utilisation of false waste heat.
4. Better process control.
5. Reduction in electricity power consumption.
6. Control on dust emission.
7. Enhance the life of equipments.

5. The equipment-wise details are as follows:

(i) Kiln

Kiln is considered to be heart and soul of the plant. The kiln has been upgraded with girth gear reversal and changing of approx. 43 meters length of kiln out of 68 meters shell to increase the standard output rate and to reduce the standard operating cost. With the above improvements, the standard revolutions per minute (rpm) of the kiln has increased from 2.2 rpm to 3 rpm resulting into increase in overall rated output from 3000 tonnes per day (tpd) to 3500 tpd resulting into increase in production of clinker by approximately 2 lakh MT. The above modifications along with other modifications in retrofitting of the clinker cooler and controlled feed of coal to calciner through installation of modified and accurate weigh feeder of 30 tph has resulted in better heat recovery and thus helped in reducing the rated coal consumption from 24% to 19%. The girth gear reversal had also helped in increasing the life of kiln by atleast another 10 to 15 years and also improving the brick lining life and reduction of refractory consumption. The increased output has further reduced the standard power consumption of clinkerisation section from 100 units to 85 units. The technical experts in the field were involved in the works associated with kiln section. The cost of new kiln would be around Rs. 100 crore.

(ii) ESP connected to kiln and VRM

The ESP connected to kiln and VRM are vital for plant operations and to maintain the requisite statutory emission norms as fixed by the Pollution Control Board. Since the plant was commissioned more than 25 years ago, the Pollution Control Board has been changing the emission norms periodically considering various parameters and also due to technological improvements/ developments in the cement industry over the years. The existing ESP has been modified/ upgraded in order to achieve the revised norms by changing the internals and gas distribution (GD), rapping mechanism and other related changes in the existing ESP System. With the above modifications, the reduction in emission has been achieved to 100 mg/Nm3 from earlier 150 mg/Nm3. The life of the modified ESP is also increased by more than 10 to 15 years, besides increased efficiency and savings in ground/calcined materials due to collection of recycling into system, which also brings productivity improvement. The approximate cost to upgrade the existing ESP with latest new ESP would be around Rs. 15 crore.

(iii) Vertical Roller Mill (VRM)

Major changes in the Vertical Roller Mill under the technical guidance of experts, such as, changing of roller assembly, table liner with improved ones and by doing other allied jobs have helped in improving the rated output of VRM from 260 tph to 280 tph. The increased rated output has further resulted in lower consumption of power to the extent of 2 to 2.5 kwh/ tonne. The mill performance has increased which has been able to meet out the grinding requirement of additional raw material due to increase in clinker output. The works related to VRM main drive gear box was supervised by engineers from Germany. The life of VRM has increased by at least another 15 years. The cost of new VRM would be around Rs. 80 crore.

(iv) Coal mill section

Coal mill is a vital equipment for coal grinding in kiln operations. Retrofitting of coal mills with modified rings and balls have been done in order to increase the efficiency of the coal mill and to reduce the operating cost. The gear box and grinding table along with polyclone have been modified and replaced to improve the standard output of the coal mill from 15 tph to 20 tph. The power consumption of the coal mill has also reduced from standard consumption of 30 units per tonne to 25 units per tonne. With the above modification, the useful life of the coal mill has increased further at least by 15 years. The cost of latest new coal mill would be around Rs.70 crore.

(v) Cement mill section

Grinding of cement takes place in cement mill before it is sent for packing and despatch. To modernise/upgrade the standard output rate of the cement mill, the gear box with latest technology/model was changed and girth gears of the cement mill were reversed. The cement mill operations had been upgraded with new Distributed Control System (DCS) which has computerised controlled operations instead of manual control. With the above modifications, the mill rated output has gone upto 100 tph in place of 80 tph besides overall improvement in productivity, better operational controls and fault annunciation through computer aided operations.

(vi) Crusher section

The function of crusher is to crush the limestone and supply to the raw mill which was upgraded by changing the rotor assembly and other allied internals with a view to obtain uniform grade of output and to increase the productivity. The crusher operations together with stacker/reclaimer operations have been upgraded with new DCS system instead of manual control. Installation of efficient crusher exhaust fans, apron feeder gear box assembly, reinforcement of concreting in hopper and above modifications have increased the overall productivity of the crusher and also resulted in saving the operating cost, besides increase in the life of the crusher by another 10 to 12 years. The installation cost of new crusher would be around Rs. 12 to 15 crore.

6. The company, being sick, does not have sufficient funds to modernise/change the entire old equipments with latest technology available in the world for manufacture of cement and therefore, efforts were made to upgrade/modernise the above equipments with certain modifications involving good amount of expenditure so as to obtain increased efficiency by way of increase in rated output with reduction in the standard operating cost and to lower the breakdown rates, wherever possible. The following amounts have been spent on the above upgradations/improvements:

1.	Kiln	:	Rs. 12.61 crore
2.	ESP for Kiln & VRM	:	Rs. 3.98 crore
3.	Vertical Roller Mill	:	Rs. 4.89 crore
4.	Coal Mill Section	:	Rs. 1.50 crore
5.	Cement Mill Section	:	Rs. 2.49 crore
6.	Crusher Section	:	Rs. 2.64 crore
	Total		Rs. 28.11 crore

B. Query

7. In view of the above, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the following issues:

(a) Whether the cost of above modifications/upgradation/improvements can be capitalised along with the cost of concerned equipments and depreciation charged accordingly; or

(b) Whether the cost of above modifications/upgradations/ improvements should be amortised/ depreciated over a period of 10-15 years as the benefit of the above works would result in further increase in useful life of the equipments by not less than 10 years.

C. Points considered by the Committee

8. The Committee notes from the Facts of the Case that the querist has stated that certain amount of expenditure has been incurred to upgrade/ modernise certain vital equipments of the cement plant with a view to obtain increased efficiency by way of increase in rated output alongwith reduction in operating cost and increasing their lives. Accordingly, the company has raised an issue as to whether the expenditure incurred on such upgradation/ modernisation can be capitalised as part of concerned equipment and depreciated accordingly or whether expenditure, so incurred, could be amortised over the period by which the life of the equipments has increased. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case.

9. As far as accounting for the expenditure incurred on upgradation/ modernisation of equipments is concerned, the Committee notes that paragraph 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') states as below:

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

10. The Committee is of the view that expenditure on fixed assets subsequent to their installation may be categorised into (i) repairs and (ii) improvements or betterments. Repairs, the Committee notes, implies "the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated service life or capacity." It frequently involves replacement of parts. On the other hand, betterment is defined as "…an expenditure having the effect of extending the useful life of an existing fixed asset, increasing its normal rate of output, lowering its operating cost, or otherwise adding to the worth of benefits it can yield. The cost of adopting a fixed asset to a new use is not

ordinarily capitalised unless at least one of these tests is met. A betterment is distinguished from an item of repair or maintenance in that the latter has the effect of keeping the asset in its customary state of operating efficiency without the expectation of added future benefits." (These definitions are reproduced from the Dictionary for Accountants by Eric C. Kohler, Sixth Edition.)

11. From the above, the Committee is of the view that normally, expenditure on repairs, including replacement cost necessary to maintain the previously estimated standard of performance, is expensed in the same period. Similarly, the cost of adopting a fixed asset to a new use or modernisation of such asset without actually improving the previously estimated standard of performance is also expensed. Accordingly, in the view of the Committee, only such expenditures that add new fixed asset units, or that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs are capitalised. The Committee is of the view that 'previously assessed standard of performance' is not the actual performance of the asset at the time of repair/improvement etc., but the standard performance of the same asset in its original state.

12. The Committee notes from the Facts of the Case that it has been stated that the expenditure has resulted in increased productivity, reduced operating costs and also enhancing the life of the equipments. However, the querist has not informed whether the increase in productivity or enhancing the life is beyond the *previously assessed* standard of performance of the concerned equipments as stated in paragraph 11 above. It is only the increase beyond the standard of performance of the concerned equipments in their original state, which is treated as betterment and related expenditure is capitalised. In this regard, the Committee also notes paragraph 12.2 of AS 10, notified under the Rules, which is reproduced below:

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

From the above, the Committee is of the view that if the expenditure incurred by the company has a separate identity and is capable of being used after the existing asset is disposed of, it should be accounted for separately and accordingly, depreciation should be provided considering the provisions of Accounting Standard (AS) 6, 'Depreciation Accounting', notified under the Rules and the Companies Act, 1956. However, if the expenditure incurred results into betterment of an existing asset, which cannot be used independently of the existing asset then the same should be added to the gross book value of the concerned asset and depreciated at the rates applicable to the asset considering the requirements of paragraph 24 of AS 6, notified under the Rules, which is reproduced as below:

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

13. As regards the period over which the asset can be depreciated, the Committee notes the requirements of paragraph 23 of AS 6, notified under the Rules, which provides as follows:

> ***"23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life."***

On the basis of the above, the Committee is of the view that if the above upgradation/modernisation results into an increase in the *useful life* of the concerned asset, the unamortised depreciable amount of the concerned asset alongwith the expenditure incurred on upgradation/modernisation (provided it is to be capitalised as discussed in paragraph 12 above) should be charged over the revised remaining useful life subject to the useful life implicit from the specified rates as per Schedule XIV to the Companies Act, 1956. The Committee wishes to point out that such depreciation should be charged with reference to the 'useful life' and not with reference to 'physical life' of the asset.

D. Opinion

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

(i) If the expenditure incurred on upgradation/modernisation of equipments increases the future benefits of the existing equipments beyond their *previously assessed* standard of performance, the cost of such upgradation/modernisation can be capitalised along with the cost of concerned equipments, as discussed in paragraphs 11 and 12 above and depreciation should be charged accordingly, as discussed in paragraphs 12 and 13 above. However, if such expenditure does not result into such increase in future benefits, it should be expensed as and when incurred.

(ii) If the above upgradation/modernisation results in increase of the useful life of the equipments, the unamortised depreciable amount of the concerned assets alongwith the expenditure incurred on its upgradation/modernisation (provided it is capitalised) should be charged over the revised remaining useful life, subject to the useful life implicit from the rates specified in Schedule XIV to the Companies Act, 1956, as discussed in paragraph 13 above.

Query No. 21

Subject: Recognition of Duty Credit Entitlement Certificates issued under the 'Served from India Scheme.[1]

A. Facts of the Case

1. A private limited company (hereinafter referred to as 'the company') domiciled in India was incorporated on March 1, 2006 under the provisions

[1] Opinion finalised by the Committee on 3.9.2013

of the Companies Act, 1956, for managing the operations and modernisation of the Indira Gandhi International Airport ('Delhi Airport'). A Limited, along with its subsidiaries, holds majority shareholding in the company. The company had entered into Operation, Management and Development Agreement ('OMDA') with Airports Authority of India ('AAI'), which gives the company an exclusive right to operate, maintain, develop, modernise and manage the Delhi Airport on a revenue sharing model for an initial term of 30 years, which can be extended by another 30 years on satisfaction of certain terms and conditions pursuant to the provisions of OMDA.

2. The querist has stated that the Director General of Foreign Trade (DGFT), Government of India, has announced a 'Served From India Scheme'. Under the Scheme, all service providers (other than hotels and restaurants) shall be entitled to duty credit equivalent to 10% of the foreign exchange earned by them in the preceding financial year. During the financial years 2006-07 to 2011-12, the enterprise obtained duty credit entitlements certificate from the DGFT under 'Served From India Scheme'.

The salient features of the 'duty credit certificates' are as under:

(a) These certificates are valid for 2 years from the date of issue.

(b) Duty credit entitlements may be used for import of any *capital goods including spares, office equipment and professional equipment, office furniture and consumables; that are otherwise freely importable under ITC (HS) classification of export and import items, provided it is part of the main line of business.*

(c) The entitlements and the goods imported *shall be non-transferable (except within group company* and managed hotels) and be subject to actual user condition.

(Emphasis supplied by the querist.)

3. The company has utilised duty credit certificates *only for the purpose of import of capital goods and has neither used for purpose of import of cosumables nor transferred to any other group company.* As the company had used the SFIS scrips for purpose of import of capital goods and not paid any customs duty in cash for capital items imported during the years 2006 to 2012 for its operations, therefore, the company is of the view that value of the scrips utilised for the purpose of imports should be adjusted against cost of assets imported and accordingly, *only the cost paid by the*

company i.e., without customs duty was capitalised in the books of account. (Emphasis supplied by the querist.)

4. The querist has further stated that the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) vide its earlier opinion (published as Query No. 32 of Volume XXVI of the Compendium of Opinions) has opined that "even though the entitlements received under *SFIS Scheme does not strictly fall within the definition of term revenue, as defined under Accounting Standard (AS) 9, 'Revenue Recognition',* such duty credit entitlements is of the nature of revenue and accordingly, it should be recognised in the books of accounts" (emphasis supplied by the querist). However, the company is of the view that since out of three options available under SFIS Scheme as mentioned above, the company has utilised the scrips only for the purpose of import of capital goods, it is appropriate to capitalise the net cost of fixed asset imported in the books (without import duty). The company is of the view that SFIS scrips utilised by the company for the import of capital goods should be treated as 'capital grant' under Accounting Standard (AS) 12, 'Accounting for Government Grants' instead of 'revenue' under AS 9. The company differs from the earlier opinion given by the EAC of the ICAI vide Query No. 32 of Volume XXVI of the Compendium of Opinions and is of the view that the issuance of scrip issued under Served From India Scheme (SFIS) should be treated as government grant under AS 12 as the same is of the nature of assistance given by the Government in respect of import of capital goods after compliance of certain conditions.

5. The issues that have been raised by the querist are as follows:

(A) The question that is to be considered is to examine as to which of the Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), i.e., whether AS 9 or AS 12 would be most appropriate for application and relevant, given the situation described above for accounting for the benefit derived by the company by the use of 'duty credit entitlement certificates'.

(B) If it is held that AS 12 is more appropriate, which of the methods mentioned in paragraph 14 of the said Accounting Standard is to be followed for accounting for the purchase of 'capital assets' or 'inventory' or 'consumables' utilising the government grant.

6. The views held by the company in respect of the above issues raised are as under:

(A) In support of its view to consider SFIS scrips as capital grant when the same has been utilised *only for the purpose of import of capital goods,* the company has submitted as under:

(i) The Accounting Standards that may be considered for application in the above situation are:

(a) AS 9 pertaining to revenue recognition.

(b) AS 12 pertaining to government grant.

As per AS 9, the definition of 'revenue' is 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."

The same has also been reiterated in the Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India. Moreover, AS 9 which deals with revenue recognition, in paragraph 2, specially states that "This Standard *does not deal with* the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts;

(ii) Revenue arising from hire-purchase, lease agreements;

(iii) *Revenue arising from government grants and other similar subsidies;*

(iv) Revenue of insurance companies arising from insurance contracts.

Accounting Standards are authoritative pronouncements of the ICAI and hence, the definition of the term 'revenue' as per AS 9 is valid for all purposes. The duty credit entitlement arising under SFIS does not fall under the definition of 'revenue' as revenue is the gross inflow of consideration *from customers or clients.* The duty credit entitlement arising under SFIS cannot be said to be flowing from customers or clients and is thus not in the nature of revenue as per the definition of this term in AS 9 and Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India.

(Emphasis supplied by the querist.)

(ii) AS 12 provides as follows:

"3.1 Government refers to government, government agencies and similar bodies whether local, national or international.

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

Thus, the thrust of 'government grant' is that it is an assistance in one form or the other and not necessarily in the form of cash. It could be seen from the above definition that any form of *assistance* from the Government whether in cash or in kind given either for the *past or future compliance with certain conditions* would constitute a government grant. (Emphasis supplied by the querist.)

(iii) An examination of the features of duty credit entitlement certificate reveals that it is in *the form of assistance given by the Government.* The relevant extracts of the policy for justification of the same are as follows:

Both the title for paragraph 3.1 of Chapter 3 of the Foreign Trade Policy is 'Promotional Measures' and the contents of paragraph states "*Assistance* to States for Infrastructure Development of Exports and goes on to state that the *Scheme for Assistance to States*... is formulated to encourage... into promoting exports."

Thus, it is clear that the purpose of the policy is to assist service sector industries to earn foreign exchange. Thus, the assistance given by the Government under the Scheme would amount to government grant since the definition states any assistance whether in cash or in kind would be regarded as grant.

The salient features of the assistance are:

(a) Paragraph 3.6.4.1 which deals with the objective of the Scheme states that "*objective is to accelerate growth in export* of service etc."

(b) Paragraph 3.6.4.2 states that all service providers of *services listed in Appendix-10 of Handbook of Procedures (Vol. 1) who have a total foreign exchange earnings ... shall be eligible to qualify for a duty credit scrip.*

(c) Paragraph 3.6.4.5 states that the duty credit scrip may be used for import of any *capital goods* (i.e. of fixed assets nature) including..." and should relate to *any service sector business* of the applicant.

(d) Paragraph 3.6.4.6 *imposes a ban on transferability (except within group companies) of either duty credit scrips or the goods imported / procured by using the duty credit scrip.* Thus, it is clear that the amount denoted by the duty credit scrip is meant *to be used for acquiring capital goods and is not meant to be used for meeting any expenses or for distribution as dividend.*

(Emphasis supplied by the querist.)

(iv) There are certain past and future compliances with certain conditions, which have to be complied with to avail the benefit under the aforesaid scheme.

Past Compliance:

All service providers (other than hotels and restaurants) listed in Appendix 10 of Handbook of Procedures (Vol.I) shall be be entitled to duty credit equivalent to 10% of the foreign exchange earned by them in the preceding financial year. *Foreign* exchange earning *is a precondition to availing benefits under the Scheme.* During financial years 2006-07 to 2011-12, the enterprise obtained duty credit entitlement certificates from the DGFT under 'Served From India Scheme' on compliance of above condition.

Future compliances:

(a) These certificates are valid for 2 years from the date of issue.

(b) *Duty credit entitlement may be used for import of any capital goods including spares, office equipment and professional equipment, office furniture and consumables, provided it is part of the main line of business.*

(c) The entitlement and the goods imported shall be non-transferable (except with in group company and managed hotels) and be subject to actual user condition.

Since the benefit flowing from the scheme falls squarely under the scope of 'government grant' as it is in the form of assistance given by the Government and the company has complied with the past and future compliances with certain conditions attached to it as contemplated in AS 12, the applicability of AS 9 on revenue recognition *is ruled out* as that Standard excludes 'government grant' from its purview.

(Emphasis supplied by the querist).

(B)(i) As regards the method of accounting to be followed in accounting for government grant, as per the querist, two broad approaches may be followed for the accounting treatment of government grants - the 'capital approach' under which a grant is treated as part of shareholders' funds, and the 'income approach', under which a grant is taken to income over one or more periods.

As the company has used the scrips for the payment of custom duty on purchase of capital assets only, the querist has provided the following accounting treatment in accordance with paragraph 14 of AS 12:

(a) Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

(b) Where the grant related to a specific fixed asset equals the whole, or virtually the whole, the cost of the asset, the asset should be shown in the balance sheet at a nominal value.

(c) Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged.

(d) Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

(ii) The duty credit entitlement certificates (i.e., duty credit scrips) can be utilised according to the scheme towards purchase of :

a. Capital assets including

b. Inventory

c. Consumables

(iii) In the case of the company, these have been used to purchase *capital assets only*. The value involved in the duty credit scrips has been utilised only for the payment of customs duty payable on such imports and not to meet the *entire cost*. Therefore, it is to be examined as to which of the methods (whether (a) or (b) or (c) or (d), as mentioned above is to be adopted. In the opinion of the company, the accounting treatment as given under (a) of paragraph 14 of AS 12 would be the only appropriate method.

(Emphasis supplied by the querist.)

7. In view of above, it is reiterated that the company is of the view that since out of three options available under SFIS as mentioned above, company has utilised the scrip only for the purpose of import of capital goods, it is appropriate to capitalise the net cost of fixed asset imported in the books (without import duty). The company is of the view that SFIS scrips utilised by it for the import of capital goods should be treated as capital grant under AS 12 instead of revenue under AS 9.

B. Query

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

(a) Whether the company is correct in contending that duty credit entitlement under SFIS does not fall strictly under 'revenue' within the definition of this term as per AS 9.

(b) Whether the company is correct in contending that duty credit entitlement under SFIS is a government grant/subsidy/assistance.

(c) Whether the company is correct in showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value as per paragraph 14 of AS 12.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised in the query relate to recognition of duty credit entitlement certificates issued under the 'Served from India Scheme', whether the duty credit entitlement under the Scheme strictly falls within the definition of the term 'revenue', as defined under Accounting Standard (AS) 9, 'Revenue Recognition' or it should be treated

as government grant/subsidy/assistance. Therefore, the Committee has considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, applicability of SFIS to the company and its entitlements to import capital goods against it, presentation and disclosure of duty credit entitlement under SFIS in the financial statements, measurement and accounting for utilisation of duty credit entitlement against imported capital goods, timing of recognition of the duty credit entitlement under SFIS, accounting for transfer of the duty credit entitlement to the group companies or managed hotels, etc.

10. With regard to the issue raised by the querist as to whether duty credit entitlement under SFIS fall under the definition of the term, 'government grants', the Committee notes paragraph 3.2 of AS 12, notified under the 'Rules', which defines government grants as follows:

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

From the Facts of the Case, the Committee notes that duty credit entitlement under SFIS is an assistance in kind by the Government as the company receives duty credit entitlement under SFIS that may be either adjusted against import of capital goods or their spare parts/ consumables. Further, it is awarded on the basis of pre-specified percentage of exports made by the company and accordingly, the value placed upon them is reasonably determinable. Therefore, it is of the nature of government grant.

11. With regard to nature of grant obtained, the Committee notes paragraphs 8.1 and 10.1 of AS 12, notified under the 'Rules', which provide as below:

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

> "10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income."

The Committee notes that as per the Foreign Trade Policy, the duty credit entitlement under SFIS is granted to exporters with the objective to accelerate growth in export of services. Thus, the grant is awarded with reference to exports made by the company and not with reference to total investment in an undertaking or by way of contribution towards its capital outlay. Accordingly, the Committee is of the view that it would not be appropriate to treat the duty credit entitlement under SFIS as 'promoters' contribution'. Further, the Committee is of the view that the duty credit entitlement under SFIS cannot be considered as a grant related to a specific fixed asset as at the time of awarding such duty credit entitlement under SFIS, no specific asset has been identified for its utilisation. The Committee notes that such duty credit entitlement under SFIS can be utilised not only for payment of duty on import of capital goods but also for their spare parts or consumables which can be revenue in nature. Moreover, it is not necessary under the Scheme that its recipient should utilise the scrips for importing goods only. The recipient may transfer them to another company within the same group or managed hotels as per the conditions of the Scheme resulting into an income for it. Thus, the award of duty credit entitlement under SFIS should be considered to be generating income to the company. Accordingly, the Committee is of the view that as per the principles of AS 12, the duty credit entitlement under SFIS should be treated as a grant related to revenue. Therefore, adjustment against the gross value of the assets concerned does not arise.

12. With regard to applicability of AS 9, the Committee notes paragraphs 2 and 4.1 of AS 9, notified under the 'Rules', which state as below:

> "2. This Standard does not deal with the following aspects of revenue recognition to which special considerations apply:
>
> …

(iii) Revenue arising from government grants and other similar subsidies;

..."

"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."

From the above, the Committee is of the view that as per the principles enunciated above, revenue is a consideration that arises from the ordinary activities of the enterprise, viz., from the sale of goods or rendering of service. The Committee notes from the Facts of the Case that duty credit entitlement under SFIS is granted to the exporters by the Government of India on the basis of foreign exchange earned by them. The Committee is of the view that the Government of India, in the extant case, is not a party to whom services have been rendered by the company, hence, duty credit entitlement cannot be construed to be a consideration received from sale of goods or rendering of services and accordingly, AS 9 is not strictly applicable for recognition of duty credit entitlement under SFIS. Thus, the principles of AS 12 are applicable in the extant case.

13. As regards earlier opinion of EAC as referred by the querist, the Committee is of the view that the earlier query was asked from the point of view of timing of recognition of duty credit entitlement under SFIS and as the principles of the timing of recognition are clearly stated in AS 9, the principles of AS 9 were applied for answering the opinion. However, the Opinion also clearly stated that the duty credit entitlement under SFIS does not strictly fall within the definition of the term 'revenue'.

D. Opinion

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

(a) Yes, the company is correct in contending that duty credit entitlement under SFIS does not fall under 'revenue', as defined in AS 9, as discussed in paragraph 12 above.

(b) Yes, the company is correct in contending that duty credit entitlement under SFIS is a government grant/subsidy/assistance as discussed in paragraphs 10 to 12 above.

(c) No, the company is not correct in showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value rather the duty credit entitlement under SFIS should be treated as a grant related to revenue as discussed in paragraphs 10 to 12 above.

Query No. 22

Subject: Treatment of income tax paid for earlier years against the uncontested demand received during the current period.[1]

A. Facts of the Case

1. A private sector listed company (hereinafter referred to as 'the company') is engaged in providing global fluid management solutions and is the largest manufacturer and exporter of centrifugal pumps and valves from India. The core businesses of the company are large infrastructure projects (Water Supply, Power Plants and Irrigation), project and engineered pumps, industrial pumps, agriculture and domestic pumps, valves, motors and hydro turbines.

2. The querist has stated that the company had a survey under section 133A of the Income-tax Act, 1961 during the financial year 2012-13. After the survey, the Income-tax authorities have sent a notice of demand disallowing certain expenses claimed by the company as allowable for earlier financial years for which assessments are pending. To avoid long drawn

[1] Opinion finalised by the Committee on 3.9.2013.

litigations and expenses, the management has decided not to contest these claims and to pay the income tax for earlier years as per the demand.

3. The management wants to adjust/debit these tax expenses for earlier years directly to general reserve instead of debiting it to the statement of profit and loss for the current period.

4. The management's argument in support of this accounting treatment is that the accounting treatment is not prohibited as per the provisions of the Companies Act, 1956 and that 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 (hereinafter referred to as the 'Rules') also does not specifically prohibit such accounting treatment. According to the management, paragraphs 1 and 5 of AS 5 relate to revenue items that are considered to arrive at the profit or loss and the tax expense is of a consequence. The management is also of the view that debiting earlier year's tax expenses to the current year's statement of profit and loss will give a distorted figure of the current year's profit.

5. The estimated profit before tax of the company for the current year is not sufficient to absorb the amount of the income tax paid for earlier years.

6. In the opinion of the statutory auditors of the company, in terms of paragraphs 1 and 5 of AS 5, such accounting treatment is prohibited.

B. Query

7. From the above background, the querist has sought the opinion of the Expert Advisory Committee whether income tax paid for earlier years against the uncontested demand raised by the Income-tax authorities during the current period can be directly debited to general reserve of the company.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether the income tax paid in respect of earlier years against a demand raised by the Income-tax authorities during this year can be adjusted directly against general reserve of the company. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as, disclosure of such income tax paid in the financial statements, deferred tax implications due to disallowance of

expenses by Income-tax authorities in the subsequent periods, etc. Further, in the absence of the details in respect of the expenses disallowed by the Income-tax authorities, the Committee presumes from the Facts of the Case that these expenses had been correctly charged off to the statement of profit and loss while arriving at the accounting profit for that period. Also, the opinion expressed hereinafter is purely from accounting perspective and not from the angle of interpreting the provisions of any law, such as, Income-tax Act, 1961 since in view of Rule 2 of the Advisory Service Rules, the Committee is prohibited from such interpretation.

9. The Committee notes paragraph 9 of Accounting Standard (AS) 22, 'Accounting for Taxes on income', notified under the 'Rules', as follows:

> ***"9. Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period."***

From the above, the Committee is of the view that income tax is an *expense* which is included in the determination of net profit or loss for the period. The Committee also notes paragraph 5 of AS 5, notified under the 'Rules', which inter alia states that all expenses and incomes should be included in the determination of profit or loss. Accordingly, the Committee is of the view that although income tax in the extant case pertains to earlier periods, it is an expense by nature. The Committee is of the view that in respect of an expense which is recognised in the statement of profit and loss, provision relating to it is also recognised in the statement of profit and loss and accordingly, if on actual determination, expenditure against such provision is in excess or short then such excess/short provision is also recognised in the statement of profit and loss. The Committee notes that in the extant case, income tax has arisen in the current year due to short provision of tax which was recognised in the statement of profit and loss of the relevant earlier period(s). Accordingly, after survey under section 133A of the Income-tax Act, 1961, when the Income-tax authorities has determined the final settlement amount of the income-tax obligation, the Committee is of the view that following the above-mentioned principle, the expense arising due to short provisioning of income tax in the earlier years should also be recognised in the statement of profit and loss. In this context, the Committee notes paragraph 9.8.1.6 of the Guidance Note on Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, under the head 'Current tax', in relation to 'Part II – Statement of

Profit and Loss' to the Revised Schedule VI also supports the above treatment while providing that "Excess/Short provision of tax relating to earlier years should be separately disclosed". Accordingly, the Committee is of the view that such tax expense should be separately disclosed in the statement of profit and loss rather than as an adjustment to general reserve.

10. As regards the view of the querist in paragraph 4 above that "AS 5 relate to revenue items that are considered to arrive at the profit or loss and the tax expense is of a consequence", the Committee is of the view that although tax is estimated on profits, for accounting purposes, it is an expense which is to be included in the determination of profit/loss, as discussed above.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that income tax paid for earlier years against the uncontested demand raised by the Income-tax authorities against the company during the current year should not be directly adjusted against the general reserve of the company. Rather it should be charged to the current year's profit as discussed in paragraphs 9 and 10 above.

Query No. 23

Subject: Treatment of commission cost paid to agent in relation to projects.[1]

A. Facts of the Case

1. A company is involved in the business of designing, engineering and erection of ethanol, brewery, water and waste water treatment plants. The company caters to both domestic and international markets. The revenue recognition of the company, as per the querist, is governed by Accounting Standard (AS) 7, 'Construction Contracts', for the above-mentioned line of

[1]Opinion finalised by the Committee on 3.9.2013.

business. The company has raised this query in relation to inclusion of certain costs as contract cost in terms of paragraphs 15 to 20 of AS 7.

2. The querist has stated that the company executes projects in international and domestic markets for the above-mentioned business. In certain cases, the company appoints agents to undertake the following activities:

(i) Generate enquiry from prospective customers.

(ii) Support in obtaining the order from the customer and facilitating the execution of the agreement.

(iii) Support in technical and commercial discussions and communications with the customer.

(iv) Project co-ordination and support, procurement support and local assistance.

(v) Overall updation about the status and completion of the project.

(vi) Facilitate and arrange advance payment from customer and ensuring timely collections from customer.

The above services rendered by the agent form an integral part of the project right from inception of project till the timely execution and completion of the project. The querist has also clarified that different agents are not deployed for undertaking the above-mentioned activities. Only one agent undertakes all the activities for a particular project right from receipt of order to recovery of last money from customer for that particular project. The activities of the agent are not limited only to finding the prospective customer and obtaining the contract. The activities involved are right from inception of project till the timely execution and completion of the project. The agent provides various services in the nature of procurement support, vendor short listing, and technical services etc., which are an integral part in the execution work of the project and as such, according to the querist, the costs towards sales commission are specific for that contract and essential for smooth execution of the project. These costs would be incurred only where the project activity is carried out for that particular contract. These are specifically identified for each project and considered in the total estimated cost of the project.

3. The querist has further stated that the company presently pays compensation to these agents for the services rendered in the form of 'sales commission' by entering into individual agreements with them. The sales commission is decided as a percentage of contract value and the same is accrued in the books of account in proportion to contract revenue of respective project. Payment terms are directly linked with specific contract and receipt of amount from customer for the said project. As per normal payment terms, the sales commission is paid to an agent, in proportion to amount received for the project from the customer. In simple words, the commission becomes due (accrued as expense) on the basis of contract revenue and would become payable as and when the company receives money from the customer for the respective project. The querist has also separately clarified that commission for a particular project is payable only on receipt of order from the customer and no commission is payable if the order from the customer does not materialise. In other words, the commission becomes due only when the company receives order for the project. In case, the company does not receive the order for the project, no commission becomes payable to the agent.

4. The querist has also informed that although the commission costs are not explicitly charged to the customer as a separate cost, these form part of the total project cost and are considered while deciding the order value. As such, they are not specifically reimbursable from the customer on one-to-one basis and there is no separate mention of these costs in the contract entered into with the customer, but the commission cost is included in total order value.

5. The commission paid to the agent is treated as direct cost of the project and included in the total estimated cost of the project as sales commission cost. These costs are included in the project cost as these are directly related to the project and can be separately identified and allocated to the project. For revenue recognition as per AS 7, the sales commission cost is included in the actual cost of project as well as budgeted cost of project to arrive at the percentage of completion. Based on the percentage completion so arrived, the revenue is recognised in the books of account.

B. Query

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

(i) Whether the treatment adopted by the company, of including the commission cost as part of project cost, as explained above is correct.

(ii) If the treatment adopted is correct, whether the cost would be classified as direct cost of project or cost allocable to the project.

(iii) If the treatment adopted is not correct, under what head these costs can be classified under indirect expenses.

(iv) Whether the treatment adopted by the company to calculate percentage of completion including the sales commission cost and thus complying the revenue recognition as envisaged under AS 7 is correct.

C. Points considered by the Committee

7. The Committee notes that the basic issues raised in the query relate to whether commission paid to agents for the service rendered in relation to projects should be included in contract costs for revenue recognition under AS 7 and if included, whether it should be treated as direct cost or as allocable expenses to project. Accordingly, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, correctness of using nomenclature 'sales commission' for compensation paid to agents, timing of recognition of commission cost in respect of various nature of activities, etc.

8. The Committee notes paragraphs 15, 19 and 20 of Accounting Standard (AS) 7, 'Construction Contracts', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), as stated below:

"15. Contract costs should comprise:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract; and

(c) such other costs as are specifically chargeable to the customer under the terms of the contract."

"19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract;

(b) selling costs;

(c) research and development costs for which reimbursement is not specified in the contract; and

(d) depreciation of idle plant and equipment that is not used on a particular contract."

"20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period."

From the above, the Committee notes that contract costs include the costs directly related to a specific contract as well as the costs that are attributable to contract activity in general and can be allocated to the specific contract. However, as per paragraph 19 of AS 7, general administration costs that are not specifically reimbursed in the contract and selling costs are excluded from the costs of a construction contract since these can neither be attributed nor allocated to the 'construction activity'. As per paragraph 20 of AS 7, the costs which are incurred in securing the contract are included as part of the contract costs only if they can be separately identified and measured reliably and its probable that the contract will be obtained. Accordingly, the Committee is of the view that whether commission payable to agent is a contract cost or not depends on the nature of activity for which commission is being paid.

9. The Committee notes from the Facts of the Case that so far as the activities of the agent related to execution of the contract activity, such as procurement support, project coordination and other technical services are concerned, the Committee is of the view that these activities are directly related to the construction contract and therefore, costs pertaining to these

activities should be treated as costs that relate directly to the specific contract. Similarly, activities of the agent related to finding the prospective customer and obtaining the contract, etc. can also be treated as directly related to the contract as in the extant case, the costs pertaining to these activities are payable only on obtaining the contract. The Committee further notes that since commission payable in respect of such activities can be identified separately and can also be measured reliably (commission being charged as a specified percentage of contract value), it can be included as part of contract costs. However, the Committee notes from the Facts of the Case that the agent, in the extant case, not only provides services in relation to securing of the contract, procurement support and other technical services relating to execution of the project, but also facilitates and arranges advance payments from the customer and ensures timely collections from them. The Committee is of the view that activities relating to facilitation and arrangement of advance payments and final collections from the customer and other similar activities are of the nature of administration costs, which cannot be considered as attributable to construction activity and accordingly, cost of these activities should not be treated as the cost directly related or that attributable to a construction contract as per the principles of AS 7. Therefore, the Committee is of the view that if the commission cost paid to the agents is a composite commission, the company should assess whether the latter activities and the cost in respect thereof are material and if it is so, attempt should be made to estimate the cost pertaining to these activities considering the factors, such as, the cost that would have been incurred had the agent performed only these activities, etc. Accordingly, the cost incurred on selling and administration activities should not be included in contract cost.

10. As regards including the commission cost for determining the stage of completion, the Committee notes paragraph 30 of AS 7, notified under the 'Rules', which is reproduced as below:

> "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."

From the above, the Committee is of the view that only those contract costs that reflect work performed should be included in costs incurred upto the reporting date. However, as per the Facts of the Case (paragraph 3 above), related commission is accrued in proportion to contract revenue. In other words, such costs are not being recognised considering the performance of related service rather the same is being recognised on the basis of contract revenue. Accordingly, the Committee is of the view that inclusion of commission on this basis is not correct; rather, it should be recognised considering the performance of related service provided the commission so determined is 'contract cost', as discussed in paragraph 9 above.

D. Opinion

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

(i) The treatment adopted by the company of including the commission cost as part of project cost would be correct only in respect of the commission cost paid to the agents to the extent it is directly related to contract and such activities are in relation to construction activity and further, it is not in the nature of administration and selling cost, as discussed in paragraph 9 above. Commission cost to the extent it is incurred on selling and administration activities, if material, should not be included in contract cost.

(ii) and (iii) Subject to (i) above, the cost may be classified as direct cost of project, as discussed in paragraph 8 above. However, if it does not meet the criteria as laid in (i) above, it cannot be treated as a contract cost. The nature of such expense should be considered to determine the head of the expense.

(iv) Subject to (i) above, the treatment adopted by the company to calculate percentage of completion would be correct provided the commission cost is recognised considering the performance of related service as per the principles of AS 7, as discussed in paragraph 10 above.

Query No. 24

Subject: Accounting for expenditure on shared infrastructure facilities and depreciation thereon.[1]

A. Facts of the Case

1. A company was incorporated under the Companies Act, 1956 during the year 1984-85 and is engaged in construction and operation of thermal power plant in the State of Odisha. The company had set up two power plants of 2 x 210 MW (Units I and II, i.e., Stage 1) as its maiden venture in the district of Jharsuguda known as IB Thermal Power Station and the Units were commercially operated during December 1994 and June 1996, respectively. The company is setting up two new power plants of 2 x 660 MW (Units III and IV, i.e., Stage 2) at same location of IB Thermal Power Station, Jharsuguda. During the year 1999, as a part of power sector reforms, the Government of Odisha disinvested 49% of the shares in favour of XYZ Corporation, USA the strategic investor. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956 as amended from time to time.

2. The querist has stated that power generated from Units I and II is sold to ABC Ltd., a Government of Odisha Undertaking, at a tariff determined as per bulk Power Purchase Agreement (PPA) executed during the year 1996. For determination of tariff, the capital cost has been taken as Rs. 1060 crore in place of total expenditure around Rs. 1135 crore. Depreciation @ 7.5% per annum of the cost of assets of Rs. 1060 crore upto 90% of total cost of such asset has been recovered in the tariff by March, 2008 as per the PPA. As per the querist, at present, there is no depreciation available for charging in the tariff as 90% of cost of asset has already been recovered. However, the company has reassessed the useful life of assets following Accounting Standard (AS) 6, 'Depreciation Accounting' and Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and the balance cost of assets including additional capital expenditure is depreciated over the extended useful life as determined and charged to the statement of profit and loss while preparing its financial statements.

3. The querist has further stated that for setting of new power plant Units III and IV (Stage 2), total capital cost has been estimated at around Rs.11,500

[1] Opinion finalised by the Committee on 3.9.2013.

crore which will be met out of 75% long terms loans and 25% as equity from the investors. 50% of the power generated from Units III and IV shall be sold to ABC Ltd., a Government company engaged in trading of power and balance 50% of power shall be sold to different power purchasers on long-term and short-term basis. As per regulatory norm, the tariff will be determined as per notifications issued from time to time and based upon number of parameters. Total capital cost is taken for determination of equity for calculation of return on equity and loan for determination of interest which is to be taken as fixed cost per unit in tariff. The new project will share some of the existing infrastructure facilities originally constructed for Units I and II (Stage 1) which are under direct control of the company as given below:

(a) Township roads and buildings

(b) Administrative building

(c) Plant roads

(d) Coal Handling plant (CHP)

(e) Merry Go Round (MGR)

(f) Intake channel

The above infrastructure facilities as stated at (a) to (f) require substantial capital expenditure for renovation, improvement and addition to make them usable in support of construction of the new project Units III and IV (Stage 2). Without above proposed expenditure, the infrastructure facilities may not support the construction of Stage 2. In other words, the company was not required to spend additional capital expenditure if there were no proposal for construction of Units III and IV (Stage 2).

Requirement under Accounting Standard:

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

> "12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed

standard of performance is included in the gross book value, e.g., an increase in capacity.

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

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

Proposed accounting and accounting treatment

5. The querist has also stated that following the requirement of Accounting Standard as reproduced above, the proposed expenditure shall qualifiy for capitalisation with original assets, but said capital expenditure shall be incurred and required for construction of Units III and IV (Stage 2). It is essential to book such additional expenses to capital cost of Stage 2 as the same will be taken for determination of tariff for power generated and sold as per power purchase agreement executed / to be executed following regulatory norms. The company has developed accounting codes in respect of different assets separately for booking of such capital expenditure related to Stage 1 and Stage 2 separately, so that actual capital expenditure related to Stage 2 will be determined. The company is of the view that the additional capital expenditure incurred for shared facilities will be booked to respective accounting code of asset under Stage 2 even if it has no separate identity which will be finally consolidated with asset cost of Stage 1 and reported in the financial statements.

6. Following the above proposed accounting, the expenditure incurred for common infrastructure facilities as stated above will be depreciated and segregated for charging to operation Stage 1 (original cost of asset taken for calculation) and Stage 2 (additional cost taken for calculation). Depreciation on additional capital cost for Stage 2 upto the date of commercial operation wherever applicable shall be treated as expenditure during construction for capitalisation and from the date of commercial operation,

shall be charged to the statement of profit and loss. The querist has illustrated the treatment with the help of following example:

Example:

Particulars of Assets	**Amount in Rs.**	**Remarks**
Capital cost of Township Road–Stage 1	100	Already accounted under respective accounting code developed for asset head for Stage 1 and depreciation is charged to the statement of profit and loss.
Additional capital expenditure proposed to be incurred to facilitate construction of Stage 2	150	Proposed to be accounted under respective accounting code developed for asset head for Stage 2 and depreciation upto date of commercial production will be treated as expenditure during construction for capitalisation and after commercial production will be charged to the statement of profit and loss.
Total Cost	250	Will appear under asset head for reporting under fixed assets in the financial statements. (Notes to balance sheet)

B. Query

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

with the generally accepted accounting principles and Accounting Standards followed in India.

C. Points considered by the Committee

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

9. As far as accounting for expenditure incurred on renovation, improvement and addition to existing infrastructure facilities is concerned, the Committee notes that paragraph 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') states as below:

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

10. The Committee is of the view that expenditure on fixed assets subsequent to their installation may be categorised into (i) repairs, and (ii) improvements or betterments. Repairs, the Committee notes, implies "the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated service life or capacity." It frequently involves replacement of parts. On the other hand, betterment is defined as "...an expenditure having the effect of extending the useful life of an existing fixed asset, increasing its normal rate

of output, lowering its operating cost, or otherwise adding to the worth of benefits it can yield. The cost of adopting a fixed asset to a new use is not ordinarily capitalised unless at least one of these tests is met. A betterment is distinguished from an item of repair or maintenance in that the latter has the effect of keeping the asset in its customary state of operating efficiency without the expectation of added future benefits." (These definitions are reproduced from the Dictionary for Accountants by Eric C. Kohler, Sixth Edition.)

11. From the above, the Committee is of the view that, normally, expenditure on repairs, including replacement cost necessary to maintain the previously estimated standard of performance, is expensed in the same period. Similarly, the cost of adopting a fixed asset to a new use or modernisation/rennovation of such asset without actually improving the previously estimated standard of performance is also expensed. Accordingly, in the view of the Committee, only such expenditures that add new fixed asset units, or that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs are capitalised. The Committee is of the view that 'previously assessed standard of performance' is not the actual performance of the asset at the time of repair/improvement etc., but the standard performance of the same asset in its original state.

12. The Committee notes from the Facts of the Case that the capital expenditure is being incurred on existing infrastructure facilities which will support the construction as well as operation of Units III and IV of Stage 2. Further, as per the facts given in paragraph 4 above, the expenditure shall increase the future benefits from the existing asset beyond its previously assessed standard of performance and such asset will be used beyond original useful life assessed for power plants at Stage 1. Accordingly, the Committee is of the view that the additional expenditure incurred on common infrastructure facilities during Stage 2 can be capitalised.

13. With regard to whether additional expenditure can be capitalised under a separate accounting code under the respective asset head for the purpose of charging depreciation thereon separately, the Committee notes paragraph 12.2 of AS 10, notified under the 'Rules', which is reproduced below:

> "12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing

> asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately."

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

> "9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life."
>
> ***"23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.***
>
> ***24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life."***

From the above, the Committee is of the view that it is only an addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is accounted for and depreciated independently on the basis of an estimate of its own useful life. However, in the extant case, the Committee notes from the Facts of the Case (paragraph 4 above) that such expenditure is not creating any new asset which is separately identifiable but such asset will be used beyond useful life assessed for power plants at Stage 1. Accordingly, the Committee is of the view that it should be capitalised with the cost of the existing assets concerned. Further, in case such expenditure results into increase in the *useful life* of the concerned asset, the unamortised depreciable amount of the concerned assets alongwith the expenditure incurred should be charged over the revised remaining useful life subject to the useful life implicit from the rates specified in Schedule XIV to the Companies Act, 1956. The Committee wishes to point out that such depreciation should be charged with reference to the 'useful life' and not with reference to 'physical life' of the asset. The Committee is also of the view that had such expenditure on infrastructure facility resulted into replacement of existing infrastructure facilities, then such expenditure would have been capitalised while derecognising the carrying amount of the assets that have been replaced. Further, the costs, thus capitalised would have been depreciated over the useful life of replaced asset subject to useful life implicit from the rate specified in Schedule XIV to the Companies Act, 1956.

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

D. Opinion

15. On the basis of the above, the Committee is of the opinion on the issues raised in paragraph 7 above that the proposed accounting treatment of expenditure incurred on infrastructure facilities and calculation of depreciation separately for charging to operation for Stage 1 and expenditure during construction for capitalisation for Stage 2 as well as inclusion in the capital cost of Stage 2 is not in consonance with generally accepted accounting principles and Accounting Standards followed in India, as discussed in paragraphs 12, 13 and 14 above. The company can capitalise the additional expenditure on common infrastructure facilities during Stage

2 as it shall increase the future benefits from the existing asset beyond its previously assessed standard of performance. However, since such expenditure is not creating any new asset which is separately identifiable, it should be capitalised with the cost of the existing asset concerned. Further, in case such expenditure results into increase in the useful life of the concerned asset, the unamortised depreciable amount of the concerned asset alongwith the expenditure incurred should be charged over the revised remaining useful life subject to useful life implict from the rates specified in Schedule XIV to the Companies Act, 1956.

Query No. 25

Subject: Creation of Depreciation Reserve Fund.[1]

A. Facts of the Case

1. A company is a Government company within the meaning of section 617 of the Companies Act, 1956 and is working under the administrative control of the Ministry of Railways (MOR). The company is engaged in the business of handling and transportation of containerised cargo. The transportation of the containers is done through road, rail and air and the customers for these services are shipping lines, clearing and forwarding agents and other customers. The company operates container terminals across the country to cater to the needs of the trade, whether it is export-import or domestic business. Accordingly, the activities of the company have been divided into international traffic (Export and Import) and domestic traffic. The operating activities of the company are mainly carried out at its Inland Container Depots (ICDs), Container Freight Stations (CFSs) and PSCTs (Port Side Container Terminals) spread all over the country.

2. The main sources of incomes of the company are freight, handling, transportation and terminal service charges (TSC), etc. A brief description of these incomes is as under:

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[1] Opinion finalised by the Committee on 3.9.2013.

- Freight and transportation incomes are the rail and road haulage charges respectively charged from the customers.

- Handling income is the amount received for handling of containers.

- TSC income is the parking charges taken by the company for the time period during which a container remains parked in its ICD after the expiry of permissible free time limit. In fact, it also includes charges for safety and security of containers/cargo.

Similarly, major expenditures are on freight payment to Railways for rail movement and payments made to contractors for handling and transportation of containers.

3. The querist has stated that the company believes in highest standards of corporate governance and recognises that financial statements are an important source of information for all its stakeholders. The company is committed to prepare its financial statements as per the applicable law(s), regulations, accounting standards/guidance notes issued by the Institute of Chartered Accountants of India (ICAI), and to make complete disclosures so as to enable its stakeholders to make informed decisions. Keeping this legal framework in mind, the company intends to create a Depreciation Reserve Fund (DRF). The procedure, which will be followed for its smooth operation and at the same time ensuring that all legal compliances are met has been detailed below:

(i) The company wishes to continue with its existing method of charging depreciation on fixed assets, i.e., written down value (WDV).

(ii) Once DRF is created, it will be recouped on annual basis by appropriation of profits equivalent to the amount of depreciation charged on 'Plant & Equipment' less adjustments during the preceding financial year. The querist has separately explained that adjustments here refer to:

   (a) Depreciation on items of plant and equipment sold during the preceding financial year; and

   (b) Depreciation on items of plant and equipment, which have become obsolete during the preceding financial year.

The querist has also explained with the help of an example. Let us assume that DRF is created during financial year (F.Y.) 2012-13, then in such a scenario, it will be recouped by appropriation of profits equivalent to an amount of Rs. 108.33 crore worked out as follows:

Particulars	**Amount (Rs. in Crore)**
Depreciation on plant and equipment during F.Y. 2011-12	113.17
Less:Depreciation on sale/adjustments of items of plant and equipment during F.Y. 2011-12	4.84
Net Amount	**108.33**

The intention behind creation of DRF by an amount equivalent to depreciation on 'plant & equipment' less 'adjustments during the preceding financial year' is that by following this method, at any stage of time, DRF and the corresponding investments will equate with the cumulative depreciation under the head 'plant and equipment'.

The querist has stated that under such circumstances, one more line 'Less: Transfer to Fund' will be inserted under the sub-heading 'Balance in Statement of Profit and Loss' in Note 2 to Balance Sheet (Refer Annual Report for the F.Y. 2011-12).

(iii) DRF will be backed by an equal amount of investment in earmarked securities. Investment in such securities will be made as per the existing guidelines of Department of Public Enterprises (DPE), which at present are being followed for investing the surplus funds of the company. Such investments will be made once a year within 15 days from the date of adoption of annual accounts by the Board of Directors (BOD) for the preceding financial year. For smooth operation, ___% (to be decided by management) of the funds will be parked in flexi-deposits, which can be utilised for meeting the urgent requirements related to replacement of small items of plant and equipment.

(iv) For operation of DRF, a separate bank account will be opened, which will have main account at corporate office and sub-accounts at eight regional offices {Northern Region, North Central Region, Western Region, Central Region, Southern Region, South Central

Region, Eastern Region and North West Region}, all linked with the main account. The modus operandi for operation of such bank account would be as follows:

- Funding to sub-accounts will be made from the main account.
- Replacement of items related to plant and equipment at corporate office will be made out of the main account.
- For replacement of items related to plant and equipment at regional level, cheques will be issued directly by the region from the dedicated sub-account.
- Sub-accounts will have zero balance and funds will be transferred to these sub-accounts from the main account on receipt of actual requirement from the regions.
- Main account will be linked to flexi-deposits, so that procurement needs of small items of plant and equipment can be easily met out.

(v) Interest earned on earmarked investments will be credited to the 'statement of profit and loss'.

(vi) Accounting entries to be performed at each step of DRF would be as follows:

Particulars	**Debit**	**Credit**
Appropriation of Profits	P&L Appropriation A/C	DRF A/C
Investment of Funds	DRF Investments A/C	Bank A/C
Interest on Investments	Bank A/C	Interest on Investments A/C
Replacement of Fixed Assets	Asset A/C	Bank A/C
Utilisation of DRF	DRF A/C	P&L Appropriation A/C
Sale of DRF investment	Bank A/C	DRF investment A/C

(vii) Accounting policy for DRF and related investments, which the company would be required to disclose in its annual financial statements, will be as follows:

“Depreciation Reserve Fund

For replacement of existing items of plant and equipment, Depreciation Reserve fund (DRF) is created. DRF is recouped from the surplus in the statement of profit and loss by an amount equivalent to depreciation charged on plant and equipment less adjustments during the preceding financial year. DRF is represented by an equal amount of investments in earmarked securities. Such investments are made in accordance with the DPE guidelines and ___% (to be decided by management) of these investments are made in flexi-deposits. Interest earned on earmarked investments is credited to the statement of profit and loss.”

(viii) On creation of DRF, disclosure in the notes to annual accounts would be as follows:

“During the year, the company framed a new policy for creation of Deprecation Reserve Fund (DRF). Consequent upon adoption of such policy, there is no impact on the profitability of the company during the year.”

(ix) During transition period, DRF will be created out of the opening surplus in the statement of profit and loss. For example, if DRF is created during F.Y. 2012-13, surplus in the statement of profit and loss will get reduced by Rs. 644.72 crore, which is equivalent to the accumulated depreciation for plant and equipment as on 01.04.2011. In such a scenario, Note 2: ‘Reserves and Surplus’ to balance sheet will appear as follows:

NOTE 2: RESERVES & SURPLUS **(Rs. in Crore)**

	As at 31.03.2013	As at 31.03.2012
(I) GENERAL RESERVE		
Opening Balance		
Add: Transfer from Statement of Profit and Loss		
(II) SURPLUS (BALANCE IN STATEMENT OF PROFIT AND LOSS)		
Opening Balance		
Add: Profit during the year		
Less: Interim Dividend including Dividend Distribution Tax		
Less: Proposed Dividend including Dividend Distribution Tax		
Less: Transfer to General Reserve		
Less: Transfer to Fund		
(III) FUND		
Opening Balance		
Add: Transfer from Statement of Profit and Loss		
TOTAL		

(x) At any point of time, DRF will be represented by the equal amount invested in specified securities. During transition period, some of the existing securities (fixed deposits/flexi deposits etc.) will be earmarked for replacement of items related to plant and equipment. In such a scenario, 'Cash & Bank Balances' in Note 9: 'Current Assets' will appear as follows (Refer Annual Report for F.Y. 2011-12):

CASH AND BANK BALANCES	
(i)	Cash & Cash Equivalents
	Cash on Hand (Including Imprest)
	Remittance in Transit
	Cheques in hand
	Bank Balances
	- in Current Accounts
	- in Deposits with original maturity upto 3 months
(ii)	Other Bank Balances
	Bank Deposits
	- With original maturity of more than 3 months and upto 12 months
	- With original maturity of more than 12 months
	Earmarked Bank Balances
	- Unpaid dividend bank account
	- Replacement of Plant & Equipment
	Bank Balances held as margin money or as security against:
	- Guarantees
	- Letters of Credit

B. Query

4. The Expert Advisory Committee of the ICAI is requested to advice on the methodology, which the company intends to follow for creation and operation of DRF and whether such procedure falls within the ambit of rules/regulation and procedures laid down in the Indian Companies Act,

1956, Revised Schedule VI, Accounting Standards issued by the ICAI and any other applicable laws.

C. Points considered by the Committee

5. The Committee notes that the company in the extant case wishes to create a depreciation reserve fund (DRF) for replacement of existing items of plant and equipment by appropriating a portion of the profit for a period equivalent to the amount of depreciation charged as per the WDV method after certain adjustments for sale/obsolescence of plant and equipment. Also, while creating depreciation reserve fund for the first time, an amount equivalent to the accumulated depreciation will be transferred from the opening surplus in the statement of profit and loss under the head 'reserves and surplus'. Further, an amount equivalent to depreciation reserve fund will be invested in earmarked securities as per the DPE Guidelines, which would be called as DRF Investments. The interest earned on such investments will be recognised in the statement of profit and loss. Similarly, when the investments will be disposed off for replacement of plant and equipment, bank account will be debited with a credit to DRF Investments and the DRF will be debited with a credit to P&L Appropriation Account. On this basis, the querist has sought the opinion of the Committee as to whether the aforesaid accounting methodology and procedures of the company are correct or not. Accordingly, the Committee has restricted itself to such issues and has not considered any other issue that may arise from the Facts of the Case, such as, the amount that should be appropriated to DRF, etc. The Committee has also not considered accounting entries to be passed by the company as the same may vary depending on the situation, for example, accounting entry for receipt of interest income on investment may vary depending on whether the interest is received periodically or at the maturity of investments. At the outset, the Committee wishes to point out that its opinion is purely from accounting view point and not from the perspective of interpreting provisions of any law since as per Rule 2 of its Advisory Service Rules, the Committee is prohibited from doing so. The Committee also notes from paragraph 3(ii) above that while creating DRF, depreciation for plant and equipment for the preceding financial year, has been adjusted for depreciation on plant and equipment sold or which became obsolete during the *preceding* financial year. The Committee wishes to mention that whether DRF should have been created for depreciation of the preceding financial year or of the current year and whether such adjustments should have been made in respect of the current financial year or preceding financial year,

has not been examined as it does not affect the opinion of the Committee expressed hereinafter. The Committee has also not examined the implication of creation of depreciation reserve fund on creation of statutory reserve/ fund.

6. The Committee notes that over and above the charging of depreciation as per the requirements of the Standard and Companies Act, 1956 in the statement of profit and loss, creation of a depreciation reserve fund for replacement of fixed assets is an appropriation of profits in respect of which there is no specific legal requirement. The Committee is of the view that from the accounting perspective, there is no bar on the company for transfer of profits to such fund. In this context, the Committee also notes Note 6 B (ii) of the General Instructions for Preparation of Balance Sheet of the Revised Schedule VI to the Companies Act, 1956, which provides as follows:

> "(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'."

From the above, the Committee notes that the expression 'Fund' should be used only if the said account is "specifically represented by earmarked investments" otherwise the term 'Reserve' should be used. The Committee notes from the Facts of the Case that while providing accounting entries in respect of creation and utilisation of DRF, the term 'Profit and Loss Appropriation Account' has been used. In this context, the Committee notes that after Revised Schedule VI coming into effect with effect from 1.4.2011, appropriations to the profit for the year (including carried forward balance) are to be presented under the main head 'Reserves and Surplus' (Refer paragraph 8.1.2.9 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, issued by the ICAI) and any appropriation item should not be shown on the face of the statement of profit and loss. Further, depreciation reserve fund should be shown separately alongwith a proper disclosure of the nature, purpose and amount of such fund. The movements in such fund and other balances of reserves/surplus while transferring to/ from such fund since the last balance sheet is also required to be disclosed as per the requirements of the Revised Schedule VI to the Companies Act, 1956. Accordingly, the Committee is of the view that the accounting treatment explained by the querist is not in contradiction to the aforesaid requirements of Revised Schedule VI to the Companies Act, 1956.

D. Opinion

7. On the basis of the above, the Committee is of the opinion that the methodology of the company for creation and operation of DRF is not in contradiction to the Accounting Standards and the Revised Schedule VI to the Companies Act, 1956, as discussed in paragraph 6 above.

Query No. 26

Subject: Accounting treatment of high sea sales/purchase.[1]

A. Fact of the Case

1. A company is a public sector undertaking registered under the Companies Act, 1956. It 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 the petrochemicals after further processing, throughout the country.

2. The company also imports LPG (Propane and Butane) from different foreign suppliers and after bottling, it sells the same to end customers through its dealer network. Similarly, other Oil Marketing Companies (hereinafter called OMCs) also import LPG for similar purposes. Under a written agreement, all OMCs undertake high sea transactions among themselves, i.e., either high sea purchase or high sea sales out of their original import consignment.

3. The agreement between OMCs came into effect from 01.04.2002, the date from which the Administered Price Mechanism (APM) was dismantled by the Government of India.

4. As per the agreement, the querist company has been designated as coordinator for Industry Logistic Plan (ILP) of LPG. The demand for LPG

[1]Opinion finalised by the Committee on 3.9.2013.

has to be worked out by product co-ordinator in consultation with OMCs on the basis of monthly domestic production numbers and demand forecast submission. Based on this, the requirement of import of LPG would be ascertained and projected by product co-ordinator.

5. As per the terms of the agreement signed between OMCs, it covers inter-alia the sale of product/products (LPG) under the agreement by one or more parties to the agreement to one or more parties to the agreement of the quantity to be determined on month to month basis as laid down in ILP.

6. In the above background, these transactions are considered as high sea sale/purchase transactions as they take place before entering the territorial waters of India. For this purpose, the importer and buying OMCs enter into a high sea sales agreement on a non-judicial stamp paper along with details of product, quantity, carrying vessel, bill of lading (B/L) date, high sea sale price (including HSS canalising charges of 0.5% of the cost + freight), applicable exchange rate and the fact that customs duty shall be settled by the buyer at the time of clearance as per the applicable rules and other charges for clearance of cargo shall also be paid by the buyer. Also, it states that the title of cargo will be transferred in the buyer's favour by way of endorsement of the documents of title/ bill of lading on high sea, i.e., before entering India's territorial waters. The agreement is jointly signed by the buyer and seller (importer).

7. The above is accompanied by a declaration to the customs department by the importer informing about the sales of imported LPG (butane and propane) to the buyer OMC indicating the quantities sold and the fact that filing of bill of entry and other necessary formalities connected with clearance of cargo shall be fulfilled by the buyer OMC.

8. The key features of the transaction comprise:

   (i) The agreement among OMCs for high sea sale/ purchase transactions is denominated in Indian Rupee (INR) and finally settled in INR. However, the sale/purchase price is arrived at in INR on the basis of price fixed from the foreign vendor in foreign currency being a back to back arrangement + canalising charges @ 0.5% cost.

   (ii) Purchase cost from the third party supplier on invoice plus canalizing charges, i.e., currently agreed at 0.5% of the cost and freight.

(iii) Importing OMC endorses the bill of lading (B/L) in favour of the buyer OMC any time when the vessel is sailing and before it enters the territorial waters of India. Ownership passes to the buyer OMC after such transfer by the importing OMC. Customs clearance is also done by the buyer OMC.

(iv) The importing OMC raises final invoice on the buyer OMC in INR for the cost, based on the conversion rate of USD on the date of payment which is settled by importing OMC on the due date, in INR.

Thus, the final consideration payable by the buying OMC is the cost applicable for the importing OMC which is inclusive of exchange variation suffered by the importing company.

9. The existing accounting treatment is as under:

(i) The purchase (import) and sales to OMCs are two distinct transactions, backed by two separate contracts.

(ii) Whereas the import is denominated and settled in USD, the sale to OMCs is denominated and settled in INR.

(iii) 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') applies to accounting for transactions in foreign currencies and translating the financial statements of foreign companies (paragraph 1 of AS 11).

(iv) A foreign currency transaction is one which is either denominated in foreign currency or requires settlement in foreign currency (paragraph 8 of AS 11).

(v) The import is denominated and settled in USD and AS 11 is applied. Accordingly, the foreign exchange (FE) variation, if any, from the BL date and settlement date is recognised as FE variation in the statement of profit and loss.

(vi) The sale transaction is a cost plus transaction denominated and settled in INR and thus the difference between the provisional price and final price settled with OMCs is accounted as part of sales. In other words, the consequential exchange variation arising out of settlement between the importing OMC and the foreign vendor is also settled by the importing OMC. However, FE gain/ loss to the extent it pertains to other buyer OMC is recovered from it by adjusting the same in the final invoice raised by the importing OMC.

(vii) The querist has provided the scheme of entries passed during the course of this transaction by the company as Annexure 'A'.

10. The views of statutory auditors regarding treatment of expenditure of such nature are as follows:

Paragraph 11 of Accounting Standard (AS) 9, 'Revenue Recognition', notified under the 'Rules' states as follows:

"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

Further, paragraph 6.1 of AS 9, notified under the 'Rules' states as follows:

"6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. ...”

11. As per AS 9, revenue should be recognised, when property, i.e., risks and rewards in goods is transferred and certainty of payment exists. In the case of high seas sales transaction, the company transfers bill of lading document to OMCs, through which all the risks and rewards are transferred. Certainty of payment also exists as all the OMCs are doing regularly these type of transactions. So all the conditions of AS 9 are satisfied regarding revenue recognition on the date as and when bill of lading is transferred to other OMCs and revenue should be recognised on that day only.

12. Accounting entries to be passed for booking a high seas sales, as per auditors have also been provided by the querist as Annexure B.

13. Thus, the statutory auditors are of the view that the difference between the provisional and final bill amounts of high sea sales transactions, arising due to exchange rate variation between the B/L date and the settlement date of the importing OMC should be accounted as exchange loss/ gain in the statement of profit and loss instead of adjustment to sales to buyer OMCs.

14. Some of the significant provisions of AS 11, notified under the ‘Rules’, that are attracted in the issue have been reproduced below:

“1. This Standard should be applied:

(a) in accounting for transactions in foreign currencies; and

(b) in translating the financial statements of foreign operations.”

“Initial Recognition

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."

"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."

15. Therefore, in the view of the company, since the criteria for recognition of high sea sales/purchase transactions amongst OMCs (as discussed above) as a foreign currency transaction is not satisfied, the provisions of AS 11 shall not be applicable on such high sea sales/purchase transactions.

16. According to the querist, the above is also in line with the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), expressed on the accounting treatment of certain foreign currency transactions, as given in Volume XIX, Query No. 14 dated 4th March, 1999. A gist of the opinion has been provided by the querist as follows:

(a) The opinion deals with the correctness of the accounting treatment and disclosure of interest income on foreign currency loans on back-to-back basis and exchange variation on account of such interest.

(b) In the opinion, the Committee noted that paragraph 17 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' recognises 'Substance over Form' which states that "the accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely the legal form."

(c) Further, the Committee noted that the corporation was required to pay a pre-determined rate of interest on the foreign currency amounts of the loans recorded in the books at the exchange rate prevailing on the date of remittance.

(d) The Committee was of the view that the economic substance and reality of the transactions was that the corporation lent to its borrowers at fluctuating rate of interest. In fact the entire interest in rupee terms payable by the corporation to its lenders was to be recovered from the borrowers.

(e) The Committee, inter alia, was of the view that the true nature of the amount reimbursed by borrowers is that of interest and should be disclosed as such in the profit and loss account. The Committee further viewed that it would be useful to disclose the nature of relevant transactions in the notes to the accounts.

Thus, the Committee was, inter alia, of the opinion that recording of interest income at the book value and crediting the exchange variation on account of such interest under a separate head was not in order. Such recovery of exchange variation from borrowers should be added to the interest recovered on loans.

17. This further strengthens the treatment of exchange variation presently considered by the querist.

18. The querist has also separately informed the steps involved in import/ high sea sales/purchases (i.e., signing of agreement with vendor, agreement between OMCs, etc.) which are as follows:

High Sea Sales:

(i) The company has entered into term contract with overseas suppliers for import of products, mainly LPG. As per the contract and agreed schedules, imports are made on principal to principal basis and bill of lading (B/L) is made in favour of the company. Payments to the suppliers are effected in USD as per the agreed credit term, which is mostly after 30 days of B/L.

(ii) The above purchase is accounted by the company based on the exchange rate as on the date of B/L. When the payments are effected after the credit period, difference between the exchange rate at which payment was effected and the purchase cost (based on the B/L exchange rate) are accounted as exchange fluctuation loss or gain as the case may be.

(iii) Ownership of the product passes to the company on the date of bill of lading.

(iv) The company also enters into agreement with other OMCs for sale of imported product on a high sea sale basis. Such sale is made by endorsement of B/L anytime when the vessel carrying the product is on high sea.

(a) Agreement for sale is made with OMC.

(b) B/L is endorsed in favour of OMCs any time when the vessel is in high seas.

(c) The same is informed to Customs Authorities and OMC completes the customs formalities and takes the product.

(d) Sale invoices are raised on OMCs as per the above sale agreement. The sale is at a margin of 0.5% of INR value of the company's cost and freight.

(v) Such high sea sales to OMCs are accounted as sales in INR for the entire amount (without any exchange fluctuation). Following points are relevant in such sale transactions:

(a) Contract of sale is in Indian Rupees and is in India and the product is transferred by endorsement of B/L anytime during the period when the vessel is in high seas.

(b) At the time of sale, the company is the owner of the product.

(c) Margin of 0.5% is collected on the total cost and freight. To protect the margin, all actual costs associated with the purchases are considered for sale price and payment due date is fixed as same as that of the due date of overseas supplier.

(d) The sale realisation is in INR.

High Sea Purchases:

(i) Transaction of high sea purchase is also similar to the above.

(ii) The company enters into agreement with OMCs for purchase of LPG on high sea sale basis. Consideration of the purchase is in INR, which includes their cost plus margin which is agreed at 0.5% of the cost and freight.

(iii) OMCs endorse the B/L in favour of the company, any time when the vessel is in high seas. Ownership passes to the company after such transfer from OMCs. Customs clearance is done by the company.

(iv) OMCs raise an invoice on the company in INR for the cost, which is settled by the company on the due date, in INR.

(v) The total cost is debited to purchases.

19. The querist has also separately informed with regard to ensurement of quality control and normal course of taking insurance for these imports as follows:

- Mutually accepted surveyors are appointed by importers, who witness the tests and loadings as per the procedure in vogue in the terminals.
- Survey costs are also shared between the importer and vendor.
- High sea buyers are not conducting any surveys at load port.
- Insurance is arranged by the high sea buyers for their stock. Ocean loss is also shared in the ratio of ownership of the quantity imported.

B. Query

20. On the basis of the above, opinion of the EAC is sought by the querist on the following issues:

(i) Whether the accounting treatment of the transaction presently given by the querist for high sea sales/purchase to/from other OMCs as mentioned above is in order.

(ii) Whether the provisions of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' are applicable on such high sea sale/purchase transactions among OMCs denominated and settled in INR.

(iii) If yes, what should be the accounting treatment to be given by the querist for the differences between the provisional and final bill value arising on such high sea sale/purchase transactions due to exchange variation between B/L date and settlement date of importing OMCs.

C. Points considered by the Committee

21. The Committee notes that the basic issue raised in the query relates to accounting for the differences between the provisional and final bill value arising on high sea purchases/sales transactions due to exchange variation between B/L date and settlement date of importing OMCs. The Committee has, therefore, considered only the issues raised by the querist in paragraph 20 above and has not examined any other issue(s) that may be contained in the Facts of the Case, such as, accounting for canalising charges, accounting for expenses incurred towards the import transaction, disclosure requirements of Schedule VI to the Companies Act, 1956 in respect of imported items, the appropriateness of the timing of recognition of high sea sales or purchase and assumes that in case of high sea sales/ purchase transaction, the transfer of risks and rewards occurs on endorsement of the document in favour of the buyer, as per the Facts of the Case provided by the querist. The Committee has also not revisited its earlier opinion referred to in paragraph 16 above, with respect to the issues raised by the querist in paragraph 20 above. The Committee presumes from the Facts of the Case that there is no principal-agency relationship and that the OMCs act on a principal-to-principal basis. The Committee also wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective such as, legal interpretation of agreements including high sea sales/purchase agreement entered into between various OMCs since as per Rule 2 of the Advisory Service Rules, the Committee is prohibited from doing so.

22. The Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the 'Rules', 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."

In view of the above, the transactions and events are accounted for and presented in accordance with their substance, i.e., the economic reality of events and transactions, and not merely in accordance with their legal form. In other words, it is the ‘economic reality’ that is important in accounting and not only the ‘legal reality’. In the extant case, the Committee notes from the Facts of the Case (paragraphs 8 (i) and (iv) above) that in respect of high sea sales/purchase, the importing OMC raises two invoices on the buying OMC - the provisional invoice and final invoice. The amount of both of these invoices is arrived at in Indian rupees on the basis of price fixed with the foreign vendor. From this, the Committee notes that although the invoices so raised are denominated in Indian rupees, they are Indian Rupees equivalent of the price charged by the foreign vendor, which is denominated in foreign currency. Hence, the Committee is of the view that while it is true that the price charged to the buying OMC is in INR, it is actually ‘linked’ to foreign currency. That’s why two invoices - provisional invoice and final invoice are raised. Accordingly, the Committee is of the view that while prime obligor in settlement of the liability denominated in foreign currency is the importing OMC, it is the buying OMC which, in substance, assumes the liabilities denominated in foreign currency in respect of high sea sales/ purchase that are settled in Indian Rupee equivalent amount.

23. As far as applicability of AS 11 to high sea sales/purchase is concerned, the Committee notes paragraph 1 of AS 11, which deals with applicability of the Standard:

> “1. This Standard should be applied:
>
> (a) in accounting for transactions in foreign currencies; and
>
> (b) in translating the financial statements of foreign operations.”

The Committee further notes paragraph 8 of AS 11, as provided below:

> “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."

From the above, the Committee notes that AS 11 is applicable to foreign currency transactions where an enterprise acquires or disposes of assets or incurs or *settles liabilities, denominated in a foreign currency*. The Committee notes from the discussion in paragraph 22 above that the buying OMC is, in substance, settling the liabilities denominated in foreign currency and accordingly, the Committee is of the view that AS 11 is applicable to high sea sales/purchase in the extant case.

24. As regards accounting for the difference between the provisional bill and the final bill value of high sea sales/purchases, the Committee notes paragraph 9 of AS 11 which states as follows:

> ***"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."***

The Committee is of the view based on the above that since an enterprise initially, recognises a foreign exchange transaction on the date of the transaction, the exchange rate variation is recognised if rate of exchange changes thereafter. Presuming that provisional bill has been raised on the date of endorsement of B/L, the Committee notes that in the extant case, the date of transaction of high sea sales/purchase is the date of endorsement of B/L as the ownership in goods passes to the buying OMCs through endorsement of B/L. Accordingly, the high sea sales/purchase transaction should be recorded by applying the exchange rate prevailing on the date of endorsement of B/L and any foreign exchange variation occurring thereafter till the date of settlement irrespective of date of final bill should be recorded as foreign exchange difference in the books of buying OMC as per the principles of AS 11.

The Committee wishes to point out that if the provisional bill includes any exchange variation arising between the original date of bill of lading and the date of its endorsement, then it will automatically become a part of purchases/ sales value as discussed above and no separate accounting treatment is required for such exchange difference.

D. Opinion

25. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 20 above:

(a) No, the accounting treatment of the transaction presently given by the querist for high sea sales/purchase to/from other OMCs, as discussed above is not in order.

(b) Since the buying OMC is, in substance, settling the liabilities denominated in foreign currency, AS 11 is applicable to high sea sales/purchase in the extant case as discussed in paragraph 23 above.

(c) The cost of high sea sales/purchase should be recorded by applying the exchange rate prevailing on the date of endorsement of B/L, which is the date of high sea sales/purchases and any foreign exchange rate variation occurring thereafter till the date of settlement should be recorded as foreign exchange difference in the books of buying OMC as per the principles of AS 11, as discussed in paragraph 24 above.

Annexure A

Scheme of entries passed by the company

A. At the time of High Sea Purchase:

Debit Purchases

(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

Credit Sundry Creditors for Purchases - OMC A/c

(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

B. At the time of High Sea Sales:

a. At the time of Import:

Debit Purchases

(Cost of product USD @ exchange rate on the date of B/L)

Credit Sundry Creditors for Purchases

(Cost of product USD @ exchange rate on the date of B/L)

b. At the time of making payment:

Debit Sundry Creditors for Purchases

(Cost of product USD @ exchange rate on the date of Payment)

Credit Bank Account

(Cost of product USD @ exchange rate on the date of Payment)

Debit/Credit Sundry Creditors for Purchases

(Difference between Purchases as per (a) and Payment (b))

Debit/Credit Exchange Fluctuation Account

(Difference between Purchases as per (a) and Payment (b))

c. At the time of High Sea Sales

Debit OMC Customer A/c

(Cost of product USD + Margin@ 0.5% @ exchange rate on the B/L date)

Credit Sales

(Cost of product USD + Margin@ 0.5% @ exchange rate on the B/L date)

d. At the time of Account Closing date/Final invoice

Debit OMC Customer A/c

(With the amount of costs/ exchange variation recovered in High Sea Sales)

Credit Sales

(With the amount of costs/ exchange variation recovered in High Sea Sales)

Annexure B

Statutory Auditor's view on entries to be passed in a High Seas Sale/ Purchase transaction

1. In a High Sea Sale transaction, following entries should be passed

a. At the time of Import:

Debit Purchases

(Cost of product USD @ exchange rate on the date of B/L)

Credit Sundry Creditors for Purchases

(Cost of product USD @ exchange rate on the date of B/L)

b. At the time of making payment:

Debit Sundry Creditors for Purchases

(Cost of product USD @ exchange rate on the date of payment)

Credit Bank Account

(Cost of product USD @ exchange rate on the date of payment)

Debit/Credit Exchange Fluctuation Account

(Difference between Purchases as per (a)(ii) and Payment (b)(i)

c. At the time of High Sea Sales:

Debit OMC Customer A/c

(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of endorsement of bill of lading)

Credit Sales

(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of endorsement of bill of lading)

d. At the time of receipt of payment from other OMCs:

Debit Bank A/c

(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of invoice)

Credit OMC Customer A/c

(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of invoice)

Debit/Credit Exchange Fluctuation Account

(Difference between as per c (i) and d(ii))

2. In a High Sea Purchase transaction, following entry should be passed:

(a) Debit Purchases

(Cost of product USD @ exchange rate on the date of endorsement of bill of lading/date of invoice, margin @ 0.5% and all expenses payable to OMC)

Credit Sundry Creditors for Purchases - OMC A/c

(Cost of product USD @ exchange rate on the date of invoice/date of endorsement of bill of lading, margin @ 0.5% and all expenses payable to OMC)

(b) Debit Sundry Creditors for Purchases - OMC A/c

(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

Credit bank A/c

(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

Debit/Credit Exchange Fluctuation Account

(Difference between as per a (ii) and b (i))

Query No. 27

Subject: Determination of 'normal operating cycle period' under revised Schedule VI to the Companies Act, 1956.[1]

A. Facts of the Case

1. A company is a navratna defence public sector undertaking. It is a multi-unit (nine manufacturing units) and multi-product company (with over 350 products). The products are in the area of military communication, radars, naval systems, C4I systems, electronic warfare systems, etc.

2. The querist has stated that as per Note 1 to General Instructions for Preparation of Balance Sheet under Revised Schedule VI to the Companies Act, 1956, issued by the Ministry of Corporate Affairs (MCA), "An asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

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

(c) it is expected to be realized within twelve months after the reporting date;

or

(d) it is Cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

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

Similarly, "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

[1] Opinion finalised by the Committee on 15.11.2013.

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. ...

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

Further, under Revised Schedule VI, an operating cycle has been defined as follows:

"An operating cycle is the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months."

3. The querist has further stated that it has been clarified in the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI) that a company's normal operating cycle may be longer than twelve months e.g., companies manufacturing wines, etc. However, where the normal operating cycle cannot be identified, it is assumed to have duration of twelve months.

Determination of operating cycle period in the company:

4. The products of the company are of different categories varying from small components to setting up of large communication systems each with different operating cycle varying from few months to more than a year. Also, there is no other comparable company, within India, with such a product mix. In view of the diversified product mix, it is not appropriate to determine a common operating cycle at company/unit level.

5. Also, determination of a common operating cycle at product level is not feasible since even in case of similar products, for example, radar, the operating cycle in respect of each contract (for supply of radar) can vary. This is due to the fact that each contract for radar may have its unique technical specification, complexity (leading to different production cycle time), installation and commissioning requirements (the time for installation and commissioning may vary depending on the terrain where a radar is required to be installed).

6. As the company is not in a position to determine operating cycle period at company/unit level/ product level, it has decided to determine operating cycle period at 'individual contract level'.

7. According to the querist, normal operating cycle period can be determined mostly based on past data which is available either within the company or in the industry in which the company operates. As the company operates in the defence sector (almost 80% to 85% of its products are sold to Indian Defence Forces) and in most of the cases, the company is the sole supplier of its products, industry related comparative data is not available in respect of its products for determination of the normal operating cycle period.

8. Also, since in the company, majority of the contracts are unique (and do not generally have a precedent), it is not possible to determine its 'normal operating cycle' period as determination of the normal operating cycle period would presuppose that a similar production activity has been carried out earlier and hence a reference (i.e., normal) period is available.

9. The querist has also stated that taking twelve months as the normal operating cycle period citing non-determinability of normal operating cycle period would be misleading since this would amount to treating inventory/ trade receivables relating to most of the high value contracts as non-current since the delivery period in respect of these contracts would be generally more than twelve months and going upto even 36 or 48 months.

10. Also, it is not uncommon for the contract execution period getting extended beyond its originally agreed date due to customer request (like change in specifications of the product, non-availability/readiness of installation site, etc.) or company's request (non-availability of material, technical issues, etc.). The company has also considered the extended period for execution of the contract, as mutually agreed between the parties (with or without levy of liquidated damages), as a part of the normal operating cycle period in the absence of a reference period (i.e., normal period) within which a contract is to be completed.

11. Considering all the above factors and after detailed discussions internally and with chartered accountancy firms, the company during the year 2011-12, has decided to determine operating cycle at individual contract level and has also treated the execution period in respect of each contract as its normal operating cycle period.

12. As per the querist, non-determination of the 'normal operating cycle' period at contract level raises an issue with respect to the current/non-

current classification of assets and liabilities especially in relation to classification of inventory and trade receivables.

Inventory

13. The querist has stated that as per revised Schedule VI norms, subject to other conditions, inventory purchased for execution of a contract would have to be classified as non-current if it is likely to be used beyond the normal operating cycle period of the contract. However, in the absence of determination of normal operating cycle period of a contract, the company has classified all inventories held against a contract as current till the contract is fully executed (however, inventory in respect of which provision – as non-moving/slow moving item – has been made is treated as non-current). According to the querist, while this appears apparently to be in contradiction to the classification criteria as defined in revised Schedule VI, it is in line with the ICAI clarification[2] that *all inventory is current* even in cases where provision for non-moving and slow moving items has been made (emphasis supplied by the querist). In view of the above, non-determination of normal operating cycle period at company/unit level does not seem to impact the company's current/non-current classification of inventory.

Trade Receivables

14. The querist has further stated that as per revised Schedule VI norms, subject to other conditions, trade receivables realisable beyond the normal operating cycle would have to be classified as non-current. However, in the absence of determination of normal operating cycle period of a contract, the company has classified all trade receivables outstanding against a contract as current till their realisation. However, where contract execution period has been extended by the customer with a condition that liquidated damages will be levied for the delayed delivery, the amount equivalent to the liquidated damages leviable (normally limited, as per contract, to a maximum amount of 5%/10% of the value of delayed delivery) is treated as doubtful at the time of booking of the sale itself, and classified as non-current. In addition, trade receivables identified as doubtful as per the company's accounting policy are also classified as non-current.

[2] The Committee wishes to clarify that the stated clarification is only a part of the Frequently Asked Questions (FAQs) on the Revised Schedule VI, issued by the Corporate Laws and Corporate Governance Committee of the ICAI.

15. The company is of the view that, on account of the above practice, non-determination of normal operating cycle period has no major impact on the company's classification of trade receivables due to the following reasons:

- As the company generally does not grant credit to its customers beyond 30/60 days from the date of invoice, all trade receivables (other than those where deferred credit has been granted) are *expected to be realised within twelve months of reporting date* and hence, qualify for classification as 'current assets' irrespective *of the normal operating cycle period of the contract* (emphasis supplied by the querist).
- Where trade receivables are not expected to be realised due to levy of liquidated damages, the same are immediately classified as non-current.
- Where trade receivables are not expected to be realised due to any other reason, the same are classified as doubtful and provision for the same is made as per the company's accounting policy and the corresponding trade receivable amount is classified as non-current.

B. Query

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

(i) Whether the company can continue with the present practice of treating the execution period of each contract as it's normal operating cycle period, i.e., without pre-determining its normal operating cycle period on a company/unit/production level.

(ii) Whether the company's classification of inventory and trade receivables as explained above is in line with the revised Schedule VI requirement.

(iii) In case the company's methodology is not in line with the revised Schedule VI requirement, the appropriate way of identifying the normal operating cycle period for the company (taking into account the complexities as explained above) so as to reflect its financial position in a correct manner may be advised.

C. Points Considered by the Committee

17. The Committee notes that the primary question raised by the querist relates to the determination of normal operating cycle and classification of inventories and trade receivables as current or non-current assets in accordance with the revised Schedule VI to the Companies Act, 1956. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as, classification of assets/liabilities other than inventories and receivables, accounting treatment of liquidated damages, revenue recognition and recognition of doubtful debts in relation to leviable liquidated damages, constituents of normal operating cycle period, classification of receivables that are on deferred credit terms, etc.

18. The Committee notes from the definition of 'current asset' as per Note 1 of 'General Instructions for Preparation of Balance Sheet' to the revised Schedule VI that for classification of an asset as current, it has to be determined whether that asset is expected to be realised or intended for sale or consumption within the company's normal operating cycle period. Further, in case an asset is held primarily for trading, or is expected to be realised within 12 months after the reporting date or is a cash or cash equivalent, it may also be classified as a current asset. The normal operating cycle period has been defined as the time between the acquisition of assets and their realisation into cash or cash equivalents. Accordingly, for classification of inventories and debtors as current, it is to be seen as to whether at the reporting date, these are expected to be realised within the normal operating cycle of the company. They can also be classified as current if they meet any of the other relevant condition(s) as mentioned above.

19. As regards determination of normal operating cycle period, the Committee is of the view that normal operating cycle is the *normal time* taken from initial acquisition of assets for processing to their realisation into cash or cash equivalents. The Committee notes from the Facts of the Case that the company in the extant case is engaged in multiple businesses and product lines making it difficult to determine single normal operating cycle for the company. Further, the querist has also stated that in case of similar products also, the operating cycle varies due to unique technical specifications, etc. In this regard, the Committee notes the following paragraphs of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956:

> "7.2 The term "Operating Cycle" is defined as the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. A company's normal operating cycle may be longer than twelve months e.g. companies manufacturing wines, etc. However, where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months.
>
> 7.2.1. Where a company is engaged in running multiple businesses, the operating cycle could be different for each line of business. Such a company will have to classify all the assets and liabilities of the respective businesses into current and non-current, depending upon the operating cycles for the respective businesses. ..."

On the basis of the above, the Committee is of the view that in the extant case, normal operating cycle should be determined for different product lines and businesses considering their nature. The Committee is of the view that in common parlance, operating cycle refers to the time taken from the outflow of cash or cash equivalents for acquisition of assets for processing until the cash or cash equivalents realised therefrom. Thus, operating cycle in the extant case should be determined in respect of each of the product lines/businesses of the company on the basis of related cash outflows to cash realisation. The Committee is further of the view that in a single product line/business also, there could be different operating cycles depending on the milestones specified in the contract and complexity of the product, etc. The Committee is of the view that these milestones should also be considered while determining the normal operating cycle provided these result into realisation of cash. For example, where a contract has milestones according to which after a defined work has been performed, a payment becomes due within a specified period, these milestones should be considered for classification of assets and liabilities as current or non-current. Similarly, the Committee is of the view that the complexity of the product should also be considered while determining operating cycle for different product lines/ businesses. The Committee is further of the view that if the company produces products of similar nature involving significantly different production time periods due to different levels of complexities involved, then such products should be considered to constitute different product lines. For instance, the company is producing radars – one type of radar may be constructed in say two months while the other type of radar may be constructed in say two years time because the latter type of radar is more advanced and involves more complex technology than the former. The

Committee is of the view that in this case, the two radars should be considered to be constituting different product lines. Thus, the Committee is of the view that irrespective of the different types of contracts the company is engaged into, it should identify different nature of product lines and businesses in which it is engaged and then determine the normal operating cycle for each such product line and business. As regards the querist's argument regarding absence of past experience or similar trend in the industry, the Committee is of the view that the operating cycle should be determined considering the normal estimated/expected time taken in performing each activity necessary for the products of similar nature. However, if it is not practicable for the company to determine operating cycle on the basis of above discussion, then operating cycle should be assumed to be 12 months. Therefore, the Committee is of the view that operating cycle cannot be determined on contract basis.

20. As regards classification of inventories as current assets, the Committee notes the following paragraphs of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956:

> "7.1.5. Based on the definition, current assets include assets such as raw material and stores which are intended for consumption or sale in the course of the company's normal operating cycle. Items of inventory which may be consumed or realised within the company's normal operating cycle should be classified as current even if the same are not expected to be so consumed or realized within twelve months after the reporting date. Current assets would also include assets held primarily for the purpose of being traded such as inventory of finished goods. They would also include trade receivables which are expected to be realized within twelve months from the reporting date and Cash and cash equivalents which are not under any restriction of use."
>
> 7.2.1. ...
>
> Let us consider the following other examples:
>
> 1. A company has excess finished goods inventory that it does not expect to realize within the company's operating cycle of fifteen months. Since such finished goods inventory is held primarily for the purpose of being traded, the same should be classified as "current".
>
> 2. ..."

As mentioned above, inventory is primarily intended for consumption or sale in the course of the normal operating cycle or for the purposes of being traded. Accordingly, it should be classified as a current asset. The Committee notes that in the extant case, the company purchases inventory for execution of a contract out of which certain items have been identified by it as non-moving/slow moving. Thus, in the extant case, inventories are held by the company for use in the manufacturing process and not for trading. The Committee has also considered the FAQs on the Revised Schedule VI, as referred by the query in paragraph 13 above. However, the Committee is of the view that if at any reporting date, a portion of inventory is identified as non-moving/slow inventory, it signifies that such inventories are not expected to be consumed within the normal operating cycle of the product or business to which it pertains. Hence, such inventories should be classified as 'non-current'.

21. As regards classification of trade receivables, the Committee notes paragraph 8.8.3 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956 as given below:

> "A trade receivable will be treated as current, if it is likely to be realized within twelve months from the date of Balance Sheet or operating cycle of the business."

From the above, the Committee is of the view that the classification of trade receivables should reflect the factual position in the context of realisablity within the normal operating cycle as discussed above. The Committee notes from the Facts of the Case that trade receivables equivalent to liquidated damages leviable for delayed delivery are considered as doubtful debts and hence are classified as non-current. The Committee does not agree with this classification of the company. The Committee is of the view that a trade receivable should be classified as current or non-current depending on its realisation within normal operating cycle as discussed above. The Committee further notes that the Revised Schedule VI requires disclosure of doubtful debts separately for current and non-current receivables. Thus, the Committee is of the view that the classification of doubtful debts should be based on the classification of trade receivables to which doubtful debts pertain. Accordingly, in the extant case, the entity's classification of receivables that are not expected to be realised on account of levy of liquidated damages as non-current is incorrect.

D. Opinion

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

(i) The entity, in the extant case, should determine the normal operating cycle for each business and product line separately by considering the cash outflow to cash realisation as well as milestones, as discussed in paragraph 19 above.

(ii) & (iii) The classification of inventories as current is correct except in case of non-moving/ slow inventories, which should be classified as non-current, as discussed in paragraph 20 above. The entity's classification of trade receivables to the extent of leviable liquidated damages as non-current is not in line with the revised Schedule VI, as discussed in paragraph 21 above. As regards determination of normal operating cycle, the company should identify the product lines and businesses in which it is engaged into and then it should determine the normal operating cycle for each such product line or business considering the normal estimated/expected time taken in performing each activity necessary for the products of similar nature, as discussed in paragraph 19 above.

Query No. 28

Subject: Accounting treatment of post-retirement medical benefit scheme.[1]

A. Facts of the Case

1. A corporation (hereinafter referred to as 'the corporation') is a public sector undertaking, incorporated under the Warehousing Corporations Act, 1962 for providing warehousing services for agricultural produce, seeds,

[1] Opinion finalised by the Committee on 15.11.2013.

fertilizers, agricultural implements and other notified commodities. The corporation is having an employee benefit scheme, viz., Post Retirement Medical Benefit Scheme ('PRMS') for its retired employees, where the corporation makes payment for the OPD expenses directly and has taken group mediclaim insurance cover for indoor hospitalisation expenses and the claims are settled by the insurance company. The annual premium is paid to the insurance company for the same by the corporation.

2. Till 2004-05, the corporation had been accounting for the expenses made on 'PRMS' scheme on 'pay-as-you-go' basis. Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits'[2] was issued by the Institute of Chartered Accountants of India in the year 2005, which became mandatory for implementation w.e.f. 1st April, 2006. As a pro-active step to implement AS 15 (revised 2005), the corporation, before finalising its accounts for the year 2005-06, had gone in for actuarial valuation of PRMS benefits as required by that Standard. The liability on account of PRMS benefits for the period up to 31st March, 2006 was valued by the actuary. The current year cost was charged to revenue and for the resultant past period cost valued at Rs. 8,814 lakh for the period up to 31st March, 2005, the corporation did not distinguish between the vested and non-vested benefits and decided to amortise the same over a period of five years w.e.f. 2005-06 and 1/5th of the amount of past period cost of Rs. 1,763 lakh was amortised in that year.

3. The above accounting treatment made was referred to the Expert Advisory Committee by the corporation vide its letter dated 23.01.2007. The opinion of the Committee was communicated to the corporation vide letter dated 16.08.2007, in which the Committee had opined that the past period cost amounting to Rs. 8,814 lakh should be charged as a prior period item in the books of account. (The opinion of the Committee has been published in the Compendium of Opinions, Volume XXVII, Query No.17).

4. The querist has stated that at the time of seeking opinion from the Committee, the corporation did not have the break-up of the past service cost for vested and non-vested benefits for which different accounting treatments have been envisaged in AS 15 (revised 2005). Therefore, as per the querist, the opinion received from the Committee could not be followed. After having the break-up of past period cost into vested and non-vested

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[2]Subsequently, AS 15 (revised 2005), was notified as AS 15, 'Employee Benefits' under the Companies (Accounting Standards) Rules, 2006, with some changes relevant for Small and Medium-Sized Companies.

benefits, the corporation reviewed the accounting treatment to be made while finalising the accounts for the year 2007-08 as per AS 15 (revised 2005). The following accounting treatment was made by bifurcating the past period cost into vested and non-vested benefits for which necessary disclosure was made in the Notes to Accounts for the year 2007-08 as under: (The querist has furnished a copy of annual accounts for the year 2007-08 for the perusal of the Committee).

> "Corporation implemented AS 15 (revised) in the year 2005-06 and the actuarial valuation of employee benefits was carried out. With respect to Post Retirement Medical Benefits (PRMS), the past service cost was valued at Rs. 8,814 lakh as on 31.03.05 which was decided to be absorbed over a period of five years w.e.f. 2005-06 and accordingly cost of Rs.3,525.60 lakh was amortised upto year 2006-07. As this accounting treatment was not found to be correct, the necessary rectification has been made in accounts by differentiating between the vested benefits and non-vested benefits as per AS 15 (revised).
>
> Accordingly, the past period cost of Rs. 1,225.07 lakh has been charged to revenue as prior period expenditure and Rs. 406 lakh towards 1/12 of the cost of non-vested benefits has been charged to revenue during the year as current year expenditure, as per details given below:
>
> i. Total past period cost for PRMS of Rs. 8,814 lakh has been bifurcated into vested benefit of Rs. 3,938 lakh and non-vested benefits of Rs. 4,876 lakh. Non-vested benefits have been recognised over average period of left over service of 12 years with effect from 2005-06 on straight-line basis.
>
> ii. The past period cost (vested benefits) and proportionate cost of past period cost (non-vested benefits) up to the year 2006-07 aggregating to Rs. 4,751 lakh was to be charged to revenue till 31.03.07, against which Rs. 3,525 lakh has already been charged. Thus, the difference of Rs.1,225 lakh has been charged to revenue in the year 2007-08 as prior period expenditure.
>
> iii. 1/ 12^{th} of the non-vested benefits past period cost i.e. Rs.406 lakh has been charged to profit and loss in the year 2007-08, and the balance Rs.3,657 lakh has been carried forward as unamortised expenditure to be charged over the remaining average period of left over service i.e. 9 years."

The above accounting treatment was accepted by the statutory auditors and no comments were issued by the Comptroller and Auditor General (C& AG) Office on this.

5. As there was also an improvement in PRMS for reimbursement of hospitalisation expenses from Rs. 1.00 lakh to Rs. 1.25 lakh w.e.f. 1.4.2008 and the resultant past period cost was Rs. 1,085.42 lakh as on 31.03.2008, similar accounting treatment was made for past period cost based on its bifurcation into vested and non-vested benefits and the following disclosure was made in the Notes to Accounts for the year 2007-08:

> "f. As there was an improvement in the Post Retirement Medical benefit scheme for reimbursement of hospitalisation expenses from Rs. 1.00 lakh to Rs. 1.25 lakh w.e.f. 1.4.2008, the actuarial valuation for the past service cost of Rs.1,085.42 lakh as on 31.3.2008, has been bifurcated into vested benefits for retired employees and non-vested benefits for existing employees at Rs. 220.99 lakh and Rs. 864.43 lakh respectively. The vested benefit has been charged to the profit and loss account and the non-vested benefit has been recognised over the average period of left over service of the existing employees i.e., 10 years. Accordingly 1/ 10th cost amounting to Rs. 86.44 lakh has been charged to profit and loss in the current year and the balance Rs. 777.99 lakh has been carried forward as unamortised expenditure to be written off over the remaining 9 years."

6. As per the querist, the above accounting treatment of past period cost based on benefits being vested as well as non-vested was made keeping in view the provisions of paragraph 94 of AS 15 (revised 2005), which reads as below:

> ***"94. In measuring its defined benefit liability under paragraph 55, an enterprise should recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately, following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately."***

7. As can be seen from the above provision in paragraph 94 of AS 15 (revised 2005), the Standard provides for amortisation of non-vested past service cost over the average period until the benefits become vested. As

per the querist, this has been followed by the corporation for accounting of past service cost of PRMS w.e.f. 2005-06 to 2011-12. The corporation is of the view that the accounting treatment given in the accounts for the past period cost of PRMS by bifurcation of the same into vested and non-vested benefits and charging the vested benefit in the same year as it arose and the non-vested benefit being amortised over the average period of left over period of service is in line with AS 15 (revised 2005).

8. As per the querist, the accounting treatment of amortisation of amount of past period cost of non-vested benefits over the average left over period of service of the employee has been followed up to the year 2011-12 and as on 31.3.2012, Rs. 2,463.88 lakh remains unamortised.

9. The C&AG Audit, while conducting its supplementary audit of the corporation for the year 2011-12, observed that the opinion of the Committee given on 16.08.2007 has not been followed by the corporation. Based on the contention of the corporation that (i) at the time of seeking the said opinion from the Committee, the corporation did not have break-up of the vested and non-vested benefits of past period cost, (ii) early implementation of Accounting Standard is encouraged, and (iii) the accounting treatment has been in line with AS 15 (revised 2005), the C&AG Office suggested that the opinion of the Committee be sought on whether the balance amount of unamortised expenditure on account of PRMS as on 31st March, 2012 amounting to Rs. 2,463.88 lakh should be charged to revenue as prior period expenditure in the year 2012-13 or the same can continue to be amortised over the balance period of service of the employees, as being done by the corporation.

10. When the issue was referred to the Committee in 2007, the corporation could not furnish the details of vested and non-vested benefits of the past period cost. At that time, AS 15 (revised 2005) had just been introduced and there was no clarity to the corporation with regard to its bifurcation into vested and non-vested benefits.

11. The querist has separately clarified the following:

(i) The employee benefit of PRMS will vest for the existing employees only after their retirement and only for those who voluntarily opt for the Scheme by paying the required contribution. Therefore, for existing employees, this employee benefit is in the nature of ‘non-vested’ benefit and for retired employees who have already opted for this Scheme, the benefit is ‘vested’ one.

(ii) The corporation revised the PRMS in the year 2004-05 where the reimbursement of OPD expenses of Rs.12,000/- per annum continued to be same as per the old scheme, whereas, for reimbursement for indoor hospitalisation expenses, the earlier limit of Rs. 30,000/- was increased to Rs.1,00,000/-. In the pre-revised scheme, benefit of indoor hospitalisation up to Rs. 30,000/- was being reimbursed directly by the corporation. After revision of the Scheme, the Group Mediclaim insurance policy was purchased by the corporation for sum insured of Rs.1,00,000/- per retired employee which covered the retired employee and his/her spouse.

(iii) As per the revised PRMS, the past period cost as on 31.03.2005 was valued by the actuary at Rs. 8,814 lakh which was bifurcated into vested benefit of Rs. 3,938 lakh and non-vested benefit of Rs. 4,876 lakh.

(iv) The corporation got the actuarial valuation done on the earlier indoor hospitalisation benefit of Rs. 30,000/- per annum. As per the actuarial certificate dated 05.04.13 (copy of which has been furnished by the querist for the perusal of the Committee), the valuation of total liability of past period cost is Rs. 5,748 lakh comprising of vested benefit of Rs. 2,670 lakh (for retired employees) and non-vested benefit of Rs. 3,078 lakh (for existing employees).

(v) As already informed, the corporation used to charge the medical expenses of retired employees on 'pay-as-you-go' basis upto the financial year 2004-05. Due to introduction of AS 15 (revised 2005), and revision of the Scheme, the actuarial valuation of liability was made in the year 2005-06.

(vi) In Note No. 14 of the Notes to Accounts for the year 2005-06, it has been mentioned that "in respect of Medical Expenses of retired employees, the corporation has been charging the same to revenue in the respective year on 'pay-as-you-go' basis upto 31.03.2006 in terms of AS 15 (pre-revised)". This was a typographical error. The date 31.03.2006 should be read as 31.03.2005.

B. Query

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

(i) Whether the early implementation of Accounting Standard is encouraged and the steps taken by the corporation for early implementation of AS 15 (revised 2005) issued by the Institute in the year 2005 and implemented by the corporation in the year 2005-06 and being continued thereafter are in order.

(ii) Whether the balance amount of unamortised past period cost can continue to be amortised over the left over period of service, as per the accounting treatment given by the corporation in earlier years or unamortised balance of past service cost of non-vested benefit as on 31.03.2012 of Rs. 2,463.88 lakh should be charged to the statement of profit and loss in the year 2012-13 as past period expenditure.

C. Points considered by the Committee

13. The Committee notes that the basic issues raised by the querist relate to implementation of AS 15 (revised 2005), 'Employee Benefits', from the year 2005-06 and the treatment of unamortised past service cost of non-vested benefit relating to PRMS as on 31.03.2012. The Committee has, therefore, considered only these issues and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting for contribution made by employees, whether the effect of increase in benefits with effect from 01.04.2008 should have been accounted for in the year 2008-09 or in the year 2007-08 as mentioned in the annual accounts for 2007-08, accounting for mediclaim policy taken against PRMS, etc. The Committee also wishes to point out that while the Facts of the Case provide the information about the improvements/changes in the employee benefits under PRMS only for the period 2004-05 and 2007-08, and their related figures, there may be several factors which may affect the period of amortisation of the past service cost and the unamortised portion as on 31.03.2012, such as, introduction of, and changes in, the PRMS benefit prior or post the above stated period, amount of benefits remaining unvested and average vesting period prevailing on the date(s) of introduction/changes in the benefit, etc. From the Facts of the Case, it is not clear as to whether the stated amounts of 'past service cost', the 'non-vested portion' thereof

and 'unamortised' portion thereof have been computed as per the principles of AS 15 or not. Accordingly, the Committee has provided only the accounting principles involved and has not verified the correctness of the various amounts.

Further, the Committee notes that the querist has stated that AS 15 (revised 2005) was implemented by the corporation in the year 2005-06 itself and there was a typographical error in mentioning the implementation date of AS 15 in the annual accounts for that year (see paragraph 11 above). However, the earlier opinion (published in Compendium of Opinions, Volume XXVII, Query No. 17) in respect of the same querist was based on the premise that AS 15 (issued 1995), 'Accounting for Retirement Benefits in the Financial Statements of Employers' (hereinafter referred to as 'AS 15 (pre-revised)') was relevant for the year 2005-06. Hence, the Committee has not examined the issues in the light of its earlier opinion. Further, the Committee reiterates its views expressed in its earlier opinion that 'pay-as-you-go' method is not permitted even under AS 15 (pre-revised) and that under AS 15 (pre-revised), entire past service cost should be charged to profit and loss account[3]. Further, the Committee wishes to point out that the term 'past service cost' is the term used in AS 15 (revised 2005) whereas the querist has used the terms 'past period cost' and 'past service cost' interchangeably at some places. The term 'past period cost' means cost pertaining to past periods, whether accounted or, by mistake, omitted to be accounted for in the past periods, whereas 'past service cost' has a different meaning (see paragraph 15 below). Further, the Committee presumes that there is no occasion where a defined benefit asset arises.

14. As regards early application of AS 15 (revised 2005), the Committee notes that AS 15 (revised 2005) was initially published in March 2005 issue of the Institute's Journal, 'The Chartered Accountant', with the following paragraph on applicability:

> "Accounting Standard (AS) 15, Employee Benefits (revised 2005), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after the date to be announced by the Council in due course. This Standard is mandatory in nature from that date."

[3] As per Revised Schedule VI, the profit and loss account is now referred to as 'Statement of profit and loss'.

The Committee notes from the above that the stated paragraph does not state any implementation date for AS 15 (revised 2005) and that nowhere it was stated that its early adoption was encouraged. Subsequently, the Standard was again published with limited revision in March 2006 issue of the Institute's Journal, and was applicable in respect of accounting periods commencing on or after 1st April, 2006. However, in that issue also, nowhere earlier application of the Standard was encouraged.

Later on, applicability of AS 15 (revised) was deferred to accounting periods commencing on or after December 7, 2006 (instead of April 1, 2006) by virtue of the Announcement of the Institute regarding "Deferrment of Applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005), published in March 2007 issue of the Journal, which states as follows:

> "The Council of the Institute of Chartered Accountants of India (ICAI), at its 265th meeting held on February 3-4, 2007, decided to defer the date of applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005), issued by the ICAI, keeping in view the practical difficulties and general hardship being faced by industry. As per the decision, AS 15 comes into effect in respect of accounting periods commencing on or after December 7, 2006 (instead of April 1, 2006, as stated in the said Standard) and is mandatory in nature from that date. Earlier application of the Standard is encouraged."

Thus, from the above, the Committee notes that the early application of the Standard was possible only from the accounting year 2006-07 and not from 2005-06. The Committee also notes from the notice of the annual general meeting for the year 2005-06 that the financial statements of 2005-06 were adopted by the company on September 28, 2006, by which date, as discussed above, none of the pronouncements of the Institute relating to AS 15 (revised, 2005), contained recommendation of its early adoption. In fact, the early adoption of the revised Standard resulted into non-compliance of the then existing AS 15 (issued 1995). Accordingly, the Committee is of the view that in the extant case, the company could have implemented AS 15 (revised 2005) in the year 2006-07 and not in 2005-06.

15. From the Facts of the Case, it is clear that PRMS is a post-employment defined benefit plan. The Committee first analyses the terms 'past service cost', 'non-vested past service cost' and 'unrecognised past service cost' (also known as 'unamortised past service cost'). The terms 'past service

cost' and 'vested employee benefits' are defined in paragraphs 7.20 and 7.10 of AS 15 (revised 2005) respectively, as follows:

> ***"7.20 Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced)."***

> ***"7.10 Vested employee benefits are employee benefits that are not conditional on future employment."***

Thus, past service cost arises *only* (i) in the period in which new defined benefits are introduced or changes are made to existing defined benefits, and (ii) if service prior to their introduction or changes, as the case may be, results into incurrence of a liability or change in a liability. Thus, it is not necessary that the vested portion of past service cost should relate only to retired employees. It can also relate to existing employees provided they have become entitled to those benefits on account of their past service etc. The Committee is further of the view that as per paragraph 94 of AS 15 (revised 2005) quoted by the querist in paragraph 6 above, non-vested past service cost should be recognised as an expense (i.e., amortised) over the average period until the benefits become vested. The portion of the non-vested past service cost which is yet to be recognised as an expense is known as 'unrecognised past service cost' or 'unamortised past service cost'.

16. The Committee presumes that, in the extant case, the various amounts of 'past service cost', the 'non-vested portion' thereof and 'unamortised' portion thereof have been computed in accordance with the understanding of those terms as explained in paragraph 15 above. The Committee further notes the following transitional provisions of AS 15 (revised 2005) which existed at the time of implementation of that Standard by the corporation[4]:

> ***"144. On first adopting this Standard, an enterprise should determine its transitional liability for defined benefit plans at that date as:***

[4] The transitional provisions were subsequently amended.

> ***(a)*** ***the present value of the obligation (see paragraph 65) at the date of adoption;***
>
> ***(b)*** ***minus the fair value, at the date of adoption, of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102);***
>
> ***(c)*** ***minus any past service cost that, under paragraph 94, should be recognised in later periods.***
>
> ***145. The difference (as adjusted by any related tax expense) between the transitional liability and the liability that would have been recognised at the same date, as per the pre-revised AS 15, should be adjusted immediately, against opening balance of revenue reserves and surplus.***
>
> **..."**

The Committee notes from the above that the corporation could have implemented AS 15 (revised 2005) in 2006-07. While implementing the same, the above quoted transitional provisions of that Standard should have been followed. Hence, AS 15 (revised 2005) should have been applied retrospectively at the time of transition to the Standard. Therefore, non-vested past service cost arising even prior to the date of transition should have been identified and that portion of the said cost which should be amortised after the transition to AS 15 (revised 2005) ('unrecognised past service cost' or 'unamortised past service cost') should have been determined. This is evident from the 'Example Illustrating Paragraphs 144 and 145' given in AS 15 (revised 2005) itself. For the purpose of applying the transitional provisions, item (c) of paragraph 144 of AS 15 (revised 2005) (i.e., 'unrecognised'/ 'unamortised' amount) should be understood as amount that would remain unrecognised/unamortised on the date of transition, had AS 15 (revised 2005) been applied retrospectively. [Under AS 15 (pre-revised), amortisation of past service cost was not permitted].

17. Accordingly, the net amount of the liability on the date of transition should have been determined by deducting the sum of the fair value of plan assets, if any, on the date of transition to AS 15 (revised 2005) and that part of the non-vested past service cost arising on various dates prior to the date of transition from the present value of defined benefit obligation as on the date of transition determined in accordance with AS 15 (revised 2005). The

difference between (i) the net amount so arrived at and (ii) the amount that should have been recognised as per AS 15 (pre-revised) as on the date of transition, *net of any related tax expense (saving) should have* been adjusted against the opening balance of revenue reserves and surplus on the date of transition, i.e., in the year 2006-07.

Thereafter, (i) *unamortised past service cost* deducted from the present value of the defined benefit obligation as on the date of transition should have been amortised in subsequent periods in accordance with paragraph 94 of AS 15 (revised 2005), quoted by the querist in paragraph 6 above ; and (ii) the *non-vested portion of past service cost,* which arose in respect of increase in benefits with effect from 01.04.2008, should also have been amortised in accordance with paragraph 94 of AS 15 (revised 2005).

18. The Committee notes that the corporation has not followed AS 15 (pre-revised) up to 2004-05, since, 'pay-as-you-go' method was not permitted in that Standard. In fact, it should have followed AS 15 (pre-revised) upto the year 2005-06. It has also not followed the transitional provisions as mentioned in paragraph 16 above for implementing AS 15 (revised 2005). Further, the unamortised amount is shown as deferred revenue expenditure in the balance sheet (as seen from the copy of annual accounts for the year 2007-08 furnished by the querist), whereas it should have been adjusted against the present value of the defined benefit obligation for presentation in the balance sheet. The Committee further notes that the adjustment against reserves and surplus as per transitional provisions of AS 15 (revised 2005) is permissible only to the extent of difference between transitional liability (as per paragraph 144 of AS 15 (revised)) as on the date of transition to AS 15, i.e., in the year 2006-07 and the liability that would have been recognised at the same date, as per pre-revised AS 15. Accordingly, in order to rectify the errors of earlier years, the corporation, should ascertain the *net* liability as at the beginning of the current year (i.e., year for which books of account are not yet closed), had AS 15 (revised 2005) been retrospectively applied, as discussed above. The difference, if any, between that amount and *net liability* as per current year's opening balance sheet (i.e., amount shown as liability less fair value of plan assets, if any and if not already deducted from the liability less amount shown as deferred revenue expenditure in respect of PRMS), *net* of tax effect, if any, and to the extent such difference is not adjusted against reserves and surplus as permitted by paragraph 145 of AS 15 (revised), as discussed above, should be recognised in the statement of profit and loss for the current year as a 'prior period item' in

accordance with AS 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the 'Rules'.

19. The Committee wishes to clarify that if service prior to the introduction of PRMS and increase in the benefits under the PRMS is not considered for the benefits/ increase in the benefits, as the case may be, there will not be any past service cost at all.

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 12 above:

(i) The early application of the Standard was possible only from the accounting year 2006-07 and not from 2005-06.The early application of the revised Standard resulted into non-compliance of the then existing AS 15 (issued 1995), as discussed in paragraph 14 above. Accordingly, in the extant case, the corporation should have implemented AS 15 (revised 2005) in the year 2006-07 and not in the year 2005-06 in advance of the effective date of applicability of that Standard.

(ii) The unamortised past service cost (and *not* 'past period cost'), determined in accordance with AS 15 (revised 2005) arising due to changes in the scheme on various dates (even prior to the date of transition), for which amortisation period is not yet over should continue to be amortised in accordance with paragraph 94 of AS 15 (revised 2005). Only if Rs. 2,463.88 lakh represents non-vested unamortised past service cost (as explained in paragraph 15 above) that would have been pending for amortisation on 31.03.2012, had AS 15 (revised 2005) been applied retrospectively, *and* only if the end of the amortisation period of unamortised past service cost arising on various dates is *same*, it can be amortised over the balance period of amortisation. Otherwise, the correct unamortised amounts arising on various dates for which amortisation period is not yet over and their respective amortisation schedules should be determined.

Query No. 29

Subject: Accounting treatment of raw-materials sent to manufacturer by the company for getting finished product.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company'), a Government of India enterprise incorporated under the Companies Act, 1956, is engaged in the business of transmission of power from the generating units to different State Electricity Boards (SEBs) through its transmission network. The company owns and operates more than 90 per cent of India's inter-state power transmission system (ISTS). It operates a network of 96,229 circuit kilometers of interstate transmission lines, 158 EHV AC and HVDC substations. The company intends to continue rapidly increasing its capacity to maintain and grow its leadership position and adding more transmission lines and substations.

2. For construction of transmission lines, one of the major material is conductor. The company is not manufacturing the conductor. It is being purchased from various manufacturers in India. Aluminium is the main raw material to manufacture the conductor.

3. To explore the possibilities in reduction in the cost of conductor, the company is undertaking a pilot project of getting conductor manufactured wherein the aluminium will be procured by the company from aluminium manufacturer and supplied to the manufacturer of conductor for conversion into finished product, i.e., conductor.

4. The company is purchasing aluminium from aluminium manufacturer (hereinafter called 'supplier'). The aluminium is being supplied directly to the manufacturer of conductor (hereinafter called 'manufacturer') on endorsement in favour of manufacturer by the company. The company also raises the invoice for sale to the manufacturer. The company does not collect any payment from the manufacturer of conductor at this stage against the aluminium supplied and shows it as trade receivable in the books. Copies of the contract agreement with the manufacturer and the invoice raised for supply of aluminium rods have been supplied by the querist for the perusal of the Committee.

[1] Opinion finalised by the Committee on 15.11.2013.

5. The querist has stated that the manufacturer, after processing aluminium along with some other raw materials and consumables (purchased by manufacturer at its own cost) like steel, wire, grease etc., manufactures the conductor and supplies it to the company and raises the invoice with full value of conductor as per the contract entered with the company. The company pays the invoice amount after deducting the cost of aluminium already supplied to the manufacturer for the conductor. The contract agreement is also entered with the manufacturer with complete break-up of cost of conductor and adjustment of cost of aluminium. It may be mentioned that the objective of the company in making this arrangement is primarily to enable it to derive the benefit of cheaper input costs (since the company would get better priced sums due to bulk purchases) and possibly greater assurance of timely delivery since the company itself is a PSU. The fact that the manufacturer is not required to finance the cost of raw material inputs during the production cycle is merely incidental and not the object of the transaction. The value of the invoices raised for sale of aluminium to the manufacturer shall not be significant in comparison to the turnover of the company (less than 5%).

6. The salient features of agreements with the supplier and the manufacturer are given below:

(i) MOU with the Supplier:

(a) The company will be giving its annual requirement to the supplier for purchase of aluminium rod. The supplier will deliver the material as per the company's requirements.

(b) The price of the aluminium rod varies from time to time.

(c) Under MOU, the company will be eligible to receive quantity discounts on fulfillment of conditions given in MOU and also PSU discount. Such discounts / rebates given by the supplier may not be passed on to the manufacturer.

(d) The company will make payment to the supplier for the quantity purchased.

(ii) Terms of Letter of Award (LOA) issued to the Manufacturer:

(a) *Scope of Work*: Design, manufacture including delivery of aluminium rod from the supplier's work located at various places in India to be sold by the company to the manufacturers on 'sale-in-transit' basis on purchase of same from the supplier from time to time during contract execution for manufacturing of ASCR Zebra conductor, matching with agreed work schedule, loading, transportation & insurance, unloading, storage and handling of aluminium at works of manufacturer, arranging all other raw materials and consumables etc., on manufacturer costs, conversion of raw material into finished ASCR Zebra conductor, testing and supply on FOR destination site basis of the conductor(s) as detailed in bidding documents.

(b) *Pricing*: The total price of the manufacturer includes:

(i) Ex-price for ASCR Zebra conductor

(ii) Total charges for transportation and insurance of conductors from supplier works to destination

(iii) Testing charges

(c) Terms of Payment:

(i) Manufacturer will not make any payment for invoice raised by the company for aluminium rod.

(ii) The company will make payment for invoice amount raised by the manufacturer after deducting cost of aluminium rod supplied by it.

(iii) Terms of Supply Agreement with the Manufacturer:

Points relating to Accounting Treatment

(a) Design, manufacture including taking delivery of aluminium rod from the supplier's work located at the manufacturer's plant to be sold by the company on sale-in-transit basis.

(b) Loading, transportation & insurance, unloading, storage and handling etc.

(c) Conversion of aluminium rod into finished ASCR Zebra conductor and supply on FOR destination site of the company as per contract.

(d) Pricing

1. Ex-work cost of price for ASCR Zebra Conductor.

2. Add :

   a. Transportation and insurance from supplier work to destination site

   b. Type test charges for test to be conducted.

(e) The ex-work cost of price for ASCR Zebra Conductor shall be determined based on following:

(i) Cost of aluminium rod supplied by the company

(ii) Inward freight and insurances

(iii) Cost of steel wires, grease and other consumables

(iv) Conversion cost (after set-off of input tax paid/CENVAT credit availed on aluminium rod)

(iv) Terms of Post-Bid Discussion with the Manufacturer:

(i) The manufacturer further confirms that in no case he will use aluminium from any other source other than that of the company under this contract. It also confirmed that the aluminium rod sold to him by the company under this contract on 'sale-in-transit' basis shall be utilised by him for supplies to be made under this contract only.

(ii) As per the provision of bidding documents, a quantity of 1.1860 MT of aluminium rod per km of finished ASCR Zebra conductor, will be sold by the company to the manufacturer on sale-in-transit basis. However, in case of actual tonnage of aluminium rod in different lot(s) exceeds the tonnage requirement worked out as above for finished Zebra conductor manufactured from corresponding lots(s), such excess quantities shall be considered to be sold by the company to manufacturer at extra cost.

(iii) The manufacturer also confirms that in the event of award, it shall not enter into any hedging/forward contract for aluminium.

(iv) The manufacturer is responsible to take necessary insurance policies in its own name for the aluminium rod to be sold to the manufacturer by the company during contract execution from time to time. Such policies shall adequately cover the manufacturer's risks during transit of material to its works, storage, processing etc. till ex-works despatch of the finished conductor from its works.

(v) The manufacturer confirmed that it shall raise his invoice for payment of different price component as per the provision of bidding documents. It further confirmed that for determining other cost components in ex-works price, it will mention the following distinctly and separately:

(a) Cost of aluminium rod (worked out at proportionate value while raising invoice for progressive payment and final payment i.e., 90% of the cost and 10% of the cost respectively) (sale price of aluminium rod) (inclusive of excise duty and CST paid, as applicable) sold from time to time to manufacturer by the company on sale-in-transit basis) for manufacturing of different lots of conductors; plus

(b) Inward freight

(c) Set-off of additional CENVAT credit

Based on the aforesaid, the company will recover the sale price of aluminium rod (inclusive of excise duty and CST paid) sold to the manufacturer on sale-in-transit basis from time to time during the contract execution from the manufacturer's respective invoices raised for payment of ex-works price component at different stages on proportionate basis.

(vi) Material (aluminium rod) traceability and accounting

"The material accounting involves (i) receipts of raw material at stores (ii) issuing for production/work in progress and

(iii) despatches of finished product. Relevant records will be maintained for identification/ traceability of material received from the company at every stage and the procedure."

As regards the insurance requirement in respect of raw material (viz., aluminium rods) and finished good (viz., conductor), the querist has seperatley informed that the bid documents basically cover selling of conductor by the manufacturer to the company, i.e., ex-works supply from the supplier to the site and relevant clause for insurance requirement is provided in clause 28 of the 'General Conditions of Contract' of the Contract Agreements with the Manufacturer, a copy of which has been supplied by the querist for the perusal of the Committee. As regards insurance requirements in respect of raw material, the querist has referred to Appendix-3 (Insurance Requirements) to the contract agreement which while providing insurance requirements in respect of finished goods provide as follows:

"In addition to aforesaid insurance, the supplier shall also be responsible to take necessary insurance policies in its own name for the Aluminium Rod to be sold to the Supplier by the Purchaser during contract execution from time to time. Such Policies shall adequately cover the Supplier's risks during transit of material to its works, storage, processing etc, till ex-works despatch of the finished conductor from its works."

In view of above, for raw material, the manufacturer has to take insurance to cover his risk in his own name from the time the materials sold and during manufacture and upto despatch.

7. The querist has also stated that considering the above facts, the transactions can be accounted for by one of the following methods:

Alternative 1:- Procurement of aluminium from the supplier be accounted for as 'purchase of goods' and aluminium given to the manufacturer may be accounted for as 'sale of goods' in the statement of profit and loss. Purchase of conductors from the manufacturer may be accounted for as construction material in the balance sheet.

Alternative 2:- Procurement of aluminium may be accounted for as input raw material as 'construction stores' in the balance sheet. Additional cost charged by the manufacturer for conversion of aluminium into conductor may be included under 'construction stores' as and when charged or simply as contract costs as and when incurred.

8. *Arguments in favour of Alternative 1:*

a. The entire documentation right from inception of tender procedure as well as contract agreement and other supplementary documentation consistently refers to sale of the aluminium rods by the company to the manufacturer.

   In accordance with the above arrangement, Form 'C' will be issued with concessional payment of sales tax. CENVAT credit will be taken by the manufacturer which reduces the cost of conductor. All this is on the presumption that the transaction will be depicted as purchase and sale. Returns of sales tax and excise will be filed considering transaction as purchase and sale. In case the transaction is not accounted as per Alternative 1, the company will have to pay higher taxes.

b. The requisite compliances under the indirect tax laws referred to in the said documentation also consistently treat the said transaction as a transaction of sale of aluminium rods. The company through the contract agreement, has in fact entered into a contract whereby the manufacturer has agreed to supply certain conductors to the company. The said contract agreement has certain in-built safeguards to ensure use of appropriate material.

c. It is noted that aluminium rods sold by the company as 'sale-in-transit' to the manufacturer falls under a different tariff chapter under excise regulations from the chapter dealing with conductors which are sold by the manufacturer to the company.

d. The manufacturer has to take insurance of aluminium rods in its name and not in the name of company. This would indicate that the risk has already passed on to the manufacturer.

e. Accounting Standard (AS) 9, 'Revenue Recognition', contains certain illustrations which do not form part of the Accounting Standard. One of the illustrations deals with the situation sale/ repurchase agreements i.e., where seller concurrently agrees to repurchase the same goods at a later date. This illustration does not squarely apply to the facts of the case as the goods (namely the conductor) supplied by the manufacturer to the company are distinct from aluminium rods sold by the company to the manufacturer in terms of their physical forms as well as their characteristics (apart from different excise categorisation) and therefore, the analogy of sale and buyback of the same goods may not be directly applicable.

f. The querist has also mentioned that in case of Rashtriya Ispat Nigam Ltd. vs. State of A.P.(1998) 109 STC 425(SC); N.M. Goel & Co. vs. STO (1989) 72 STC 368(SC); CST vs. Mohammad Zahoor (1975) STC 414(SC); and Hindustan Steel Ltd. vs. State of Orissa(1970)26 STC 302(SC), it has been held that *"Material supplied by the contractee*: This has been a controversial question. In building contracts, materials such as bricks, coal and cement, when supplied to contractor and value of such supplies deducted from the contract value, was held to be a sale. By use or consumption of materials in the work of construction, there is passing of the property in the goods from the contractee to the contractor. By appropriation and by the agreement, there is a sale, which is liable to tax." However, in case of Cooch Behar Contractors Asso. vs. State of West Bengal (1996) 103 STC 477 (SC), it has been further held that "there could be a works contract where the customer supplies material free of cost to the contractor, with the condition that such material is supplied to the contractor on bailment, where the ownership of the material always vests with the contractee. The cost is nowhere reflected in the contract and consequently, no deduction is made from the running bills of the contractor. In such a situation, as there is no transfer of property in goods passing from the contractee to the contractor, there shall not be a sale. On the other hand, if prices of such goods are deducted from or adjusted against the bills or dues of the contractor, it will be considered as sale and their value form part of the contractual transfer price, for the purpose of the tax."

9. *Arguments in favour of Alternative 2:*

(i) On examination and analysis of above clauses of LOA, Post Bid documents and agreement between the manufacturer and the company, a view emerges that, by endorsing purchase of aluminium rod on the invoice documents of supplier in favour of the manufacturer, terming the same as 'sale-in-transit', do not constitute sale of aluminium rod by the company to manufacturer.

(ii) By endorsement of documents, rights in the goods do not pass to the manufacturer, right in goods is transferred when there is no encumbrance to the buyer. That is to say the buyer has all the rights to use the goods, in the manner it likes. It can use it for own consumption or re-sell the same to any person at the price, time and venue, as it likes.

(iii) Paragraph 5 to 'A. Sale of Goods' of Illustrations to AS 9 clearly, inter alia, states as given under:

"5. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date."

To apply the above paragraph, it is not necessary that re-purchase material should be same material which has been sold earlier. Substance is more important than form as given in the Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' of the Institute of Chartered Accountants of India.

(iv) The agreement/arrangement between the manufacturer and the company involves delivery of material to the manufacturer with restricted use and repurchase agreement for follow-on product.

Since there is no actual sale to and purchase from manufacturer, the company should not account in books as sales and purchase.

B. Query

10. On the basis of the above, opinion of the Expert Advisory Committee is sought by the querist on the correct accounting treatment between alternative 1 or 2 mentioned in paragraph 7 above or any other alternative.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist is whether the supply of raw material (viz., aluminium rod) by the company to the manufacturer for manufacturing conductors to be supplied back to the company should be regarded as sale by the company. In other words,

whether the supply of raw material to the manufacturer can be considered as an independent transaction from the transaction of purchase of the conductors from the manufacturer given the fact that such conductors would be manufactured only by using the raw material supplied by the company. 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 other costs incurred to manufacture conductors, accounting treatment in the books of the manufacturer, etc. Further, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting point of view and not from the view point of interpretation of any legal enactment, such as, Sale of Goods Act, 1930 and enactments relating to Excise, CENVAT, VAT, etc., since in accordance with Rule 2 of its Advisory Service Rules, the Committee is prohibited from doing so.

12. The Committee notes that in the extant case, the aluminium rods are procured by the company and supplied to the manufacturer of conductor for conversion into finished product, i.e., conductor. As regards the issue whether the aluminium rods sent to the manufacturer can be treated as sales by the company to the manufacturer, the Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', which states as follows:

> "b. *Substance over Form*
>
> The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form."

The Committee notes from the above that the transactions and events are accounted for and presented in accordance with their substance, i.e., the economic reality of events and transactions, and not merely in accordance with their legal from. In other words, it is the 'economic reality' that is important in accounting and not only the 'legal reality'.

13. The Committee further notes that Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006, provides as follows:

> "6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred

the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes."

"10. Revenue from sales or service transactions should be recognised 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.

..."

"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

The Committee notes that as per the principles enunciated above, revenue should be recognised when all significant risks and rewards of ownership are transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership. From the Facts of the Case, the Committee notes that although the legal form of the transaction is that the company is raising invoice on the manufacturer for the supply of raw material to it and the manufacturer has also taken an insurance policy in his name for the goods supplied to him, the substance of the transaction is that the company still retains effective control on the aluminium rods transferred to the manufacturer and the significant risks and rewards relating to ownership of raw material (aluminium) are not transferred to the manufacturer, as explained below:

(i) The **'**Terms of Post-Bid Discussion with the Manufacturer' as given in paragraph 6 above provide that the aluminium rods transferred to the manufacturer can only be used for the manufacturing of conductor of the company and cannot be used for any other purposes. In other words, the manufacture will not use aluminum from any other source other than that supplied by the company. It clearly indicates that the manufacturer has no control on the aluminum rods to be used in the manufacture of conductor and the company controls the usage of aluminium rods.

(ii) As per the provision of bidding documents as given in paragraph 6(iv) above, "a quantity of 1.1860 MT of aluminium rod per km of finished ASCR Zebra conductor, will be sold by the company to the manufacturer on sale-in-transit basis. However, in case of actual tonnage of aluminium rod in different lot(s) exceeds the tonnage requirement worked out as above for finished Zebra conductor manufactured from corresponding lots(s), such excess quantities shall be considered to be sold by the company to manufacturer at extra cost". From this provision, it is clear that an estimated quantity of aluminium rod is sent to the manufacturer for use in the manufacture of finished product and if there is excess consumption of material, then that excess quantity only is considered as sale to the manufacturer. In other words, the company does not sell aluminium rods to the manufacturer rather it issues raw materials on estimated basis in proportion to finished goods.

(iii) As per the 'Terms of Post-Bid Discussion with the Manufacturer' as given in paragraph 6(iv) above, the manufacturer will maintain relevant records for identification/ traceability of material received from the company at every stage and the procedure. Further, it is noted from the contract agreement between the company and the manufacturer that the company will also receive a declaration from the manufacturer regarding utilisation of aluminium rods supplied to it by the company. These facts further provide evidence that the company is controlling the material sent by it to the manufacturer.

(iv) While raising ex-works invoice, the manufacturer mentions different price components stating separately the price charged for aluminium rods, inward freight, insurance, cost of other consumables and conversion cost (after set off of the CENVAT credit on account of aluminium rods and scrap value of raw materials). Hence, the invoice raised basically segregates the various components being reimbursed by the company alongwith the conversion cost. Thus, the manufacturer is not charging for the end product but is primarily charging for the conversion cost and other cost being incurred by him for conversion of aluminium rods into conductor.

(v) It was further noted from the price break-up on invoice as per the contract agreement that the same price of aluminium rod is being charged by the manufacturer as is being incurred by the company in respect of the aluminium rods. Thus, the manufacturer does not possess any price risk or reward associated with the ownership of aluminium rods.

(vi) The manufacturer cannot enter into any hedging/forward contract for aluminium rods, which indicates that the manufacturer neither has any control on the aluminium rods nor it can hedge its risk, if any, arising in respect of raw material or obtain any benefit out of it.

14. From the above, the Committee is of the view that in the extant case, the manufacturer does not have control on the use of aluminium rods supplied to it by the company. The Committee is also of the view that even though invoices may be raised for raw materials transferred to the manufacturer, significant risks and rewards of ownership and effective control on the goods still vest with the company. Therefore, in the view of the Committee, there is no sale to the manufacturer. In fact, the company pays to the manufacturer only for conversion of aluminum rod into conductor. Accordingly, the Committee is of the view that no revenue from sales should be recognised on despatch of raw materials to the manufacturer rather, the company should

treat them as its own inventory and should account for it accordingly. The company should also make adequate disclosures so as to clearly disclose that such inventory is lying in the premises of the manufacturer for finished product, viz., conductor.

15. The Committee also wishes to point out that the treatment of transactions under MoU arrangements as purchase and sales of the company for the purposes of taxation cannot be the criteria for determining the true nature of the transactions and their correct accounting treatment.

D. Opinion

16. On the basis of the above, the Committee is of opinion that that to account for the raw material supplied by the company to the manufacturer as its own inventory is the appropriate alternative. However, the company should also make adequate disclosures so as to clearly disclose that such inventory is lying in the premises of the manufacturer of the conducter, as stated in paragraph 14 above.

Query No. 30

Subject: Accounting for unspent expenditure towards Corporate Social Responsibility.[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 NSE and BSE. The turnover of the company was Rs. 50,156 crore in the financial year 2012-13. The company had employee strength of 48,399 Nos. as on 31.03.2013.

[1] Opinion finalised by the Committee on 15.11.2013.

2. *DPE Guidelines on Corporate Social Responsibility (CSR) for Central Public Sector Enterprises:*

As per DPE Guideline No. 15(3)/2007-DPE(GM) dated March 2010, each Central Public Sector Enterprise (CPSE) has to mandatorily create CSR budget through a Board Resolution as a percentage of net profit of the previous financial year. CSR budget should be fixed for each financial year. This funding will not lapse. It will be transferred to a 'CSR Fund', which will accumulate – as in the case of non-lapsable pool – for the North East.

The implementation of CSR Guidelines will form a part of the Memorandum of Understanding (MoU) that is signed each year between CPSEs and the Government. The performance of each CPSE with reference to its CSR activities should be monitored by the Ministry/ Department concerned on a regular basis.

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

DPE Guidelines on CSR were adopted by the Board at 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). Accordingly, any unspent amount on this account was transferred to a separate 'CSR Fund', which is non-lapsable, for spending on CSR activities exclusively in subsequent years. This is shown under Note 9 as 'Corporate Social Responsibility' for CSR and 'Other short term provisions' for Sustainability Development (SD) in line with paragraph 8.6.4 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956.

4. *Point raised by Government Audit:*

During the audit of annual accounts for the year 2012-13, Government auditor has raised a query stating that unspent amount related to CSR and SD should be shown as 'CSR & SD reserve' under 'Reserve & Surplus' instead of 'Provision for CSR activities'. They have referred to the opinion of Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) (published as Query No. 27 of Volume XXXII of the Compendium of Opinions), which states that "the requirement in DPE Guidelines for creation of a CSR budget can be met through creation of a reserve as an appropriation of profit rather than creating a provision as per Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and

Contingent Assets'". This opinion of the Expert Advisory Committee has also been made available by the ICAI on its website.

5. *The querist's views:*

Paragraph 14 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') states as below:

> ***"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.***
>
> ***…"***

Since the amount to be spent on CSR is linked to the net profit for the previous year, the company has a present obligation as a result of profit generated in the previous year. As defined in AS 29, notified under the 'Rules', **"*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.*"** Other two conditions as given in paragraph 14 of AS 29 for recognising the unspent amount is also satisfied as an outflow of resources will be required to settle the obligation and a reliable estimate can also be made of the amount of the obligation. Considering intention of DPE Guidelines which depicts obligating nature of CSR & SD expenditure, the company seems to be correct in its treatment of unspent amount as provision in line with above paragraph of AS 29.

6. The querist has stated that the point raised by Government auditor for treating the unspent amount on CSR and SD as 'Reserve' is stated to be based on EAC opinion (referred above) which stresses on non-obligating nature of CSR and SD fund on account of no penalty prescribed for non-incurrence of such expenditure. But inclusion of CSR and SD expenditure in MOU targets for evaluating company's performance hints at its obligating

nature. Moreover, this obligating nature is confirmed by the clauses newly introduced in the Companies Bill already passed by Lok Sabha and Rajya Sabha which proposes that "The Board of every company shall ensure that the company spends in every financial year at least 2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its CSR policy. Where the company fails to spend such amount, the Board shall in its report specify the reasons for not spending the amount." In view of this, it is felt that the present practice of the company of creation of provision for the unspent amount of CSR is in line with AS 29 as it fulfills all the criteria given in paragraph 14 of AS 29.

B. Query

7. Based on the above facts, the querist has sought the opinion of the EAC on the following issues:

(i) Whether treatment of unspent amount of CSR and SD as provision by the company is correct and in line with AS 29 or not.

(ii) In case, if it is not, then how to account for the change during the financial year 2013-14. Also, whether financial statements of previous year be restated for such change, if any.

C. Points considered by the Committee

8. The Committee notes from the Facts of the Case that while raising issue on accounting for funds earmarked for CSR and SD activities, the querist has referred to DPE Guidelines No. 15(3)/2007-DPE(GM) dated 9th April, 2010 which were effective till 31.03.2013 and has raised the issue in respect of financial year 2012-13. Further, the querist has also referred to an earlier opinion of the Committee which was also based on these Guidelines. Accordingly, the Committee has considered the issue only in the context of the above-mentioned Guidelines effective till 31.03.2013 and it has not considered the issue in relation to the revised Guidelines on Corporate Social Responsibility and Sustainability for Public Sector Enterprises, issued by DPE, coming into effect on 1st April, 2013. Further, it has also not considered the issue in the context of proposed requirements of the Companies Act, 2013 as that matter has not been raised by the querist. The Committee also wishes to point out that before the revised DPE Guidelines coming into force, there were separate Guidelines on CSR and Sustainability Development. Since the Guidelines on Sustainability

Development have neither been referred to by the querist in the Facts of the Case nor it was the subject matter of the earlier EAC Opinion referred to by the querist, the Committee has examined the issues raised by the querist in paragraph 7 above viz., relating to accounting for unspent expenditure towards CSR only in the context of DPE Guidelines on CSR. The Committee has also not examined any other issue arising from the Facts of the Case, such as, determination of the amount to be earmarked for CSR activities, legal interpretation of DPE Guidelines, etc.

9. The Committee notes the definitions of the terms, 'provision', 'liability', 'obligating event', 'present obligation' and paragraphs 14, 16, 17 and 18 of AS 29, notified under the Rules, as follows:

> ***"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***10.2 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.***
>
> ***10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation."***
>
> ***"10.6 Present obligation - 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."***
>
> ***"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.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised."

10. The Committee further notes the following features of the DPE Guidelines:

(i) The CSR *budget* will be mandatorily created through a Board Resolution as a percentage of net profit in the manner specified in the DPE Guidelines. (Clause 5.1 of DPE Guidelines)

(ii) Loss-making companies are not mandated to *earmark specific funding for CSR* activities. (Clause 5.2 of DPE Guidelines)

(iii) The CSR *Budget* should be fixed for each financial year. This funding will not lapse. It will be transferred to a *CSR Fund,* which will accumulate - as in the case of non-lapsable pool – for the North East. (Clause 5.4 of DPE Guidelines)

(iv) The implementation of CSR guidelines will form a part of the Memorandum of Understanding that is signed each year between CPSEs and Government. (Clause 8.4 of DPE Guidelines)

(v) In MoU Guidelines from 2010-11 onwards, 5 marks have been earmarked out of the non-financial parameters for CSR activities. … (Clause 8.6 of DPE Guidelines)

(Emphasis supplied by the Committee.)

From the above, the Committee notes that as per the DPE Guidelines, there is a mandate for creation of a budget/fund and not to spend on CSR activities as a percentage of profits, which would only form a basis for evaluation of the performance of an enterprise. However, there is no mandate on the amount of expenditure, which has to be necessarily incurred by an enterprise during a period of its operation. Thus, there is a mandate only on the creation of a budget or fund rather than an obligation to incur expenditure during a period. Further, neither there is any time limit for incurring the expenditure out of CSR fund nor any penalty is prescribed for non-incurrence of such expenditure. The Committee also notes that as per the provisions of AS 29, a 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 that obligation exists independently of an enterprise's future actions. Since as per DPE Guidelines, there is no such obligation on the enterprise, provision should not be recognised. Accordingly, the Committee is of the view that the requirement in the DPE Guidelines for creation of CSR budget is to be met through creation of a reserve as an appropriation of profits rather than creating a provision as per AS 29.

As regards the querist's argument that since the amount to be spent on CSR is linked to the net profit for the previous year, the company has a present obligation as a result of profit generated in the previous year, the Committee is of the view that 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. Further, as per the requirements of paragraph 18 of AS 29, if the enterprise can avoid the future expenditure by its future actions, it has no present obligation for that future expenditure and no provision is recognised. The Committee notes that in the extant case, the company can avoid the obligation to create CSR fund and spend on CSR activities by compromising on a lower scale of performance evaluation by the DPE and thus, the earning of profits in itself cannot be considered as an obligating event, requiring recognition of provision as per AS 29.

11. On the basis of the above, the Committee is of the view that in the extant case, it is not appropriate to recognise a provision in respect of unspent expenditure on CSR activities. However, a CSR reserve may be created as an appropriation of profits.

12. 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 definition of the term 'prior period items' 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' 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."***

On the basis of the above, the Committee is of the view that since the company has wrongly treated the amount set aside for future expenditure as provision, it is an error in the preparation of the financial statements. The Committee is of the view that 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 Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. Accordingly, the question of restatement of financial statements does not arise.

D. Opinion

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

(i) No. The treatment of unspent amount of CSR as provision by the company is not correct and not in line with AS 29, as discussed in paragraphs 10 and 11 above.

(ii) During the financial year 2013-14, the company should rectify its error of prior accounting period(s) by making appropriate changes in the current reporting period by treating it as a 'prior period item' as per the provisions of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. Accordingly, the question of restatement of financial statements does not arise, as discussed in paragraph 12 above.

Query No. 31

Subject: Notional interest on deposits received from nominees of employees under a defined benefit plan.[1]

A. Facts of the Case

1. A company is a Schedule 'A', Mini Ratna, Government of India Undertaking. The company is the second largest urea producer in the country with a share of 15.40% of total domestic urea production. It was incorporated on 23rd August, 1974 under the Companies Act, 1956. At present, the company has five Nitrogenous fertilizer plants at Nangal, Bathinda, Panipat and Vijaipur. The company is listed with the Bombay Stock Exchange and the National Stock Exchange. It prepares its annual financial statements as per the provisions of the Companies Act, 1956. During the year ended 31st March, 2011, the turnover and net worth of the company were Rs. 5,837 crore and Rs. 1,672 crore respectively.

2. During the year 2010-11, as a part of employee welfare measures, the company introduced an 'Employees' Family Economic & Social Rehabilitation Scheme' ('EFESRS'). The scheme envisages payment of monthly benefits to the legal heirs of deceased employees or disabled separated employees. The benefits under the scheme are paid upon deposit of a prescribed amount (equivalent to gratuity and provident fund to the credit of employee at the

[1] Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

time of death/separation) by the beneficiaries with the company. The gratuity and PF dues of the employee are paid to the eligible payee in the first instance and are deposited voluntarily by the beneficiary as deposit under 'EFESRS'. (The querist has furnished a copy of the said scheme for the perusal of the Committee).

3. As per the scheme, the beneficiary is required to make the deposit under the scheme and such deposit does not carry any interest for the period of the deposit. It is returned to the beneficiary without any interest when the benefits under the scheme cease to become payable on the date of notional retirement of the employee which is governed by clause no. 9 of the Scheme.

4. The deposits received from the beneficiary are accounted under "Other Liabilities" in the books of account. The deposits *are not* kept in any separate bank account earmarked for the above scheme, but these receipts are subsumed in the current bank account of the company. (Emphasis supplied by the querist.)

5. As per the querist, since the scheme is in the nature of a Defined Benefit Scheme, the liability for benefits payable to legal heirs of the deceased/separated disabled employees, who have opted for the benefits under the scheme, is worked out as per the principles of Accounting Standard (AS) 15 (Revised), 'Employee Benefits', issued by the Institute of Chartered Accountants of India (ICAI). The computation of the liability is made by an independent Actuary. (The querist has furnished a copy of the Actuarial Report for computing liability under 'EFESRS' as on 31.03.2011 for the perusal of the Committee). At the end of financial year 2010-11, a sum of Rs. 3.13 crore was computed as the liability based on actuarial principles, which was provided for in the books of account. The amount of the liability under the scheme is also disclosed by way of notes to accounts along with other employee benefit schemes (Note no. 8.1.3). (The querist has furnished a copy of Annual Report of the company for the financial year 2010-11 for the perusal of the Committee). The Actuary has stated in its report that no separate disclosures are required for other long-term employee benefits as per paragraph 132 of AS 15 (Revised).

6. As per the querist, since deposits received by the company under the scheme do not meet the criteria of 'Plan Assets' under AS 15 (Revised), no cognizance has been taken of any notional interest on such deposits while computing actuarial liability of Rs. 3.13 crore under 'EFESRS'.

7. The Comptroller and Auditor General (C&AG) auditors, while carrying out their review under section 619(4) of the Companies Act, 1956 for the financial year 2010-11, made an observation that the benefit of interest saving accrued to the company on account of interest free deposit of Rs. 2.58 crore retained by the company has not been factored by the Actuary while computing actuarial liability of Rs. 3.13 crore as on 31.03.2011. (The querist has furnished a copy of audit observation for the perusal of the Committee). The auditors made reference to paragraph 103 of the AS 15 (Revised), issued by the ICAI, which is reproduced below:

> ***"103. When, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, an enterprise should recognise its right to reimbursement as a separate asset. The enterprise should measure the asset at fair value. In all other respects, an enterprise should treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement."***

As per the C&AG auditors, the non-adjustment of return on deposit resulted in overstatement of provision and the fact regarding non-consideration of return on deposit at the time of creating provision was not disclosed in the accounts.

8. The querist is of the view that above parameters of paragraph 103 of AS 15 (Revised) are applicable when the liability for making payment of the defined benefit obligation is reimbursable from a third party, like insurers etc. However, in the company's case, deposits of Rs. 2.58 crore received from legal heirs of the deceased employees are in no way available to discharge/reimburse the company's obligation under the scheme. The liability under 'EFESRS' is a liability computed on actuarial basis, and, is an additional liability of the company to return the deposits upon expiry of the scheme. The company has not created any fund to service this actuarial liability. The liability under 'EFESRS' has a distinct character and any appropriation of notional interest benefit on deposits for mitigating the company's liability under the scheme will not be in accordance with AS 15 (Revised), issued by the ICAI.

9. As per the querist, so far as deposits received by the company from beneficiaries are concerned, as per the actuarial principles and parameters

contained in AS 15 (Revised), an asset has to meet the definition of plan asset and has to be exclusively and specifically available to meet the liability under the defined benefit plan. The querist has drawn attention of the Committee to the following definitions given in AS 15 (revised):

> ***"7.13 Plan assets comprise:***
>
> > ***(a) assets held by a long-term employee benefit fund; and***
> >
> > ***(b) qualifying insurance policies."***
>
> ***"7.14 Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:***
>
> > ***(a) are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and***
> >
> > ***(b) are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise's own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:***
> >
> > > ***(i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or***
> > >
> > > ***(ii) the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid."***

Hence, as per the querist, only assets which maintain a legally separate identity from the reporting entity and are available specifically for payment of defined benefit obligation qualify as plan asset. Since neither deposit received from nominees of employees nor notional interest thereon qualifies as plan assets, the notional interest has not been considered for actuarial valuation of liability under 'EFESRS'.

B. Query

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

(i) Whether the accounting treatment/disclosure made by the company pertaining to the 'EFESRS' is correct.

(ii) Whether the notional interest savings/income on the interest free deposits received from the legal heirs of the deceased/ separated disabled employee is to be factored while computing actuarial liability under AS 15 (Revised).

(iii) Whether notional interest savings/income on the interest free deposits is to be considered separately by the company and adjusted/netted off with the provision under the scheme reported by the Actuary.

C. Points considered by the Committee

11. The Committee notes that the main issues raised by the querist relate to treatment, if any, required for notional interest savings/income on the interest free deposits received from nominees/legal heirs under 'EFESRS' (the 'Scheme') as well as adequacy of disclosure. The Committee notes that the latter issue is connected with the classification of the 'Scheme' as a defined benefit plan and classification of the benefits under the Scheme as 'Other long-term employee benefits'. The Committee has, therefore, considered only these issues and has not examined any other issue that may be contained in the Facts of the Case, such as, correctness of the actuarial valuation, classification of deposits received as 'Other liabilities', accounting treatment of interest free deposits under AS 30, 'Financial Instruments: Recognition and Measurement', issued by the Institute of Chartered Accountants of India (in case AS 30 is adopted early), accounting for 'Social Security Benefit Scheme' (SSB), etc. The Committee further notes that the querist has stated in paragraph 5 above that liability for benefits "payable to legal heirs of the deceased / separated disabled employees, *who have opted for the benefits under the scheme*" is worked out as per the principles of Accounting Standard (AS) 15 (Revised), 'Employee Benefits'". In this regard, the Committee notes that C&AG auditor's observations also mention that the provision of Rs.3.13 crore was made in respect of 15 employees who/whose nominees have *opted* for the Scheme launched during the year. The Committee also notes that the report of the Actuary mentions that there are only 15 active members of the Scheme as on 31.03.2011. The querist has also referred to deposits *received* in paragraphs 5, 8, and 10(ii) above. Since the Scheme was introduced during the year 2010-11, it appears that reference to (i) beneficiaries who have *opted* for the Scheme

benefits and (ii) deposits *received* is in respect of deaths/disabled separations that have occurred on or after the date specified in the Scheme up to 31.03.2011. However, the querist has not raised any issue on treatment of possible liability for employees in service as on 31.03.2011, who (or their legal heirs) *may* become eligible in future under the Scheme and who *may* opt for the benefits in future by depositing the prescribed amount and, hence, the Committee has not addressed that issue. Incidentally, the Committee notes that while the Facts of the Case and the copy of the Scheme furnished by the querist mention the name of the Scheme as 'Employees' Family Economic & Social Rehabilitation Scheme' ('EFESRS'), Note 8.1.3 of Notes to Accounts in the annual report for the year 2010-11, captioned 'Other Employee Benefit Schemes', makes reference to 'Employees' Family Economic Rehabilitation Scheme ('EFERS') and Actuarial Valuation Report makes reference to 'Employee Family Rehabilitation Scheme'. The Committee presumes that all of them refer to the same Scheme. The Committee also wishes to point out that the opinion expressed hereinafter is purely from accounting point of view and the issue whether the notional interest saving/income on interest free deposits received from beneficiaries should also be one of the factors for the actuarial valuation, should be independently considered by the Actuary and accordingly, it has not been examined by the Committee.

12. The Committee notes the following paragraphs of AS 15, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> ***"7.2 <u>Short-term employee benefits</u> are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.***
>
> ***7.3 <u>Post-employment benefits</u> are employee benefits (other than termination benefits) which are payable after the completion of employment.***
>
> ***7.4 <u>Post-employment benefit plans</u> are formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees.***
>
> ***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.

7.6 <u>Defined benefit plans</u> are post-employment benefit plans other than defined contribution plans."

"7.8 <u>Other long-term employee benefits</u> are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service."

7.9 <u>Termination benefits</u> are employee benefits payable as a result of either:

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

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

"27. Under defined benefit plans:

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

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise's obligation may be increased."

13. The Committee notes the following features from the copy of the Scheme furnished by the querist:

(i) The Scheme is optional – both in the case of disabled separated employees and the legal heirs of the deceased employees. The Scheme is applicable when the disablement leading to separation or death occurs while the employees are in service of the company.

(ii) The benefits are given under a separate Scheme and *not* as a part of any existing post-employment benefit plan. However, the beneficiary can only opt for this Scheme or 'SSB' Scheme.

(iii) On deposit of the prescribed amount, which is refundable, the beneficiaries are entitled not only to monthly payments but also some other benefits – both monetary and non-monetary.

(iv) The monthly payments under the Scheme are equal to last drawn pay (or 75% of last drawn pay in some situations), subject to a ceiling amount of Rs.50,000 p.m. (or Rs.40,000 p.m in some situations). This implies that the benefit is related to the length of service.

(v) The beneficiary could be the legal heirs of the deceased employee or disabled separated employee, where the death/ disabled separation takes place before the notional superannuation of the employee.

(vi) The beneficiary can opt out of the Scheme at any time before the notional retirement date of the employee.

(vii) The deposits are refundable either on the notional retirement date or even before that date, if the beneficiary desires to opt out of the Scheme before that date.

(viii) The Scheme is wholly unfunded.

14. From the above, the Committee notes that the benefits under the Scheme are defined and the liability of the company is not limited to any fixed contribution. Further, the benefits under the Scheme are payable only on separation due to disability or death of employees, subject to the exercise of option by the beneficiary and deposit of the prescribed amount with the company. Such benefits are given under a separate Scheme and *not as a part of any existing post-employment plan.* Also, the benefits are payable, at the maximum, upto the notional superannuation of the employee. From the above, the Committee is of the view that the benefits under the Scheme do not meet the definition of short-term employee benefits (reproduced in paragraph 12 above). Further, these are neither post-employment benefits nor termination benefits. Thus, the Committee is of the view that the Scheme is of the nature of a defined benefit plan and the benefits under the Scheme are of the nature of 'Other long-term employee benefits'. The Committee further notes that though the definitions reproduced in paragraph 12 above use the concept of defined benefit plans in the context of post-employment benefits, this concept is relevant in the context of other long-term employee

benefits also, as evident from paragraph 129 of AS 15 reproduced in paragraph 15 below.

15. As regards the measurement of the liability under the Scheme, the Committee notes the following paragraphs of AS 15:

"Recognition and Measurement

129. The amount recognised as a liability for other long-term employee benefits should be the net total of the following amounts:

(a) the present value of the defined benefit obligation at the balance sheet date (see paragraph 65);

(b) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102).

In measuring the liability, an enterprise should apply paragraphs 49-91, excluding paragraphs 55 and 61. An enterprise should apply paragraph 103 in recognising and measuring any reimbursement right."

"Actuarial Valuation Method

65. An enterprise should use the Projected Unit Credit Method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost."

"Attributing Benefit to Periods of Service

68. In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an enterprise should attribute benefit to periods of service under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an enterprise should attribute benefit on a straight-line basis from:

(a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service); until

(b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases."

"131. One form of other long-term employee benefit is long-term disability benefit. If the level of benefit depends on the length of service, an obligation arises when the service is rendered. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

..."

16. From the above, the Committee notes that depending on the circumstances, in the case of 'other long-term employee benefits', the benefit should be attributed to the period of service, or a period less than the period of service when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases, or on the occurrence of specific events, such as, long-term disability, as the case may be. In the extant case, the Committee notes that the Scheme was introduced in the year 2010-11 and the Facts of the Case deal with beneficiaries who have *opted* for the Scheme on death/disabled separation of employees. Accordingly, the Committee has restricted its opinion to such cases only wherein death/ disabled separation of employee has already occurred. In such cases, the Committee presumes that liability has been provided for present value of the expected payments in future up to the expected date of opting out of the Scheme or notional retirement date, whichever is earlier, based on actuarial assumption. Accordingly, in such cases, the question of attributing benefit to future periods does not arise at all.

17. The Committee notes paragraph 130 of AS 15 which reads as below:

"130. For other long-term employee benefits, an enterprise should recognise the net total of the following amounts as expense or (subject to paragraph 59) income, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

(a) current service cost (see paragraphs 64-91);

> ***(b)*** ***interest cost (see paragraph 82);***
>
> ***(c)*** ***the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement right recognised as an asset (see paragraph 103);***
>
> ***(d)*** ***actuarial gains and losses, which should all be recognised immediately;***
>
> ***(e)*** ***past service cost, which should all be recognised immediately; and***
>
> ***(f)*** ***the effect of any curtailments or settlements (see paragraphs 110 and 111)."***

The Committee notes that a combined reading of paragraphs 129, 130 and 103 of AS 15 indicates that net expense or income recognised in the statement of profit and loss, inter alia, includes (i) expected return on any plan assets and on any reimbursement rights recognised as an asset, (ii) actuarial gains and losses (which, inter alia, include difference between actual return and expected return on any plan assets and on any reimbursement rights recognised as an asset) and (iii) amount recognised for reimbursement. In the balance sheet, the fair value of the plan assets will be reduced from the present value of the defined benefit obligation whereas the reimbursement right will be recognised as a separate asset. Hence, first of all, it has to be examined whether, for the Facts of the Case, there are any plan assets or reimbursement rights. The Committee notes that the Scheme is wholly unfunded and, as stated by the querist in paragraph 4 above, the deposits received are not kept in any separate bank account earmarked for the scheme, but are subsumed in the current bank account of the company. Further, as stated by the querist in paragraph 8 above, they are not (specifically) available to discharge/reimburse the company's obligation under the scheme. The Scheme also does not envisage any appropriation of notional interest saving/income for the purpose of discharging /reimbursing the company's obligation under the Scheme. Hence, the Committee is of the view that the deposits received as well as interest saving, if any, realised and forming part of the company's bank account do not qualify as plan assets as defined in paragraph 7.13 of AS 15. Consequently, the question of computation of return on plan assets does not arise at all.

18. Further, the Committee examines the question whether the company gets any reimbursement in the form of beneficiary's obligation to give deposits to opt for the Scheme and interest saving/income on the deposits, so received and, consequently, whether paragraph 103 of AS 15 reproduced in paragraph 7 above is applicable as viewed by C&AG auditors. The Committee notes that while deposit of the prescribed amount is a condition for eligibility of the benefits under the Scheme, the deposits are refundable either on the notional retirement date or even before that date, if the beneficiary desires to opt out of the Scheme before that date (see paragraph 13(vi) above). Thus, the deposit is simply a liability of the company over and above the liability under the Scheme, as rightly contended by the querist in paragraph 8 above. The Committee is also of the view that the expression 'another party will reimburse some or all of the expenditure' occurring in paragraph 103 of AS 15 covers situations where the reimbursement is specifically receivable for meeting the cost of providing the benefits under the Scheme and the amount is clearly identifiable. Further, the term 'another party' refers to parties like insurers and, generally, the beneficiary of the Scheme cannot be construed as 'another party'. Consequently, deposits or notional interest saving/income on such deposits are not reimbursements for the purposes of paragraph 103 of AS 15. Therefore, the Committee is of the view that the same should not be considered while determining liability under the Scheme. The question of disclosing, in the accounts, the fact of non-consideration of return on deposit at the time of creating provision, therefore, does not arise. Incidentally, the Committee wishes to mention that a reimbursement right cannot reduce the amount of a provision in the balance sheet, though the amount recognised for the same reduces the expense relating to a defined benefit plan in the statement of profit and loss (see paragraph 17 above). This is because amount payable to the beneficiary is not reduced by the existence of a reimbursement right.

19. Now, the Committee examines the issue as to whether notional interest savings/income on the interest free deposits can be considered separately by the company and adjusted/netted off with the provision under the scheme. In this regard, the Committee notes paragraph 91 of AS 15, which reads as below:

> "91. Some post-employment health care plans require employees to contribute to the medical costs covered by the plan. Estimates of future medical costs take account of any such contributions, based on the

> terms of the plan at the balance sheet date (or based on any obligation that goes beyond those terms). ..."

The Committee notes that though the above paragraph 91 of AS 15 is in the context of post-employment benefit plans, paragraph 129 of AS 15 requires, inter alia, application of the same in measuring the liability for other long-term employee benefits. The issue that arises is whether notional interest saving/income on the deposit received can be treated as a 'contribution' by the beneficiaries of the Scheme towards the costs of the benefits provided under the Scheme. The Committee is of the view that a contribution should be specifically identifiable and receivable from the beneficiaries for meeting a portion of the cost of the benefits. Further, as per Indian GAAPs, income and expenses are recognised on accrual basis of accounting, i.e., only those events are recognised which have occurred. The Committee notes that in the extant case, the deposits are subsumed in the current bank account of the company. This has the effect of reducing interest expense or, increasing interest income, if the type of the bank account offers interest income on positive balance. Thus, the notional interest saving/income on the balance of such account is not separately identifiable and therefore cannot be considered to be a contribution by the beneficiaries. Further, imputed (notional) interest income (or expense) can be recognised in financial statements only if it is required or permitted by an Accounting Standard and then only the question of offsetting the same against any other item arises. Any attempt to impute notional interest income on the deposit received (and to offset the same against employee benefit expense) will result in concurrent increase in notional interest expense, which is not permitted by AS 16, 'Borrowing Costs', notified under the 'Rules'. Under AS 16, only actually 'incurred' borrowing costs can be recognised in financial statements. Alternatively, in the latter case (i.e., situation where there is increase in interest income), any attempt to identify the whole or portion of actual interest income with the deposits received is also not permitted because of the fungible nature of money subsumed in the current bank account of the company. Hence, the Committee is of the view that notional interest saving/income on the interest free deposits cannot be considered separately and adjusted /netted off with the provision for measuring the liability under the Scheme.

20. As regards disclosures, the Committee notes that since the benefits under the Scheme are of the type of 'Other long-term employee benefits', paragraph 132 of AS 15, reproduced below, is applicable:

"Disclosure

132. Although this Standard does not require specific disclosures about other long-term employee benefits, other Accounting Standards may require disclosures, for example, where the expense resulting from such benefits is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period (see AS 5 *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*). Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about other long-term employee benefits for key management personnel."

Accordingly, the company should consider whether any disclosure is required under other Accounting Standards.

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:

(i) The accounting treatment and disclosure made by the company pertaining to the 'EFESRS' is correct in respect of beneficiaries who have opted for the benefits, if disclosures required by other Accounting Standards are not applicable. The Committee, however, does not express any view on the correctness of actuarial valuation and the amount provided for as the liability under the 'EFESRS'. Also, the Committee does not express any view on possible liability in respect of employees in service who (or their legal heirs) *may* become eligible in future and who *may* opt for the benefits in future.

(ii) As regards the notional interest savings/income on the interest free deposits received from the legal heirs of the deceased/ separated disabled employees, from accounting point of view, it should not be considered to determine the liability under AS 15. However, as regards the issue as to whether notional interest savings/income should be factored in while computing actuarial liability under AS 15, should be independently considered by the Actuary.

(iii) In view of 21(ii) above, from accounting point of view, the notional interest savings/income on the interest free deposits (received) should not be considered separately by the company and should not be adjusted/netted off with the provision under the Scheme reported by the Actuary, as discussed in paragraph 19 above.

Query No. 32

Subject: Capitalisation of borrowing costs under AS 16.[1]

A. Facts of the Case

1. A company is a Government of India Undertaking under the Ministry of Defence (MoD). The company manufactures a wide range of products, like super alloys, titanium alloys, maraging steel, etc. for strategic sectors, like space, defence, nuclear power, etc. The products manufactured are sold in the form of ingots, forged billets, sheets, plates, strips, rods, rings, etc. To enable supply of the material in the form specified by the customers requiring special operations, like machining, rolling, ring forming, etc., for which facilities are not available in-house, such jobs are off-loaded to the sub-contractors in India. The company's turnover in the year 2011-12 was to the tune of Rs. 509 crore.

2. The Government of India, during the period 2008-09 to 2011-12, has granted a financial assistance of Rs. 100 crore to the company (i.e., Rs. 50 crore as equity contribution and Rs. 50 crore as loan) for procurement of 10 tonne ESR furnace and 6000 tonne forging press. While 10 tonne ESR furnace valued at Rs. 1,384.34 lakh has been commissioned and capitalised during the year 2010-11, the other equipment, 6000 tonne forging press, is still under procurement stage. In respect of loan of Rs. 50 crore, repayable in 5 equal installments after the lapse of one year from the date of withdrawal of loan, the company has repaid a loan of Rs. 2,020.00 lakh along with interest of Rs. 1,014.30 lakh @ 11.50 per cent p.a. on respective due dates.

[1] Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

3. It is observed by the Government auditor during audit of annual accounts of the year 2011-12 that entire interest payment of Rs. 1,014.30 lakh has been charged to revenue between the period 2009-10 to 2011-12 instead of capitalisation of borrowing costs against the ESR furnace commissioned in the year 2010-11 and forging press under acquisition. The query of the C&AG auditors and the reply of the company are placed below:

> "Query:
>
> As per significant accounting policy No. 13, read with Accounting Standard (AS) 16, 'Borrowing Costs', borrowing costs that are attributable to the acquisition or construction of qualifying assets are to be capitalised as a part of the cost of such assets.
>
> The Government of India, between the year 2008-09 and 2011-12, granted a financial assistance of Rs.100 crore to the company (i.e., Rs. 50 crore as equity contribution and Rs.50 crore as loan) for procurement of 10 tonne ESR furnace and 6000 tonne forging press. While 10 Tonne ESR furnace valued Rs. 1384.34 lakh has been commissioned and capitalised during the year 2010-11, the other equipment, 6000 tonne forging press, is still under procurement stage.
>
> In respect of loan of Rs. 50 crore, repayable in 5 equal installments from the first anniversary after the date of drawl of loan, company has repaid a loan of Rs. 2020.00 lakh along with interest of Rs. 1014.30 lakh @ 11.50 percent p.a. on respective due dates. However, no provision has been made in the books for a liability of Rs. 2.70 lakh towards interest accrued but not due on outstanding loan of Rs. 2980.00 lakh, as on 31st March, 2012.
>
> It is observed that entire interest payment of Rs. 1014.30 lakh has been charged to revenue between 2009-10 to 2011-12 instead of capitalisation of borrowing cost (to the extent admissible) against the ESR furnace commissioned in the year 2010-11 and forging press under acquisition.
>
> The failure to capitalise the borrowing cost in compliance of significant accounting policy No. 13 / AS 16 and failure to recognise a liability towards interest accrued but not due on loan in compliance with Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets' has resulted in:

Understatement of other current liabilities by Rs. 2.70 lakh (Note No.10)

Understatement of tangible assets (plant and machinery) gross block by Rs. 85.15 lakh and Depreciation by Rs. 4.85 lakh (Note No.12)

Understatement of Capital Work in Progress by Rs. 865.04 lakh (Note No.14)

Overstatement of Finance Cost by Rs. 341.58 lakh (Note No.28)

Overstatement of Prior Period Adjustments by Rs. 605.92 lakh (Note No.29) and

Understatement of Profit by Rs. 942.65 lakh.

Further, non-compliance of AS 16 and AS 29 in preparation of financial statements and impact thereon has not been suitably qualified in the Auditors' Report dated 05.07.2012 and hence, the opinion vide paragraph 4 (d) of the report is incomplete to that extent."

"Management reply:

The total funding from Ministry towards ESR furnace and 6000 tonne forge press is as under originally:

ESR furnace	Rs.15 crores
6000 tonne forge press	Rs.85 crores
	Rs.100 crores

ESR furnace instead of importing, the company has taken up fabrication in house after procuring mechanical and electrical items and commissioned during 2010-11. Thus, the accounting policy No.13 defines capitalisation of borrowing cost as the amount was very meager and there are no substantial economic benefits going to accrue to the company in future by capitalising the same. Thus, interest of Rs. 85.15 lakh incurred towards ESR furnace was ignored in the year 2010-11 as a tax planning measure.

Out of Rs. 46 crore borrowed from the MoD, the company has already repaid Rs. 11.00 crore by 31.3.2011. The contract for 6000 tonne press on M/s XYZ was signed only in 2011-12. An initial advance and advance on submission of drawings was paid during the year 2011-12. There is already an existing press of 1500 tonne on which the company is carrying out its regular operations. In order to enhance the capacity to handle more load 6000 tonne forge press is ordered. Thus, this is not a new facility but enhancement of existing capacity. The amount was drawn from MoD Rs. 9 crore in 2008-09, Rs. 37 crore in the year 2009-10 and Rs. 4 crore in the year 2011-12.

The original order placed on M/s ABC, South Korea in 2008-09 was not executed as the supplier became bankrupt and the security deposit was encashed and kept under suspense in the year 2010-11. This is also to be considered at the time of capitalisation of 6000 tonne forge press.

While calculating interest during construction related to present order, it is yet to be decided whether interest element on borrowed amount outstanding as on 31.3.2011 is to be considered or even prior to that as the present order is placed only in the year 2011-12.

Thus, taking into consideration of above facts, a definite view will be taken in the year 2012-13 accounts suitably, by which time the press will be commissioned and capitalisation will be done.

In view of the above the audit enquiry may please be dropped."

4. The querist has stated that the auditor, not satisfied with the management reply, had retained the query. Subsequently, management has replied further which is as under:

(i) ESR furnace

Rs. 1,384.34 lakh was spent on ESR furnace which was capitalised in the year 2010-11 assuming 50% is from equity and 50% is from loan. Borrowing cost is calculated on Rs. 692.0 lakh till the date of capitalization in the year 2010-11 by government audit. As per second paragraph of the audit enquiry, it is clear that the Government of India had granted a financial assistance of Rs. 100 crore to the company, Rs. 50 crore as equity and Rs. 50 crore as loan for procurement of 10 tonne ESR furnace and 6000 tonne forge press. While drawing the loan, the company had given an undertaking confirming that the amount will not be diverted for any other purpose except for using the same towards procurement of specified equipment. As per the undertaking, the amount should be kept identified separately and it should not be diverted for any other purpose.

Attention is invited to Note under Schedule 3 as well as Note under Schedule 8.3 of the year 2010-11 accounts wherein it is clearly published that the amount is received from Ministry of Defence for specific purpose. Attention is also invited to Point No.1 under A. Balance Sheet in Schedule 20 Notes on Accounts attached forming part of Accounts for the year ended 31/3/2011 wherein again it is clearly brought out about the amount received as well as the amount kept separately for meeting capital expenditure.

As per AS 16, the borrowing cost can be applied on qualifying assets.

To qualify the assets for borrowing cost, the asset must necessarily take substantial period of time to get it ready for intended use.

In commercial parlance, one can say that any time over a period of one year may be termed as substantial period.

The period for ESR furnace from the date of contract to date of installation is eight months. Further, interest for the delay period cannot be capitalised as per AS 16.

In view of the above, borrowing cost cannot be allocated on ESR furnace capitalisation as per AS 16.

(ii) Forge press

As per paragraph 17 of AS 16, capitalisation of borrowing cost should be suspended during extended periods to which active development is interrupted. Audit party had been provided with the total document relating to the forge press in the first stage where the amounts were paid but finally the contract was closed under force majeure because of bankruptcy of the supplier but the company earned interest of Rs. 1,043.97 lakh, (interest on encashment of bank guarantees Rs. 392.66 lakh as well as encashment of security deposit Rs. 732.69 lakh).

As the project is closed, the interest earned and the interest paid were both carried to profit and loss account in the respective years and the amount realised towards encashment of security deposit is kept in suspense A/c (being a capital receipt).

Equipment was re-tendered and the contract was finalized with M/s XYZ, Italy in June, 2011 and the advances are paid as under:

First Advance	Rs. 6,73,16,345/- on 27/7/2011
Second Advance	Rs. 7,18,51,180/- on 29/3/2012

Hence, there is a need to capitalise borrowing cost in the year 2011-12 with effect from June 2011 till the commissioning of the forge press which is likely to take place in July/August 2013.

In the meanwhile the company had repaid two instalments of loan by 31/3/2011 and also earned interest on Rs. 72.22 crore upto 31/3/2012. If the borrowing cost is to be capitalised and kept in capital work in progress as on 31/3/2012 as pointed out by government audit, it is also necessary to consider the interest earned on the specific fund sanctioned and received for specific project which needs to be set off against the borrowing cost.

As per the Guidance Note on Treatment of Expenditure during Construction Period[2], issued by the Institute of Chartered Accountants of India (ICAI), interest from investments of idle project funds should be adjusted in the capital cost of the project (refer paragraphs 8.1, 15.2, 16.1, 16.2 and 17.11). Accordingly interest earned also need to be set off against borrowing cost.

In addition to this, the amount received towards encashment of security deposit is also to be given treatment while capitalising the forge press which needs to be reduced from the total cost as this being a capital receipt. Paragraph 17.11 of the said Guidance Note closes with an advise "consideration may have to be given to the question of providing for income tax liability on such income (paragraph 8.2)."

Thus, there is a lack of clarity on capitalisation of borrowing cost. In view of this, a conscious view is taken to give appropriate treatment once the plant is commissioned so that it will be a fair treatment of income as well as expenditure relating to the equipment and there will be a clear picture available on the total cost of the project.

[2]The Guidance Note on Treatment of Expenditure during Construction Period has been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision at its 280th meeting held on August 7-9, 2008.

5. As the audit had raised enquiry, in order to have the different views, as brought out above, clarified as well as to have back up, it is proposed to refer the issue to the Expert Advisory Committee of the ICAI for its opinion, as this procurement is not a normal one but is having all complications during the execution period as well as due to the undertaking given by the company to the Ministry of Defence, not to divert the funds for any other purpose.

6. Besides taking into consideration the above government audit, enquiries and replies, the following information may also be relied upon to come to appropriate conclusion:

(i) Procurement of forge press is for debottlenecking as the capacity was not sufficient to meet production requirement and therefore it became bottleneck resulting in delayed supplies and getting into liquidated damages.

(ii) While sanctioning the fund, the Ministry insisted for an undertaking from the company that the amount will not be diverted for any other purpose.

(iii) The earlier contract on M/s ABC got terminated under Force Majure condition which qualified for suspended period of operation. As per the Guidance Note on Treatment of Expenditure during Construction Period, issued by ICAI, interest from investments of idle project funds should be adjusted in the capital cost of the project (refer paragraphs 8.1, 15.2, 16.1, 16.2 and 17.11 of the Guidance Note).

(iv) For the purpose of arriving at the net borrowing cost, the amount of interest paid to the Government on the outstanding loan from the date of award of new contract in June 2011 as well as the interest earned on the funds invested in fixed deposits are also considered. Thus, a detailed worksheet bringing out all the facts and figures to know the exact impact of borrowing cost has been provided by the querist for the perusal of the Committee.

(v) To have detailed information on the various notes published in the annual accounts which are duly accepted by statutory auditors as well as government auditors, a summarised sheet bringing out all the notes for ready reference has also been provided by the querist for the perusal of the Committee. Besides, two copies of printed annual reports of 2010-11 and 2011-12 have also been provided.

B. Query

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

(i) Whether the company is right in not capitalising the interest cost in respect of ESR furnace as the total period of contract execution was eight months only which cannot be treated as substantial period.

(ii) Whether the company is right in not capitalising the net interest cost (i.e., paid so far as well as interest earned on funds invested in short term fixed deposits) for forge press which is yet to be installed and also in view of the fact that net interest cost cannot be capitalised for suspended period of operation as the original contract was not executed due to bankruptcy of the supplier, i.e., M/s ABC, Korea and by refloating the tender, a fresh contract was awarded for supply, installation and commissioning of forge press in June 2011, and thus, operation was suspended till June, 2011.

(iii) Whether the amount of security deposit which was encashed and kept in suspense account is to be reduced from the procurement cost at the time of capitalising the forge press after installation and commissioning in the year 2012-13 or 2013-14.

C. Points considered by the Committee

8. The Committee, while answering the query, has considered only the issues raised in paragraph 7 above viz., (i) considering the time period involved in getting ESR furnace ready for its intended use, whether non-capitalisation of the related borrowing cost during that period is in line with AS 16, (ii) whether non-capitalisation of the borrowing costs incurred in relation to forge press is in line with AS 16 on the grounds that it is not yet installed and that borrowing costs are not eligible for capitalisation for the period when original contract could not be executed due to bankruptcy of supplier, and (iii) whether security deposit encashed on bankruptcy of original supplier should be reduced from the procurement cost of forge press. It has

not examined any other issue that may arise from the Facts of the Case, such as, accounting for financial assistance received from the Government, accounting for interest accrued but not due on outstanding loan, accounting for borrowing costs in respect of second contract for forge press, borrowing cost incurred if any between the date when ESR furnace was ready for its intended use and put to use, accounting for various payments made to the contractor under the first contract for forge press, correctness in calculating the interest amount, correctness of impact on financial statements as stated by Government auditors, propriety of keeping the encashed security deposits under suspense account, treatment of any advance given to M/s ABC, Korea and interest thereon, etc. The opinion of the Committee contained hereinafter is from the accounting point of view only, and not from the point of view of income-tax considerations as the latter may be different from accounting considerations. Further, the Committee wishes to point out that the opinion expressed hereinafter provides the principles to be applied while accounting for the issues raised in paragraph 7 above and has not gone into the calculation of various amounts.

9. As regards accounting for borrowing costs in respect of ESR Furnace, the Committee notes the definition of the term 'qualifying asset' and paragraph 5 of AS 16, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') as reproduced below:

> ***"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.***
>
> **Explanation:**
>
> > ***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."***
>
> "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."

From the above, the Committee notes that an asset can be considered as qualifying asset only if it takes substantial period of time to get ready for intended use or sale thereof. Ordinarily, 12 months may be considered as a substantial period of time, unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In this regard, time which an asset takes, technologically and commercially to get ready for its intended use should be considered. The Committee notes from the Facts of the Case (paragraph 4(i) above) that the period of ESR furnace from the date of contract to the date of installation is eight months. Further, it has also been mentioned that the ESR furnace was commissioned and capitalised in the year 2010-11. Accordingly, in the absence of any other related information, the Committee presumes that ESR Furnace takes total time period of eight months to get technologically and commercially ready for its intended use. Further, the Committee is of the view that if the company, based on the facts and circumstances, is of the view that eight months period does not constitute 'substantial period of time' in its case, then the company would be correct in not capitalising the interest cost in respect of ESR Furnace.

10. With regard to capitalisation of interest cost incurred on forge press, the Committee notes paragraphs 6, 10, 11 and 14 of AS 16, notified under the 'Rules', which are stated 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."***
>
> ***"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."

"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."

On the basis of the above, the Committee is of the view that for capitalisation of borrowing costs, it is not sufficient that the funds borrowed are outstanding during the period; it is also essential that the expenditure for construction of the asset is being incurred and the activities necessary to prepare the asset for its intended use are in progress. The Committee notes from the Facts of the Case that the company had entered into contract with M/s ABC, the first supplier of the forge press, which was cancelled due to bankruptcy of the supplier. The Committee is of the view that during the period when the original contract was cancelled and fresh contract to acquire forge press was awarded to another supplier, neither any expenditure was being incurred in construction of the asset nor any activity necessary to prepare the asset for its intended use was in progress, and hence, the question of capitalisation of interest or borrowing costs relating to that period does not arise.

The Committee also notes from paragraph 4 above that decision to capitalise the borrowing costs has been postponed till the commissioning of the plant. In this regard, the Committee wishes to point out that AS 16 prescribes determination of the amount of borrowing costs eligible for capitalisation in *each period* rather than postponing till the commissioning of the asset. If all the conditions stated in paragraph 14 of AS 16 are satisfied in relation to a qualifying asset, the borrowing costs should be capitalised as and when incurred. As regards accounting for interest earned on the encashed security deposits, 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. From the Facts of the Case, the Committee is of the view that the interest earned on the encashment of security deposits on the cancellation of first contract is not of the nature of an income earned from investment of borrowed funds. The source of such income is non-performance on the part of supplier originally identified for acquisition of forge press. Hence, such income cannot be adjusted against the interest cost to be capitalised under second contract of forge press, rather it should be recognised in the statement of profit and loss.

11. As regards adjustment of encashed security deposit in the procurement cost of the forge press, the Committee notes paragraphs 69(a) and 91 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, as reproduced 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 contribution from equity participations."
>
> "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 examples, 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)."

From the above, the Committee is of the view that extinguishment/decrease in the liability should be recognised as income in the statement of profit and loss. In the extant case, the Committee notes from the notes to accounts of the company (Note No. 6), as provided by the querist that the security deposit realised from M/s ABC, Korea was disclosed under the head 'other long-term liabilities'. Accordingly, the Committee is of the view that as and when extinguishment of such liability takes place, the same should be recognised as income in the statement of profit and loss and, therefore, question of adjustment of the same against the cost of the forge press does not arise.

D. Opinion

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

(i) Subject to the presumption that ESR Furnace takes total time period of eight months to get technologically and commercially ready for its intended use and further, if the company, based on its facts and circumstances, is of the view that eight months period does not constitute 'substantial period of time' in its case, the Committee is of the opinion that the company would be correct in not capitalising the interest cost in respect of ESR Furnace.

(ii) The company is correct in not capitalising the interest cost incurred during the period when the original contract was cancelled and fresh contract to acquire forge press was awarded to another supplier, as discussed in paragraph 10 above.

(iii) No, the amount of security deposit which was encashed cannot be reduced from the procurement cost at the time of capitalising the forge press after installation and commissioning in the year 2012-13 or 2013-14, as discussed in paragraph 11 above.

Query No. 33

Subject: Accounting treatment of liquidated damages on unexecuted portion of contract.[1]

A. Facts of the Case

1. A central public sector enterprise, registered under the Companies Act, 1956, was established for manufacturing of weapon systems required for Armed Forces.

2. *Existing practice:*

> "The customers of the company recover liquidated damages for delayed delivery of goods, i.e., when goods are delivered after due date. The company makes provision for liquidated damages for the unexecuted portion of contract for the period of delay from due date of delivery till the date of the accounts. The company is following this practice as a prudent policy and liquidated damages amount is quantifiable and is a definite known liability. In most of the cases, the customer extends the due date, however, with levy of full liquidated damages. At the time of payment, the customer recovers the liquidated damages amount and pays the balance amount only. Then, the company reverses the liquidated damages provision and debits to liquidated damages recovered account (expense account)."

The querist has also stated that the company is following Accounting Standard (AS) 9, 'Revenue Recognition', with regard to main products of the company and the present query has been raised in the context of contract for supply of goods in respect of which principles of AS 9 apply.

3. *Opinion of the Government auditors:*

Provision for liquidated damages is to be made for delay in supply to the extent of executed portion of sales only. Making liquidated damages provision for unexecuted part of contract merely for the delayed time beyond due date is not correct due to matching principle not being satisfied.

4. *Rationale for the existing practice:*

After considering Accounting Standard (AS) 29, 'Provisions, Contingent

[1]Opinion finalised by the Committee on 22.1.2014 and 23.1.2014

Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, as well as General Accounting Pronouncements and Accepted Accounting Practices, the company is of the opinion that liquidated damages is to be provided for unexecuted portion of the contract for the delayed period from the due date of delivery till the date of the accounts for the following reasons:

(1) Customers are recovering liquidated damages for delayed delivery of goods as per the contractual terms.

(2) Amount of liquidated damages is quantifiable and is generally recovered by the customer.

(3) Customer in all cases recovers liquidated damages as per the terms of the contract, and makes the balance payment. There is no clause for the waiver or refund of the liquidated damages by the customer. There is also no clause in the contract to exit from the contract entered with the customer, with or without penalty.

(4) Reference may be made to AS 29 wherein paragraph 14 mentions that ***"a provision should be recognised when: (a) an enterprise has a present obligation as a result of 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."***

(5) In AS 29, 'present obligation' has been defined as follows:

"<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."

(6) Paragraph 16 of AS 29 provides that "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."

(7) The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India (ICAI) 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. 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.

(8) The Framework further mandates that a liability is to be recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

(9) The key aspect which needs to be addressed is therefore - what is the past event? Whether the sales affected is a past event or slippage of delivery schedule as per the contract which is binding is the past event. (Emphasis supplied by the querist.)

(10) A distinction ought to be made between a 'past event' and a 'past transaction'. While a past transaction, in the opinion of the company, will be restricted in the instant case to the sales made and recognised as revenue, the past event may include the delivery schedule and other terms of the contract which are binding in nature and enforceable in law.

(11) Therefore, as the company has not adhered to the delivery schedule, there is a present obligation of paying the liquidated damages which is recovered by the customer from the sales invoices raised subsequently.

(12) The principle of prudence is one of the qualitative characteristics of a financial statement. Prudence demands that the liabilities are not understated.

(13) With regard to the matching principle of costs with revenue, the expenses that result directly and jointly from the same transaction, for example - cost of goods sold are to be matched with the income derived from the sale of goods. The liquidated damages being recovered by the customer is, in the opinion of the company, in the nature of compensatory payment made for the delay in delivery of goods and accrues from the due date of delivery as per the delivery schedule in the contract.

(14) Accordingly, the company feels that it need not revise its accounting treatment with regard to the provision made for liquidated damages recovered by the customers as the present accounting treatment is in order.

5. For better understanding of the facts, the querist has also explained the accounting followed by it with the help of the following example:

Example:

The delivery schedule of an item to be supplied and details of sales to the customer are as follows:

S. No.	Due date of supply	Qty (Nos.)	Value in Rs. Lakh	Actual date of Supply	Qty	Remarks
1.	31st Dec., 2010 (2010-11)	6000	6000	31st Dec., 2010	5000	Slippage of Delivery – 1000 Nos.
2.	28th Feb., 2012 (2011-12)	2000	2000	30th June, 2011 31st Dec., 2011	1000 500	Slippage of Delivery – 1500 Nos.
3.	30th Sep., 2012 (2012-13)	1000	1000	31st May, 2012 31st Dec., 2012	1500 1000	-
4.	31st Mar., 2013 (2012-13)	1000	1000	Yet to be supplied		
	TOTAL	**10000**	**10000**			

Liquidated damage (LD) is @ 0.5% per week or part thereof, Maximum LD is 5%.

At the time of slippage (not yet sold), LD provision is made. At the time of delayed sales, LD provision is reversed and LD liability is created. Debtor's balance is reduced if customer recovers subsequently.

<u>In the year 2010-11, entries to be passed:</u>

I. 1000 Nos. are not sold in the year 2010-11:

Profit & Loss A/c Dr. 50 Lakh

To Provision for LD 50 Lakh

Being LD provision created for 1000 Nos. (Rs. 10,00,00,000 * 5%) not sold as per delivery schedule. 1000 Nos supplied on 30 Jun 2011. Delay from 01 Jan 2011 to 31st March, 2011 is 3 months (12 weeks). LD at the rate of 0.5% per week subject to a maximum of 5% works out to Rs 50 lakhs.

<u>In the year 2011-12, entries to be passed:</u>

A. 1000 Nos. pertaining to the year 2010-11 are sold in the year 2011-12:

I. Provision for LD Dr. 50 Lakh

To provision no longer required written back
(Profit & Loss A/c – income) 50 Lakh

Being LD provision made in the year 2010-11 written back

II. LD Expense A/c Dr. 50 Lakh

To Trade Receivable
(If LD recovered by Customer) 50 Lakh

B. 1500 Nos. are not sold in the year 2011-12:

Profit & Loss A/c Dr. 37.50 Lakh

To Provision for LD 37.50 Lakh

Being LD provision created for 1500 Nos. which is due by 28th Feb., 2012. LD is calculated for March, 2012 only, i.e., @ 2.5% for 31 days or 5 weeks delay (Rs 15,00,00,000 * 2.5%).

<u>In the year 2012-13, entries to be passed:</u>

A. 1500 Nos. pertaining to the year 2011-12 are sold in the year 2012-13:

I. Provision for LD Dr. 37.50 Lakh

To Provision no longer required written back
(Profit & Loss Ac – Income) 37.50 Lakh

Being LD provision made in the year 2011-12 written back

II.	LD Expense A/c	Dr.	75 Lakh	
	To Trade Receivable			75 Lakh

(LD recovered by customer for 1500 nos. from 1st March, 2012 to 31st May, 2012 -5% on 1500 lakh)

B. 1000 Nos. pertaining to the year 2012-13 are sold with delay in the year 2012-13:

Due date	: 30th Sep., 2012
Date of scale	: 31st Dec., 2012
Delay	: 3 Months
LD	: Max. 5 %

I.	LD Expense A/c	Dr.	50 lakh	
	To Trade Receivable			50 Lakh

(LD recovered by customer for 3 months subject to maximum of 5%. The delay is in the same financial year)

C. Balance 1000 Nos. are not sold in the year 2012-13:

LD provision is not provided for 1000 Nos. of items to be supplied in the year 2012-13 since due date for delivery is 31.03.3013 and further, it is the policy of the company not to account for LD in case the due date is at the end of the financial year, i.e., 31st March, 2013."

B. Query

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

(i) Whether the provision for liquidated damages should be made or not in respect of unexecuted portion of the contract for the period of delay from the due date of delivery till the date of accounts.

(ii) Whether such provision for liquidated damages is also required to be made in case the due date falls exactly on the last date of the accounts of the financial year, viz., balance sheet date, i.e., whether one day delay is to be reckoned or not.

(iii) Whether the practice is to be spelt out as a 'Major Accounting Policy' in terms of AS 1 or will it be sufficient if a financial note is appended to the statement of profit and loss or even financial note is not required to be appended.

C. Points considered by the Committee

7. The Committee, while expressing its opinion, has restricted itself to the issues raised in paragraph 6 above and has not examined any other issue that may arise from the Facts of the Case, such as, journal entries passed by the company in respect of liquidated damages and provision thereof, measurement of the provision/liability, if required to be created in respect of liquidated damages, propriety of recognising revenue in the extant case as per the principles of AS 9, etc.

8. The Committee notes from the Facts of the Case that the query is in the context of sales contract(s) for the sale of goods in respect of which the principles of Accounting Standard (AS) 9, 'Revenue Recognition' apply. The Committee also notes that in the extant case, the company has to supply goods to the customer as per the agreed schedule of delivery. At times, a portion of the contracted supplies is delayed on which the customer imposes liquidated damages. The Committee further notes the following requirements of AS 29 and Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006, and Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI as follows:

AS 29

"6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of AS 9.

7. This Standard defines provisions as liabilities which can be measured only by using a substantial degree of estimation. ..."

"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."

"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."

Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'

"17. ...

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Framework for the Preparation and Presentation of Financial Statements

"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.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset

> is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party."
>
> "63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations."

The Committee notes that in the extant case, liquidated damages are recovered by the customers for the period of delay between the due date of supply of goods as per the delivery schedule and the actual date of delivery of the said goods. Further, as per the querist, there is no clause in the contract to exit from the sales contract(s) entered with the customer, with or without the payment of penalty and the past experience of the company shows that in most cases, although the customers extend the due date of supply, the liquidated damages are recovered in full. Accordingly, the Committee is of the view that the terms and conditions of the sales contract(s) are binding and legally enforceable with the customers. In the extant case, although the querist has stated in paragraph 4(13) above that the liquidated damages are in the nature of compensatory payment, the Committee is of the view that the liquidated damages are akin to penalty and there is a contractual obligation on the part of the company to pay for liquidated damages as soon as there is a delay in the supply of goods beyond the due date as per the delivery schedule. Further, this obligation cannot be avoided by the company's future course of actions as it does not have any realistic alternative but to settle the contractual obligation (i.e., making the payment of such liquidated damages). Thus, there exists a present obligation arising from past event, viz., delay beyond scheduled delivery and settlement of which is expected to result in an outflow of resources embodying economic benefits. Accordingly, the Committee is of the view that the company should recognise a provision in respect of liquidated damages for the period of delay between the due date of supply of goods as per the delivery schedule and the expected date of delivery of the said goods and not only for the period of delay till the date of financial statements, in the light of evidence provided by events occurring after the balance sheet date, as per paragraph 36 of AS 29 which provides as follows:

> "36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date."

The Committee is of the view that 'matching concept' does not preclude recognition of present obligations as liabilities at the reporting date.

10. As regards the issue relating to disclosure of accounting policy relating to the practice of the company in respect of provision/liability of liquidated damages, the Committee is of the view that the same would depend upon the materiality of the items and transactions and their impact on the financial statements from the perspective of users of financial statements. In this regard, the Committee notes the following paragraphs of AS 1:

> "11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements."
>
> "17. ...
>
> c. *Materiality*
>
> Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."
>
> ***"24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.***
>
> ***25. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place."***

On the basis of the above, the Committee is of the view that the company should consider disclosure of its accounting policies in accordance with the above-reproduced requirements of AS 1.

D. Opinion

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

(i) and (ii) The company should recognise a provision in respect of liquidated damages for the period of delay between the due date of supply of goods as per the delivery schedule and the expected date of delivery of the said goods and not only for the period of delay till the date of financial statements, in the light of evidence provided by events occurring after the balance sheet date, as per paragraph 36 of AS 29, as discussed in paragraph 9 above.

(iii) The company should disclose its accounting practice in respect of liquidated damages, considering the materiality of the items and transactions and their impact on the financial statements from the perspective of users of financial statements, as discussed in paragraph 10 above.

Query No. 34

Subject: Accounting for Revenue by a Real Estate Developer.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company' or 'the Developer') is a real estate developer, who has entered into a Joint Development Agreement with 'Owners' to develop villaments/row houses/duplex units ('the project' or 'the units'). The Agreement between the Developer and the Owners (a copy of which has been supplied by the querist for the perusal of the Committee) defines the following terms:

A. 'Revenue' shall mean and include all the proceeds, including sales, advances/booking amount generated from the sale of the villaments/row houses/units subject to a minimum total built up area/saleable area of 7,50,000 sq. ft. together with proportionate percentage of undivided share in common areas and facilities, including all the receipts towards charges for car park and for usage of the common areas and facilities, garden area and

[1]Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

also the terrace area but shall not include any amount received as deposits payable for State Electricity Supply Company and State Water Supply and Sewerage Board, back-up power arrangement, and other statutory deposits, if any, payable to the departments/boards at present or in the future.

B. 'Revenue sharing' – The term revenue sharing shall mean the ratio of 62:38 agreed between the Developer on the one hand and the Owners on the other hand.

2. *Obligations of the Owner:*

The Owners hereby irrevocably and exclusively (but subject to the terms contained in this Agreement) granted, permitted and licensed to the Developer and its agents, servants, associates and any person claiming through or under them to enter upon the 'Schedule A Property' as part of the 'Total Lands' immediately on execution of these presents for the development of the same as envisaged under this Agreement form the Effective Date. The Owner shall also grant the Developer a Power of Attorney for the purpose set out in Clause 13.2 of this Agreement. It is clarified that the Owners will continue to be in possession till such time as the contract is discharged by performance and the Developer will have only the right of entry to the Schedule A Property for the purpose of this contract. The Owners shall also grant the Developer a Power of Attorney to obtain the necessary approvals to carry out all the developmental work and to raise finance at any stage and to draw such loans on the security of the Developer's share for the purpose of implementing the project excluding the Owners' unimpaired and unimpeded entitlement to Owners' revenue share of the project. The Owners shall not revoke the Power of Attorney as the agency created is one coupled with interest insofar as the Developer will be incurring expenditure for development of the Total Lands, based on the assurances, representations and permissions granted by the Owners.

3. The Owners, subject to the Developer's compliance with and adherence to the terms of the Agreement and similar Agreement with the Owners of 'Schedule B properties', hereby further agree and undertake not to disturb or interfere with the mechanism adopted in implementing the project or interrupt the construction activity carried out by the Developer and/or commit any act of omission that would result in stoppage or delay of the construction activity to be undertaken by the Developer under the Agreement.

4. *Obligations of the Developer:*

   (i) The Developer has paid a refundable security deposit of Rs. 34.9 million on execution of the Agreement.

   (ii) The Developer hereby agrees to prepare the necessary plans, drawings and designs for the implementation of the project (development plan) at its cost, subject to the terms of the Agreement and similar Agreement with the land owners of Schedule B properties as per all applicable laws and submit the same to the concerned Governmental authorities from whom licenses, sanctions, consents, permissions, no-objections and such other orders required to be procured and to take all approvals for implementation of the project, including the commencement approvals ('approvals'). The responsibility for preparing the plans and obtaining the approvals shall be that of the Developer, however, subject to furnishing all necessary documents by the Owners as may be required from time to time by the planning/licensing authorities.

   (iii) *The Developer shall not be required to consult the Owners while preparing plans/ drawings/ designs (development plan) to be submitted for approval in relation to the project subject to the condition that the Developer shall achieve the minimum total built - up/saleable area of 7,50,000 sq. ft. in the total lands. The Developer shall have the discretion in matters relating to the manner, method and design of construction of the villaments/row houses/units and the execution of the project as per the specifications specified.* (Emphasis supplied by the querist.)

   (iv) The Developer shall have the right to make additions, deletions and alterations to the plans/ drawings/ designs (development plans) submitted subject to such additions, deletions and alterations being permissible under applicable laws and as may be required by the concerned Government authorities and the assurances that the Developer will achieve the minimum total built up/saleable area of 7,50,000 sq. ft. in the total lands and accordingly, the Developer is entitled to carry out the constructions as may be deemed fit to give effect to the terms of the Agreement.

(v) The Owners shall co-operate with the Developer in preparation and submission of plans/ drawings/designs (development plan) whenever so called upon by the Developer in writing and; however, all the cost, howsoever, in this regard shall be borne by the Developer.

(vi) The Developer shall commence construction of the project immediately upon receipt of all the commencement approvals, including the commencement certificate issued by the concerned Governmental authority. The Developer shall immediately on the execution of the Agreement, be entitled to carry out civil works such as, conducting surveys, installing security mechanism (including placing security personnel) and laying roads, drains, pathways, etc.

(vii) The Developer shall be entitled to engage architects, engineers, contractors and other professionals and workmen as it deems fit to execute the construction work. The Developer shall be solely liable for penalties levied by the Government authorities, any defect in quality of construction and shall also be liable for all actions and proceedings, commenced, prosecuted and continued in the event of any deviations in constructions or quality of construction.

(viii) All the costs in relation to developing and implementing the project, including the costs of obtaining the approvals, fees payable to Government authorities, the architects, contractors, staff and workmen, the cost of constructions and to complete developments shall exclusively be borne and paid for by the Developer.

(ix) The Developer shall secure project completion within a period of 42 months from 31st December, 2012. The Developer shall be entitled to a period of 6 (six) months beyond the period of 42 months as 'grace period'.

(x) Minimum sale price - The Developer shall determine the sale price of the villaments/row houses/units subject to the condition that the minimum sale price of the villaments/row houses/ units shall not be less than Rs. 5,500/- (Rupees five thousand five hundred only) per sq. ft. The Developer shall take all necessary measures/steps to market the villaments/row houses/units at the rate of Rs. 5,500/- (Rs. Five Thousand five hundred Only) per sq. ft. or at higher rate and in such event the revenue shall be shared as agreed above.

(xi) The Developer and the Owners undertake and declare that· all the revenue received from the sale of the villaments/row houses/ units shall be solely and only deposited into/ credited to the joint escrow account opened with the bank by mutual consent till the date of completion of the sale of all the villaments/row houses/ units in the project.

(xii) The Developer and all the Owners/the Adjacent Land Owners together shall simultaneously with the opening of the escrow account instruct the bank to transfer by RTGS/NEFT (or such bank transfer) to the Developer's and the Owners'/Adjacent Owners' designated accounts every fortnight in their respective revenue sharing ratio.

5. Default by Developer:

The Developer agrees and covenants with the land owners to comply with and deliver the following to ensure project completion as envisaged under this Agreement within a period of 24 months from the effective date:

- To obtain all permissions, sanctions, approvals, clearances, commencement certificate, including necessary sanctioned building plan from all concerned departments/ boards/authorities and Government agencies;
- To commence construction of villaments / row houses / units in the total lands as per plans/drawings sanctioned by the competent authorities;
- To appoint appropriate banks as 'escrow agent' and to conclude the tripartite escrow agreement as contemplated under this Agreement;
- To set-up marketing office in the total lands and to put in place all marketing strategies and practices for the effective marketing of the villaments/row houses/units; and
- To commence sale of the villaments/row houses/units.

That in the event of such default by the Developer, the land Owners shall be entitled to insist upon the Developer to execute necessary Sharing Agreement demarcating and allotting the villaments/row houses/units to each of the individual land Owners in proportion to the percentage as mentioned in clause 8.1 of the Developer's undertaking to complete such villaments / row house/ units identified for each of the land Owners on priority and deliver possession of such villaments/ row houses/units to the individual land Owners within 42 months and a grace period of 6 months from the effective date as mentioned in this Agreement.

The Developer shall be exclusively liable and responsible towards Governmental authorities for compliance of any of the statutory requirements in relation to development of the lands.

The Developer shall be exclusively liable and responsible for any damage/injury caused to any human being or labours/employees due to the negligence or any other reasons while executing the project/construction and the Owners shall not be liable for any of the aforesaid acts.

The Developer shall complete the project in accordance with the terms of this Agreement. Any dispute between the Developer and their contractors, sub-contractors, labour, agents, employees, Government authorities etc., shall be settled at the earliest by the Developer at its own cost and the Developer shall keep the Owners completely indemnified against all losses, claims and consequences that the Owners may be exposed.

6. The company has also entered in to a General Power of Attorney (GPA) with the land Owners which has the following key clauses:

- To appear and represent the Owners before various Government authorities and apply for and to obtain necessary construction approvals;

- To entrust/assign the development work to such person(s) or companies as deemed fit by the Attorney.

- To apply for and to obtain from the concerned authorities, Plan Sanctions, No Objection Certificates, Commencement Certificate, Occupation Certificate, Completion Certificate and other

Certificates, Permissions, Orders etc. as may be required, in respect of the building/buildings to be constructed and completed on the Schedule Properties.

- To apply for and secure from the concerned authorities, electricity, water and sanitary connections, any other requirements to the buildings to be constructed in the Schedule Properties.
- To raise, borrow funds from banks, financial institutions and other public by creating equitable and other mortgages on security of the Developer's revenue share in terms of the Development Agreement, and to sign and execute requisite mortgage deeds and other conveyances required thereof.
- To consequently sign and execute any agreement(s) to sell, sale deed/s, amalgamation deed and other conveyance(s) in favour of the aforesaid purchaser(s) and/or transferee(s) or his/her/their nominee(s) or assignee(s) on such terms and conditions as our attorney(s) deem(s) it fit in respect of Developers' undivided share in the schedule properties with or without Developers' share of villaments/row houses.

7. *Recognition of Revenue:*

The company proposes to account for the *gross revenue realised* from the sale of villaments/row houses/units as revenue in its books. Subsequently, the obligation of the company to pay the land Owners would be accounted as cost in its books (emphasis supplied by the querist).

8. The company proposes to account for gross revenue realised due to the reason that in substance, goods and services have been received in exchange for goods and services supplied (land received and villaments sold as *quid pro quo*) and also there is no agency relationship between the Developer and the Owners.

9. The company places reliance on the following:

A. Paragraph 73 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India spells out as follows:

"The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent."

B. Paragraph 76 of the Framework spells out as follows:

"Various kinds of assets may be received or enhanced by income; examples include cash, receivables and *goods and services received in exchange for goods and services supplied.* Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in the settlement of an obligation to repay an outstanding loan." (Emphasis supplied the querist.)

(c) Paragraph 4.1 of Accounting Standard 9 states that

*"*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. *In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."* (Emphasis supplied by the company.)

10. The company believes that there is no agency relationship between itself and the Owners due to the following reasons:

(a) The company is responsible for providing the goods and services desired by the ultimate customer, and takes responsibility for fulfillment of an order.

(b) The company has risks and rewards of ownership, such as the risk of loss for collection (credit risk other than for the commission or fee).

(c) The company has general inventory risk before delivery or after return, or inventory risks during shipping.

(d) The company has discretion in establishing price.

(e) The company changes the product or performs part of the service.

(f) The company has discretion in supplier selection.

(g) The company is involved in the determination of product or service specifications.

Further, it is Developer who fully executes the project, incurs costs, obtains certificate of completion, and fixes the sale price. The Agreement specifically mentions that no agency is created. There is a reference in paragraph 4 of AS 9 as to the treatment of sale proceeds distinguishing an agency situation. The Developer has risks and rewards. The querist is of the view that only the gross realisation in the statement of profit and loss will reflect the total efforts of the Developer who has 'complete control' over the land and the amount he passes on to the Owner is only a 'cost' and must be shown as an expenditure as a separate item. The Schedule VI to the Companies Act, 1956 also requires that full value of sales should be shown – notwithstanding any overriding requirement that any expenditure in the nature of revenue sharing is to be incurred by the Developer. The Developer is a substantial stakeholder as it has been given full control over the land which is in effect 'possession' coupled with interest on the land.

B. Query

11. The querist has sought the opinion of the Expert Advisory Committee as to whether or not the method of accounting for gross revenue realised is appropriate as the company has the obligation by virtue of the agreement to effect sales, credit the proceeds to an escrow account and is incurring risks and obtaining rewards.

C. Points considered by the Committee

12. The Committee restricts itself to the issue raised by the querist in paragraph 10 above regarding the accounting for the gross revenue as the revenue of the Developer. The Committee has not touched upon any other issue that may arise from the Facts of the Case, such as, the method of accounting followed by the Developer for the development project, i.e., the 'Completed Contract Method' or the 'Percentage of Completion Method' as enunciated in Accounting Standard (AS) 7, 'Construction Contracts', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') and the Guidance Note on Accounting for Real Estate Transactions (Revised 2012), issued by the Institute of Chartered Accountants of India, timing of recognition of revenue, etc.

13. The Committee notes from the Facts of the Case that in the extant case, there are two parties, viz., the Owners of the land and the Real Estate Developer, who have entered into a contractual arrangement for development of real estate property in order to obtain benefits by sharing the revenue arising from the sale of units so developed in the agreed ratio. Further, the Committee notes the following key features of the Agreement between the two parties:

(a) The "Revenue" refers to "all the proceeds, including sales, advances/booking amount generated from the sale of the Villaments/Row Houses/Units..." (paragraph1.1w). Further, the Agreement contains the provision relating to "Revenue sharing" between the parties in the ratio of 62:38, which essentially indicates that there is a project involving development of property in respect of which the revenue will be shared in the agreed manner between the Owners of the land and the Real Estate Developer.

(b) The share of obligations and duties, each party has to perform, are predetermined in the sense that the Developer is to obtain the permissions and approvals to commence construction, to construct the Villaments/Row Houses/Units, to arrange for the funds, and to sell the said units constructed (paragraph 8.9.1 of the Agreement); and the Owner shall provide the total land with clear and marketable title which is free from encumbrances.

(c) Similarly, financial contribution by both the parties is also predetermined in the sense that the Developer will arrange for the financial resources required for the development of property while the Owners shall fund the project by contributing their land.

(d) As per paragraph 8.4 of the Agreement, all the revenue received from the sale of the units shall be deposited only into the Joint Escrow Account till the date of completion of the sale of all the units in the Project which will be transferred by the bank to the Developer's and the Owners' accounts every fortnight in their respective *revenue sharing ratio*. In other words, none of the party has a sole control on the revenue collected.

(e) Paragraph 8.7.2 of the Agreement provides that the Developer cannot execute the sale agreement of any unit constructed without the Owners. This indicates that the Owners possess the ownership rights till the sale of property and the Developer does not have full control on the same.

(f) Paragraph 8.9.3 of the Agreement provides that in the event of default by the Developer to achieve any or all of the specified tasks, viz., to obtain permissions, to commence construction or to commence sale, etc. within specified period, the Owners can insist the Developer to execute necessary Sharing Agreement, allotting the units to the Owners in their specified proportion and undertaking to complete and deliver possession of such units within the period specified. Further, as per paragraph 8.9.6 of the Agreement, in case of unsold units, the Owners and Developer shall be entitled to execute all appropriate Agreements *for their respective share* as per the Agreement at the price as they may negotiate and settle with the prospective purchases. Thus, the Owners and Developer jointly share the risks and rewards associated with the developed property.

(g) Paragraph 25.6 of the Agreement provides that neither party is entitled to assign its right or obligation under the Agreement without the prior consent of the other party. Thus, none of the party can exit from the Agreement without the consent of other party.

(h) Paragraph 8.8 of the Agreement further provides that the Owners' revenue share shall be the Owners exclusive property. Paragraph 22 of the Agreement also provides that the Developer can raise finance and draw loans *on the security of the Developer's share*. These indicate that the Developer has no right and control on the share of the Owners' revenue.

On the basis of the above, the Committee is of the view that in the extant case, in substance, there is a contractual arrangement between the Developer and the Owners to achieve benefits from the developed project (rather than getting benefits from the individual asset/activity) where both the parties are performing their respective obligations and are also earning revenue in lieu of such performance. While the Developer is earning the revenue for his development and marketing services, the Owners are earning revenue for their contribution in terms of land. Accordingly, in the extant case, for each party, revenue from sale of units will be its share in the gross consideration and not the entire consideration received.

14. With regard to the querist's contention that the company (viz., Developer) has complete control over the land, the Committee is of the view that although the Developer in the extant case enjoys operational flexibility with regard to the project, it cannot be considered as complete 'control' over the land as he has to use the land only for the limited purpose of developing the units in the manner specified under the Agreement as well as due to other reasons as stated in paragraph 12 above. Accordingly, it is not correct to say that the revenue that is being passed on to the Owner is only a 'cost' for the Developer rather, the Committee is of the view that the amount that is being shared with the Owners is their share of revenue for the performance of obligation on their part as per the Agreement.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that for the reasons stated in paragraphs 13 and 14 above, it would be inappropriate for the company to account for the gross revenue from the sale of units as revenue in its books. The company should account for only its share of the gross proceeds from the sale of the units as per the 'Revenue Sharing' arrangement between the Owners and the Developer.

Query No. 35

Subject: Bifurcation between Current and Non-Current Assets of Credit Card Receivable in line with the Revised Schedule VI to the Companies Act, 1956.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is an unlisted non-deposit accepting non-banking financial company registered with the

[1]Opinion finalised by the Committee on 22.1.2014 and 23.1.2014

Reserve Bank of India ('RBI'), engaged in issuing credit cards to consumers in India. The credit card holders are offered revolving credit and term loan products. Spends by customers through credit cards are invoiced every month through credit card statement with 20-25 days payment terms from the date of statement. Further, the credit card holders are offered loan products also, which are repaid by them on EMI (Equated Monthly Installment) basis.

2. The querist has stated that the company follows the 'Guidance Note on the Revised Schedule VI to the Companies Act, 1956' (the 'Guidance Note'), issued by the Institute of Chartered Accountants of India for classifying the assets between current and non-current. Clause 7.1.1 of the Guidance Note states that "An asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

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

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

(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

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

3. The company classifies the outstanding credit card receivables between current and non-current on the balance sheet date as follows:

- All the monthly credit card spends, billed and unbilled, which become due within 20-25 days from the monthly billing date are classified as current assets on the basis of the criteria specified under clause 7.1.1 (a) of the Guidance Note as these are expected to be realised in the company's normal operating cycle.

- All the EMIs due within next 12 months from the balance sheet date are classified as current assets on the basis of the criteria specified under clause 7.1.1 (c) of the Guidance Note as these are expected to be realised within twelve months after the reporting date.

- All other EMIs which will become due after 12 months from the balance sheet date are classified as non-current assets.

4. The company is a Non-Banking Financial Company registered under section 45-1A of the Reserve Bank of India Act, 1934 (2 of 1934) and has been granted certificate of registration (COR) by Reserve Bank of India on 06.10.1998. The company is required to follow "Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007" ("the Directions"). Clause 5 of the Directions states that "Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India shall be followed insofar as they are not inconsistent with any of these directions." Clause 10(5)(iii) of the Directions requires a company to disclose the "maturity pattern of assets and liabilities" in its balance sheet.

5. In compliance of the above requirement, the company prepares the maturity pattern of credit card receivables on the basis of business forecast for recovery of outstanding. The business forecast is based on the actual recovery trend/pattern for past periods. The maturity pattern is shown under different age buckets in following format as per the Directions:

Item	1 day to 30/31 days (one month)	Over one month to 2 months	Over 2 months upto 3 months	Over 3 months to 6 months	Over 6 months to 1 year	Over 1 year to 3 years	Over 3 years to 5 years	Over 5 years	Total

6. The querist has pointed out that as the maturity pattern of the credit card receivable amount in the format mentioned in paragraph 5 above is computed on the basis of business forecast, the maturity value for over one year in the above format is different from the credit card receivable amount shown under non-current assets as per the Guidance Note.

7. During the course of their audit, the auditors from the Comptroller & Auditor General of India's (C&AG) office audited both the disclosures made in terms of paragraphs 3 and 5 above. Following are the observations of C&AG and the corresponding management response:

Observations	**Management's Response**
The Guidance Note on the Revised Schedule VI to the Companies Act	The financial statements have been prepared in line with Revised

1956, states that besides other criteria an asset shall be classified as current if (1) it is expected to be realised in, or is intended for sale or consumption in, the company's normal operating cycle or (2) it is expected to be realised within 12 months after reporting date. The company in Note No. 24 for loans and advances discloses dues outstanding from customers up to 180 days considered good as Rs. 3,29,438 lakh, which include long term loans and advances to customers amounting to Rs. 33,334 lakh (Note No. 13) and short term loans and advances to customers amounting to Rs.296104 lakh (Note No. 15). However, as per Asset Liability Management (ALM) statement reported to RBI which is forming part of the financial statements of the company, the advances recoverable within a period of 12 months is Rs. 2,50,703 lakh and during a period of over one year to three years based on maturity pattern for advances is Rs. 78,735 lakh. Since the company is required to prepare financial statements in compliance with Revised Schedule VI, the short term loans and advances shown as current assets are overstated and the long term loans and advances are understated by Rs. 45,401 lakh.	Schedule VI. According to the requirement of Schedule VI, the classification of assets between current and non-current should be made according to company's normal business cycle which is based on the contractual terms for payments. This process is being followed consistently since the first time Revised Schedule VI became applicable. The ALM for RBI reporting has been prepared based on the projected realisation considering the past trend. However, the company will revisit the ALM in line with contractual terms for payments during the current year and report appropriately. Since this does not have any financial impact, it is requested to defer the audit observation.

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee as to whether the classification of credit card receivable between current and non-current by the company in the balance sheet is correct considering the maturity pattern of credit card receivables shown in the prescribed format by the RBI also.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised by the querist in paragraph 8 above relate to the basis that should be used by the company for classifying outstanding trade receivables in respect of the spends by customers through credit cards and loan products offered, which are payable on EMI basis, as stated in paragraph 2 above, as 'current' and 'non-current' assets in the balance sheet in terms of the Revised Schedule VI to the Companies Act, 1956. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, the manner of disclosure of assets in the disclosure of the 'Maturity pattern of assets and liabilities' in terms of the 'Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007', classification of loans and advances as short term and long term, etc.

10. The Committee notes that in terms of the Revised Schedule VI to the Companies Act, 1956, a company is required to disclose current and non-current assets separately in its balance sheet. The criteria for classification of assets as 'current' have been given in clause 1 of the "General Instructions for Preparation of Balance Sheet" of the Revised Schedule VI to the Companies Act, 1956 (hereinafter referred to as 'General Instructions') which have been enumerated in paragraph 7.1.1 of the Guidance Note and reproduced in paragraph 2 above. The Committee notes that the querist has applied criteria (a) of paragraph 7.1.1 of the Guidance Note which is based on realisation taking place within the company's normal operating cycle in respect of credit card spends as referred to in paragraph 3 above. The Committee further notes that the 'operating cycle' has been defined in the Revised Schedule VI to the Companies Act, 1956 as the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. The Committee is of the view that it is not ordinarily practicable for a financial institution to correlate the 'acquisition of assets for processing

and their realisation in cash'. Therefore, in the extant case, the Committee is of the view that it is not practicable for the company to determine clearly identifiable operating cycle. Accordingly, the Committee is of the view that the company should make the classification of current and non-current on the basis of criteria (c), i.e., all assets expected to be realised within the time period of 12 months after the balance sheet date should be classified as 'current assets'. The Committee further notes that as per this requirement, it is '*expected realisation* within 12 months' and not *'due date'* of realisation which should be considered for the classification of assets. The Committee is also of the view that while determining expected realisation, the company should also consider the realisability factor based on its past data and current trends.

11. The Committee notes from the policy followed by the company as stated in paragraph 3 above that all the EMIs due within next 12 months from the balance sheet date are classified as current assets on the basis of the criteria specified under clause 7.1.1 (c) of the Guidance Note as "these are expected to be realised within twelve months after the reporting date." The Committee notes that the company appears to be presuming that all EMI receivables falling due within 12 months will be realised. It would *prima facie* appear that in such classification, the company may not be factoring those EMI dues which may not be realised within twelve months after the balance sheet date as there would inevitably be cases of non-realisable/ delayed payments of such dues as appears from paragraphs 5 to 7 above. However, while complying with RBI Directions, the same are determined on the basis of the expected recoveries of the outstanding dues. Accordingly, the Committee is of the view that the company should consider the realisability factor in classification of assets as current and non-current based on its past data and current trends.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the classification of assets as current and non-current is to be done only on the basis of the expected realisation of the credit card receivables within 12 months after the balance sheet date, irrespective of them being credit card dues or EMI dues, and not on the basis of their due dates or the contracted dates of payment and should also consider the realisability factor in such classification based on its past data and current trends.

Query No. 36

Subject: Accounting treatment of expenditure incurred on stamp duty and registration fees for increase in authorised capital.[1]

A. Facts of the Case

1. A company was incorporated under the Companies Act, 1956 as a private limited company. The company is registered as a non-banking financial company ('NBFC') (non-deposit accepting) as defined under section 45-1A of the Reserve Bank of India ('RBI') Act, 1934. The company is primarily engaged in the business of lending for purchase of equipments.

2. The details of share capital of the company as at 31st March, 2013 are as follows:

Authorised share capital (70,00,000 equity shares of Rs. 10/- each)	Rs. 7,00,00,000
Issued, subscribed and paid-up capital (64,80,000 equity shares of Rs. 10/- each)	Rs. 6,48,00,000

The company has not issued shares or other securities at premium and hence, does not have securities premium account.

The company has received share application money of Rs. 55,62,55,000. To be able to allot further equity shares, the shareholders of the company, have approved increase in authorised share capital to Rs. 75,00,00,000/-. The company has incurred an expenditure of Rs. 47,60,000 (Rs. 34,00,000 towards stamp duty and Rs. 13,60,000 towards registration fees paid to the Registrar of Companies) for the said increase in authorised share capital.

Post increase in authorised capital, the Board of Directors of the company has passed a resolution for allotment of 5,56,25,500 equity shares of the company of Rs. 10/- each at par amounting to Rs. 55,62,55,000.

3. The issue relates to accounting treatment of the expenditure of Rs. 47,60,000 incurred by the company for increase in authorised capital.

[1] Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

Relevant legal/accounting requirements

4. The querist has stated that the following technical literature merits consideration to determine the appropriate accounting treatment for stamp duty and registration fee incurred by the company for increase in authorised share capital:

- Section 78 of the Companies Act, 1956 permits the use of securities premium account, inter alia,

  (a) in writing off the preliminary expenses of the company, and

  (b) in writing off the expenses of any issue of shares or debentures of the company.

- As per Accounting Standard (AS) 26, 'Intangible Assets',

  "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."

  "5. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of contracts between insurance enterprises and their policyholders. Therefore, this Standard does not apply to expenditure on such activities. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. Accounting issues of specialised nature also arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, *share issue expenses* and discount allowed on the issue of shares. Accordingly, this Standard does not apply to such items also." (Emphasis supplied by the querist.)

- As per the Guidance Note on Terms Used in Financial Statements:

  "**15.08 Share Issue Expenses**

  Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares."

- As per the Guidance Note on Audit of Miscellaneous Expenditure:

  "14. Preliminary expenses are the expenses relating to the formation of an enterprise. For example, in the case of a company, preliminary expenses would normally include the following:

  (a) Legal cost in drafting the memorandum and articles of association.

  (b) Fees for registration of the company.

  (c) Cost of printing of the memorandum and articles of association and statutory books of the company

  (d) Any other expenses incurred to bring into existence the corporate structure of the company."

  "***Expenses Related to Subscription or Issue of Shares***

  20. Expenses related to subscription or issue of share include commission or brokerage on underwriting or subscription of shares or debentures, discount allowed on issue of shares or debentures. ..."

  "24. Other expenses on issue of shares or debentures, such as fees of the managers to the issue, fees of the registrars to the issue including mailing and handling charges, fees of the advisors to the issue, advertisement expenses, expenses on printing and supply of prospectus and application forms, expenses on printing of share/debenture certificates, etc., should be verified with reference to supporting documents such as invoices, agreements, etc. ..."

  (Emphasis supplied by the querist)

- As per paragraph 8.7.4 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956, dealing with 'Other non-current assets':

  "The Revised Schedule VI does not contain any specific disclosure requirement for the unamortized portion of expense items such as share issue expenses, ancillary borrowing costs and discount or premium relating to borrowings. The Old Schedule VI required these items to be included under the head "Miscellaneous Expenditure".

  As per AS 16 *Borrowing Costs* ancillary borrowing costs and discount or premium relating to borrowings could be amortized over the loan period. Further, share issue expenses, discount on shares, ancillary costs-discount-premium on borrowing, etc., being special nature items are excluded from the scope of AS 26 *Intangible Assets* (Para 5). Keeping this in view, certain companies have taken a view that it is an acceptable practice to amortize these expenses over the period of benefit, i.e., normally 3 to 5 years. The Revised Schedule VI does not deal with any accounting treatment and the same continues to be governed by the respective Accounting Standards/practices. Further, the Revised Schedule VI is clear that additional line items can be added on the face or in the notes. Keeping this in view, entity can disclose the unamortized portion of such expenses as "Unamortized expenses", under the head "other current/non-current assets", depending on whether the amount will be amortized in the next 12 months or thereafter."

- As per an EAC opinion (Volume XI, Query No. 3.1) regarding classification of share issue expenses:

  "3. The Committee is of the view that, in general, all expenses incurred directly in relation to a public issue should be considered as public issue expenses. In other words, public issue expenses are those expenses which would not have been incurred had the public issue not been made, e.g., Registrar's Processing Charges, expenses on printing and distributing of a application forms, prospectus, etc. Further, in the view of the Committee, public issue expenses would be those which are incurred between the

> *decision to make the public issue and completion of all necessary formalities with regard to the issue."* (Emphasis supplied by the querist.)

Querist's analysis

5. As per the literature quoted above, it is permissible to amortise share issue expenses over a period of 3 to 5 years. A company has also an option to write off expenses on issue of shares against the securities premium account. However, none of the aforesaid literature makes specific reference to expenditure incurred on increase in authorised share capital and whether such expenditure is a part of share issue expenses. The querist's analysis is as follows:

- One argument is that the increase in authorised capital happens before issuance of shares and should not be regarded as share issue expenses. However, the purpose of increasing authorised share capital of a company is solely to enable the company to issue shares to that extent. There is no other reason why any company would increase its authorised share capital. Thus, the benefit from incurring expenditure on increase in authorised capital arises when the company issues shares. To properly reflect this cost-benefit relationship, expenditure on increase in authorised share capital should be regarded as part of share issue expenses.

- In the given case, the nexus of increase in authorised capital with issue of shares is even clearer than is the case generally. The test (laid down in the EAC opinion referred to above) for determining whether an expenditure is a part of share issue expenses is whether it would have been avoided if the share issue had not been made. This test is satisfied in the present case:

  - ➢ Further equity shares could not have been allotted without increasing the authorised share capital as the company's issued capital was nearly equal to its authorised share capital.

  - ➢ Share application money was received first and the increase in authorised share capital was effected later.

- ➢ The expenditure was incurred after the company had firmed up its decision to issue shares.

Thus, it is clear that the company would not have incurred this expenditure had the share issue not been made.

6. On the basis of the above analysis, the querist believes that the expenditure incurred by the company for increase in authorised share capital should be treated as part of share issue expenses.

- If expenditure on increase in authorised capital is treated as part of share issue expenses, it would be a logical corollary that pending issue of shares, the same should be regarded as an asset. What are the future economic benefits from this asset - can capacity to issue shares be regarded as a future economic benefit?

- If shares are issued only for a part of the increase in authorised capital, should a proportionate part of the relevant expenditure for such increase be carried as an asset? The current accounting practice does not seem to support an affirmative answer to the above.

B. Query

7. On the basis of the above, opinion of the Expect Advisory Committee is sought by the querist on whether the company can treat the whole of the expenditure incurred on increase in authorised capital as 'share issue expenses'.

C. Points considered by the Committee

8. The Committee notes from the Facts of the Case that the company has received share application money in excess of the authorised share capital and subsequently increased its authorised share capital and made allotment of shares. The Committee notes that the query raised is in relation to expenses (stamp duty and registration fee) incurred for increase in authorised share capital of the company. Accordingly, the Committee has examined only that issue and has not examined any other issue arising from the Facts of the Case, such as, accounting for expenses incurred on allotment and other share issue expenses, etc. Further, the opinion of the

Committee expressed, hereinafter, is only from accounting point of view and not from legal viewpoint.

9. The Committee notes that the querist has argued that the expenses incurred on increase in authorised share capital can be considered as share issue expenses as in the extant case, the shares against the excess share application money received can be issued only after increasing the authorised share capital. Accordingly, the Committee has first analysed whether these expenses can be termed as 'share issue expenses'. In this respect, the Committee notes paragraph 5 of Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006 (as reproduced in paragraph 4 above), which states that this Standard does not apply to accounting for share issue expenses. The term 'share issue expenses', however, has not been defined in AS 26. The Committee further notes that the term has been defined in the Guidance Note on Terms Used in Financial Statements which provides as under:

> "Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares."

From the above, the Committee notes that share issue expenses are costs incurred *in connection with the issue and allotment of shares*.

10. The Committee also notes that the querist has cited the view expressed by the Committee in one of its opinion (refer paragraph 4 above), wherein the Committee had expressed the view that public issue expenses are those expenses which would not have been incurred had the public issue not been made, e.g., Registrar's processing charges, expenses on printing and distributing of application forms, prospectus, etc. Further, the Committee had expressed the view that, public issue expenses would be those which are incurred between the decision to make the public issue and completion of all necessary formalities with regard to the issue. The Committee wishes to point out that in the cited query, the issue of enhancing the authorised capital was not raised. The Committee is of the view that increase in authorised share capital is an independent process which does not necessarily lead to issue of shares. The need to increase the authorised capital and to incur expenses for increasing the same would not have arisen had the additional allotment of shares was within the limits of existing authorised capital. Accordingly, the Committee is of the view that the

expenses incurred on increase in authorised share capital are distinct and separate from the expenses incurred on share issue. Additionally, the Committee is of the view that accounting depends on the nature of expense and the fact that the share application money was received before increase in authorised share capital will not change the nature of expense. Further, increase in authorised share capital does not represent issue of additional share capital and only sets a limit for the paid up capital of a company at any given point of time. Accordingly, the Committee is of the view that the expenses incurred on increasing the authorised share capital cannot be termed as 'share issue expenses'.

11. As regards the issue relating to accounting for the expenses incurred on increase in authorised capital, the Committee notes the following paragraphs of 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. ..."

From the above paragraph of AS 26, the Committee notes that if an expenditure does not result into acquisition of an asset, it should be recognised as an expense as and when incurred. The Committee also notes that the amount spent towards increase in authorised share capital does not give rise to any *resource controlled* by the enterprise. In fact, such expenses are only permitting the company to enhance the limit for the paid-up capital of the company which does not ensure any flow of funds to the company. Accordingly, it does not meet the definition of an asset, as reproduced above. Thus, the amount aggregating to Rs. 47,60,000 incurred towards stamp duty and fees paid to the Registrar of Companies should be recognised as expense in the statement of profit and loss as per the requirements of paragraph 56 of AS 26.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the expenditure incurred by the company towards increase in authorised share capital (stamp duty and registration fee paid to the Registrar of Companies) cannot be considered as share issue expenses and should be treated as expense and charged off in the statement of profit and loss, as discussed in paragraphs 10 and 11 above.

Query No. 37

Subject: Accounting treatment of dividend declared by mutual fund in debt fund scheme under dividend re-investment plan.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a maharatna Central PSU engaged in mining of coal having touched a production of 452 million tonnes during the 2012-13 fiscal year. The company is a direct holding company of nine subsidiaries out of which eight are registered in India and the ninth one is registered in Mozambique. Two of its direct subsidiaries have further three and two sub-subsidiaries, respectively. Further, there are few joint ventures and associate companies which also form part of the group accounts. The consolidated turnover of the company for the year 2012-13 was Rs. 88,281 crore with profit before tax of Rs. 24,979 crore. The main object of the company is to produce or otherwise engage generally in the production, sale and disposal of coal and its by-products.

2. The querist has stated that the company and its subsidiaries have surplus funds which are invested in bank fixed deposits (FDs) as well as in mutual funds (debt fund scheme). While the bank fixed deposits are shown under the note 'cash & bank balance', the investment in mutual fund is shown under the Note 'current investments' in the balance sheet. The term

[1] Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

of the mutual fund is dividend re-investment plan which signifies that the dividend accruing on daily basis of net assets value (NAV) of the scheme as on the date of declaration of dividend, results into increase in the number of total units held by the company.

Accounting Policy:

3. As per annual accounts of the company, the significant accounting policies with respect to investments and recognition of dividend income are reproduced below:

> **Note — 33**
>
> **5.0 Investments:**
>
> "Current investments are valued at the lower of cost and fair value as on the balance sheet date. Investments in mutual fund are considered as current investments. Non-current investments are valued at cost."
>
> **11-2 Dividend:**
>
> "Dividend income is recognised when right to receive is established".

4. *Practice being followed:*

The valuation of the mutual funds is done on NAV basis and any dividend earned and re-invested over and above the initial investment is credited to the mutual fund account by increase of appropriate number of units at the NAV as on that date. (A copy of typical mutual fund accounts statement as an illustration to the above method has been supplied by the querist for the perusal of the Committee). The terms and conditions of the mutual funds are subject to market risk. A copy of the disclaimer clause issued by the mutual funds managers in this respect has also been supplied by the querist for the perusal of the Committee.

5. As already stated above, the initial investment in mutual fund for which the direct cash outflow took place is shown under the note 'Current Investments' in the balance sheet. The increase in number of units by way of dividend and the resultant increase in valuation thereby are not recognised either as income or as increased valuation of investment as on the balance sheet date on the ground that the same has not been realised and that investments are valued at cost. The dividends are recognised only in the period in which the initial investment along with additional units allotted due *to reinvestment of dividend declared on daily basis are redeemed and realised.*

Treatment as described hereinabove is based on the logic that since investments in mutual funds are subject to market risks and there is no certainty that the dividend incomes by way of units at NAV (which is reckoned at the NAV value of the initial investment) shall be ultimately realised upon redemption.

As per the disclosure requirement of Accounting Standard (AS) 13, 'Accounting for Investments', the NAV value / market value of the investment alongwith the increased number of units received due to conversion of dividend are however disclosed at fair value of unquoted investment. An illustration has also been supplied by the querist as Note-14, current investment (unquoted at cost) from the annual accounts of the company (standalone) for the perusal of the Committee.

(Emphasis supplied by the querist.)

Thus, the company is following a very conservative method of not recognising the income till ultimate realisation thereof by way of redemption and at the same time, disclosing the fair value of investment (in mutual funds) as per the requirements of AS 13.

6. *Issue raised:*

Statutory auditor of one of the subsidiary companies is of the view that the dividend declared is credited to the mutual fund account of the company and thereafter the number of units held by the company is increased by additional units following conversion of such dividend amount into units at NAV of the scheme. Thus, the dividend declared and reinvested in the scheme should be recognised as revenue income on the balance sheet date as per Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules').

B. Query

7. In the above background, the querist has sought the opinion of the Expert Advisory Committee as to whether the dividend declared on daily basis and credited in the form of additional units in the mutual fund account under debt fund dividend re-investment plan should be recognised as revenue

income as on the date of balance sheet in the final accounts of the company even if the same has not been redeemed/encashed. If yes, the value at which such recognition is to be made.

or

The present conservative practice of the company of not recognising the dividend declared and re-invested in the mutual fund • dividend re-investment plan on the balance sheet date due to non-encashment of such additional units be continued.

C. Points Considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to timing of recognition of dividend income which has been declared on mutual fund units of debt fund dividend re-investment plan, which is classified by the company as a current investment. The Committee has, therefore, considered only this issue raised by the querist in paragraph 6 above and has not examined any other issue(s) that may be contained in the Facts of the Case, such as, accounting for fixed deposits, classification of investments, disclosure requirements under AS 13, accounting policy as adopted for valuation of current investments and long-term investments, etc.

9. The Committee notes from the Facts of the Case that the company invests in the debt fund scheme of the mutual funds and has opted for dividend reinvestment plan wherein the dividend declared by the mutual fund on daily basis is reinvested in the additional units of the same scheme. The querist has raised the issue with respect to timing of recognition of such dividend declared by the mutual fund which is received by the company in the form of additional units of mutual fund. For recognition of such dividend, the Committee notes the following paragraph of AS 9, notified under the Rules:

> ***"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:***
>
> ***...***

(iii) Dividends from investments in shares :	***when the owner's right to receive payment is established."***

In view of the requirements of AS 9 referred to above, the Committee notes that dividend income should be recognised at the time when the unit holder's right to receive the payment thereof is established. The Committee is of the view that the right to receive is established when dividend is declared. In the extant case, the Committee notes from the Facts of the Case that dividend is declared on daily basis and credited to the account of the company, which is represented by units determined on the basis of NAV per unit under initial investment of the units. This is reflected in the mutual fund account statement of the company. The Committee also notes from the Dividend Policy under one of the Schemes in the Key Information Memorandum, which is provided by the querist for the perusal of the Committee, that such reinvestment option was available in respect of a liquid fund wherein payout option on periodic basis was also available. Thus, dividend was realisable both in cash or in kind, i.e., in the form of units of the fund as per the option exercised by the investor. The Committee is further of the view that nature of dividend would not change due to opting for reinvestment of dividend. Change in the value of reinvested units as a function of market price is a separate risk from the risk of investor's right to receive the dividend. Accordingly, the Committee is of the view that the present practice of the company to defer the dividend declared and re-invested in the mutual fund scheme till the actual redemption of units and realisation of cash is not correct, rather it should be recognised as and when right to receive the dividend is established.

10. As regards the value at which dividend and investment should be recognised, the Committee is of the view that revenue from dividend should be recognised at the value of dividend received. Similarly, investments should be recognised at the issue price on the date of acquisition of each unit of mutual fund. With regard to any decline in the value of investments occurring subsequently due to market risks involved in mutual fund, viz., fluctuations in the NAV vis-a-vis interest rates, etc., the Committee is also of the view that since current investments are carried at lower of cost and fair value, such decline/impairment in value of investment would be recognised while valuing the investments at the reporting date.

D. Opinion

11. Based on the above, the Committee is of the opinion that the dividend declared on daily basis and credited in the form of additional units in the mutual fund account under debt fund dividend re-investment plan should be recognised as revenue income as and when the right to receive is established, as discussed in paragraph 9 above. As regards the value at which dividend and investment should be recognised, refer to paragraph 10 above.

Query No. 38

Subject: Accounting treatment of hedging costs incurred on External Commercial Borrowing (ECB) Loan.[1]

A. Facts of the Case

1. A Government company (hereinafter referred to as the 'corporation' or the 'company') within the meaning of section 617 of the Companies Act, 1956 is in the business of refining and marketing of petroleum products. The corporation is arranging funds through external commercial borrowings (ECB) route for its various capital project requirements. The corporation had taken ECB for a period of 5 years during the financial year 2006-07 for an amount of JPY 18,079 million (Rs. 623 crore). The allocation of the loan was for various capital projects (which, as per the querist, are qualifying assets as per Accounting Standard (AS) 16, 'Borrowing Costs') at the refineries of the corporation. Forward and option contracts were taken to hedge the above loan exposure, which more or less coincided with the repayment of the loans.

Above loan was hedged with the following:

a. JPY / USD Forwards,

[1] Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

b. USD / INR Forwards &

c. USD / INR Options.

The above loan got fully repaid on 18th July, 2012.

2. *Accounting treatment followed by the corporation:*

Till March 2012, the premium/discount on forward contracts were recognised over the period of such contracts and the same were treated as a part of 'other expenses' (exchange rate variation cost). During the year 2012-13, the premium/ discount on forward contracts has been continued to be recognised over the period of the contract (in line with the corporation's significant accounting policies), the only difference in the treatment made during the year 2012-13 is towards the classification of such cost wherein, the amortised portion has been recognised as a part of 'finance cost'. During the year 2012-13, total premium on forward contracts for the period 2006-07 to 2012-13 amounting to Rs. 190.90 crore was treated in the books as 'other borrowing cost'. Out of this amount, Rs. 64.82 crore was capitalised, being the borrowing cost pertaining to qualifying assets, till the date the said qualifying assets were put to use.

The following were disclosed in this regard vide Note 28 and 36 of the annual accounts for the year 2012-13:

"Note # 28

Prior Period Expenses/ (Incomes)

Rs. in Crore

	F.Y. 2012-13	**F.Y. 2011-12**
Expenditure on enabling assets	-	1.70
Depreciation (Ref. note 11 & 12)	(49.10)	-
Finance costs (Ref. Note 36)	**(64.82)**	**-**
Exchange rate variations	0.53	(1.21)
Total	(113.39)	0.49

Note # 36

Hitherto, premium on forward exchange contracts entered into to hedge the liability from syndicated loans from foreign banks (repayable in foreign currency) were amortised over the period of the syndicated loans from foreign banks (repayable in foreign currency). As per AS 16, borrowing costs include costs incurred by an enterprise in connection with borrowing of funds. Accordingly, during the current financial year, the premium on forward exchange contracts entered into to hedge the liability towards syndicated loans from foreign banks (repayable in foreign currency) has been considered as borrowing cost as per AS 16. Consequently, an amount of Rs. 64.82 crore has been capitalised in the current financial year and disclosed as a part of Note #28 'Prior Period Expenses/ (Incomes)'. As a result, profit for the year before tax of the corporation (net of depreciation) is higher by Rs. 52.43 crore during the current financial year."

The following are the extracts of significant accounting policies as followed in the accounting year 2012-13 in the above context:

"Construction period expenses on projects

a. Related expenditure (including temporary facilities and crop compensation expenses) incurred during construction period in respect of plan projects and major non-plan projects are capitalised.

b. Financing cost incurred during the construction period on loans specifically borrowed and utilised for projects is capitalised. Financing cost includes exchange rate variation in relation to borrowings denominated in foreign currency.

c. Financing cost, if any, incurred on general borrowings used for projects during the construction period is capitalised at the weighted average cost."

"Foreign Currency Transactions

a. Foreign currency transactions during the year are recorded at the exchange rates prevailing on the date of transactions.

b. All foreign currency assets, liabilities and forward contracts are restated at the rates prevailing at the year end.

c. All exchange differences (except as stated in note #2.3 (b), 33, 34 and 35) are dealt with in the statement of profit and loss including those covered by forward contracts, where the premium/ discount arising from such contracts are recognised over the period of contracts.

d. The realized gain or loss in respect of commodity hedging contracts, the pricing period of which has expired during the year, are recognised in the statement of profit and loss along with the underlying transaction. However, in respect of contracts, the pricing period of which extends beyond the balance sheet date, suitable provision is made for likely loss, if any."

3. *Views of government auditor:*

The government auditor has objected to the above accounting treatment and made the following comments:

"Statement of Profit and Loss

Prior Period Expenses/ (Incomes) :- Rs. (113.39) crore (Note-28)

This includes an amount of Rs. 64.82 crore (finance cost) in the current financial year towards reversal of premium on forward exchange contracts which was amortised over the period of the loan and charged off in the statement of profit and loss till the year 2011-12. The forward exchange contracts are entered to hedge the liability of syndicated loans from foreign banks (repayable in foreign currency).

In this regard attention is drawn to the significant accounting policies (note 2) wherein with regard to 'Foreign Currency Transactions' vide paragraph no. 2.6 'c' it has been stated that, "All exchange differences (except as stated in note # 2.3 (b), 33, 34 and 35) are dealt with in the statement of profit and loss including those covered by forward contracts, where the premium/discount arising from such contracts are recognised over the period of contracts". Thus, as per declared significant policy of the company relating to foreign currency transactions, the premium relating to forward exchange contracts is amortised over the period of contracts in the statement of profit and loss. Thus, the reversal of the premium on forward exchange contracts, charged off in the statement of profit and loss of the earlier years, in the current financial year contradicts the own declared policy of the company.

Moreover, as per provisions of paragraph 36 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', 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. Thus, the reversal of the premium, charged off in the statement of profit and loss of the earlier years, in the current financial year also contravenes the provisions of mandatory AS 11.

Thus, the reversal of the premium on forward exchange contracts, in current year is not only in contravention of corporation's own declared accounting policy and provisions of mandatory AS 11 but also resulted in overstatement of prior period income and gross block of assets by Rs. 64.82 crore and of profit (net of depreciation) for the year by Rs. 52.43 crore."

4. The querist has stated that the government auditor has also made the following submission for inclusion in this case for opinion:

(a) The basic underlying principle behind the provisions of AS 16, to allow capitalisation of foreign exchange losses in connection with foreign currency loan is that the amount of expenditure which an enterprise would have incurred domestically had loan in Indian rupees would have been taken instead of foreign currency loan. Thus, any cost which is incurred in connection with foreign borrowing should be incurred essentially for arranging the subject foreign currency loan as the same otherwise also would have been incurred had the loan been taken domestically.

(b) In this regard, reference is invited to paragraph 4 of AS 16 which states the items which may be considered as borrowing cost. As could be seen that there is no mention in this paragraph about hedging cost. Thus, the careful reading of paragraph 4 of AS 16 would indicate that borrowing costs are those costs which are incurred for arranging the borrowings and as the hedging costs are not incurred for arranging the borrowings, such costs are not to be considered as borrowing costs even though they might have been incurred in connection with borrowings. Had only 'in connection with' been the determining criteria of borrowing costs, then the mention of hedging cost would have also been included in paragraph 4 of AS 16 which states the items which may be considered as borrowing costs.

(c) In this regard, attention is also drawn to paragraph 4 (e) of AS 16, which provide that borrowing costs may include "exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs". Paragraph 4(e) of AS 16 covers exchange differences on the amount of principal of the foreign currency borrowings to the extent of difference between interest on local currency borrowings and interest on foreign currency borrowings. For this purpose, the interest rate for the local currency borrowings should be considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings. If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4 (e) of AS 16. In this regard, attention is drawn to the example given at the end of AS 16.

(d) Moreover, the Ministry of Corporate Affairs' (MCA's) clarification allowing the impact of entire exchange difference relating to interest amount only (which earlier was not allowed fully) considering the 'economic reality' has to be seen in the context that entire exchange difference relating to interest amount was decided to be allowed for capitalisation due to constant devaluation of Indian Rupee. However, under the pretext of 'economic consideration', it would not be correct to consider the hedging cost incurred as borrowing cost as per AS 16 due to this clarification of MCA.

(e) As regards the contention that the hedging costs are necessarily to be incurred in connection with foreign currency borrowings, and are integral part of the foreign currency borrowings and thus inseparable from borrowing portfolio is not found tenable on the following grounds:

  (i) Even though it may be in connection with foreign currency loan, however, such hedging costs are not for arranging the foreign currency loan but are incurred by corporation for mitigating its risk towards exchange fluctuation.

(ii) As contended, if the hedging cost would have been integral part of borrowings then without hedging cost, no ECB would have been possible. However, it is pertinent to mention that corporation itself has raised loans (ECB-3 and ECB-4) for which no hedging has been done. This proves that hedging is optional as without incurring hedging cost also the foreign currency loan could be arranged by the enterprise. Therefore, hedging cost cannot be considered as integral part and necessarily to be incurred for availing ECB.

In light of the above, hedging cost cannot be considered as borrowing cost within the ambit of provision of AS 16 even though it might have been incurred in connection with foreign borrowing.

Additionally, as per provisions of paragraph 36 of AS 11, 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. To amortise as expense means to charge off against the profit in the statement of profit and loss. Thus, in view of the above facts, the reversal of the premium, charged off in the statement of profit and loss of the earlier years, in the current financial year is not found correct.

Rationale behind treating hedging cost as borrowing cost:

(A) References of various Accounting Standards and Guidance Note:

Reference is invited to the following paragraphs of AS 16, AS 11 and of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956:

AS 16

"*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;*

(d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

...” (Emphasis supplied by the querist)

“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.”

AS 11

“7.3 <u>Exchange difference</u> is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

7.4 <u>Exchange rate</u> is the ratio for exchange of two currencies.”

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

“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.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date."

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:

(A) Interest expense

(B) Other borrowing costs

(C) Applicable net gain/loss on foreign currency transactions and translation

...

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."

(B) Further contentions of the corporation are:

(i) Enterprises often borrow in foreign currency at a lower interest rate as an alternative to borrowing locally in rupees, at a higher rate. However, the likely currency depreciation in INR and resulting exchange loss often offset, fully or partly, the anticipated savings in interest rates (foreign interest rate v/s domestic interest rate).

Nevertheless, one of the ways to ensure that the adverse effect of this likely depreciation of local currency is avoided is to carry out a hedge against the Rupee fluctuations through instruments like forwards and options. In such a scenario, the hedged portfolio becomes an integral part of the foreign currency borrowing and needs to be seen together while carrying out any cost-benefit-analysis to ascertain if the anticipated savings in interest rates (foreign loan v/s domestic loan) is safeguarded.

The above establishes the fact that the derivative transactions of forwards and options of the company are backed by a physical exposure (herein the loan portfolio). Also, this principle is as per the requirements of RBI Guidelines on derivatives transactions which entails that derivative transactions in India needs to be necessarily backed up by a physical exposure.

(ii) The Institute of Chartered Accountants of India (ICAI), while issuing clarification on foreign exchange transactions in November 2003 vide Accounting Standards Interpretation (ASI) 10[2], 'Interpretation of paragraph 4(e) of AS 16', has, inter alia, stated-

> "it is not appropriate to consider only the explicit interest cost on the foreign currency borrowing as the borrowing costs" and that exchange differences are to be considered as borrowing cost and accounted for accordingly "with a view to reflect economic reality."

It may be noted that the above clarification was issued by the ICAI subsequent to the issuance and publication of Accounting

[2] The ASI has been withdrawn by the Council of the Institute of Chartered Accountants of India and the consensus portion thereof has been added as 'Explanation' to the paragraph 4(e) of Accounting Standard (AS) 16, 'Borrowing Costs'.

Standard (AS) 11 (Revised 2003), 'The Effects of Changes in Foreign Exchange Rates' in March 2003 journal.

Attention is also drawn to a more comprehensive paragraph included in the ICAI's pronouncement, 'Framework for the Preparation and Presentation of Financial Statements' which is reproduced below:

> "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."

The economic reality with respect to cost incurred towards premium / discount is that when an organisation finds the long-term foreign currency borrowing costs lower, on a fully-hedged basis, than comparable Rupee borrowing costs, then only such foreign currency borrowing options are undertaken. This signifies that the implied interest cost (herein referred to as the premium on forward / option contracts) also needs to be considered as a part of the borrowing costs and treated accordingly as per the relevant Accounting Standard.

(iii) The ECB has been taken for various capital projects as stated above and hence, the same is directly attributable to the acquisition, construction or production of qualifying assets as per paragraph 6 of AS 16. Hence, hedging cost (after establishing the fact that hedged portfolio is an integral part of the foreign currency borrowing as per (i) above) is also attributable to acquisition, construction or production of a qualifying asset.

(iv) As per paragraph 37 of AS 11, the premium or discount on entering into forward or option contracts are to be separately accounted from the exchange differences on such contracts. Hence, hedging cost is separately accounted as borrowing cost and not considered as a part of exchange rate variation.

(v) Hedging cost is considered to be in nature of ancillary costs in connection with the arrangement of borrowings as indicated in paragraphs 3.1 and 4 (c) of AS 16 and paragraph 9.5.5 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956.

(vi) Paragraph 6 of AS 16 does not state that only 'mandatory' costs need to be capitalised. It only states that borrowing cost that are "directly attributable to the..." should be capitalised.

(vii) Had the corporation not entered into any forward contract, the entire exchange rate variation would have been capitalised as per paragraph 46 of AS 11, without any amount being charged to the statement of profit and loss.

(viii) Interest Rate Parity theory states that 'the size of the forward premium (or discount) should be equal to the interest rate differential of the two countries of concern' [ICAI - Foreign Exchange and Risk Management]. When interest rate parity exists, interest arbitrage is not feasible, because any interest rate advantage in the foreign country will be offset by the discount on the forward rate.

Thus, forward premium is directly dependent upon the interest rate differential of the two countries and can be construed as corollary to paragraph 4 (e) of AS 16.

Based on the above referred paragraphs of Accounting Standards/Guidance Note and the rationale given above, the corporation has considered premium/ discount on forward/ option contract (i.e. hedging cost) on the ECB as finance costs. This accounting treatment has been concurred by the statutory auditors and is also supported by an independent opinion taken from a reputed Chartered Accountant firm.

B. Query

5. On the basis of the above, opinion of the EAC is sought by the querist on the following issues:

(i) Whether the hedging cost incurred in connection with external commercial borrowings can be considered as 'borrowing cost' under provisions of AS 16.

(ii) If answer to query (i) is negative then what should be the correct accounting treatment for hedging cost in connection with ECB in the light of various notified accounting standards and notifications/ clarifications of MCA issued so far.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to accounting treatment of hedging cost, viz., premium/ discount on forward/ option contract undertaken in connection with external commercial borrowings (ECB) (which are repayable in foreign currency) as per the provisions of AS 11 and AS 16, notified under the Companies (Accounting Standards) Rules, 2006. 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 ECB, accounting for exchange differences arising on ECB, accounting for foreign currency transactions and commodity hedging contracts, correctness of accounting policy of the company in respect of finance/borrowing cost and other accounting policies in general, accounting for expenditure incurred during construction period apart from hedging cost, accounting treatment of exchange differences arising on forward contracts as at the reporting date or the settlement date, correctness of treating the hedging cost as prior period item when there is a change in accounting policy, etc. The Committee presumes from the Facts of the Case that the option under paragraphs 46 and 46 A of AS 11 for capitalisation of foreign exchange differences in respect of ECBs, is not exercised by the company.

7. The Committee notes from the Facts of the Case that the querist has argued the hedging cost to be other/ancillary borrowing costs as per paragraph 4(c) of 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;

..."

From the above, the Committee notes that other/ancillary borrowing costs are the costs incurred in connection with the *arrangement of borrowings,* viz., for obtaining the borrowings whereas hedging costs, viz., the discount or premium on forward contracts are the costs incurred to enter into forward contracts for hedging or mitigating the risks associated with adverse movement of foreign exchange rate variations on foreign currency borrowed through ECBs and not for arranging the borrowings itself. Further, the Committee is of the view that it is not necessary to hedge risk against foreign currency movement to obtain the borrowings. In other words, ECBs are not received with a pre-condition to hedge its foreign currency risks. Therefore, hedging costs cannot be considered to be an anciliary cost incurred for arrangement of borrowings. Thus, hedging costs cannot be considered as a type of borrowing costs.

8. As far as the querist's argument that derivative transactions in India need to be necessarily backed by physical exposures as per the RBI guidelines, the Committee is of the view that this requirement does not mandate that all physical exposures, viz., foreign currency loans and borrowings necessarily need to be covered by hedging instruments. Thus, the hedging costs are avoidable and not an integral or necessary part of the borrowings and, therefore, cannot also be considered as directly attributable cost. Further, in the view of the Committee, the forward exchange contracts are independent from underlying transactions and therefore, AS 11 prescribes separate accounting for forward exchange contracts. Accordingly, in the extant case, foreign currency borrowings and hedging instruments are two separate transactions and that hedged portfolio is not an integral part of the foreign currency borrowings, as being argued by the querist.

9. With respect to the accounting for hedging costs, the Committee notes that AS 11, notified under the Rules explicitly provides its accounting principles in paragraphs 36 and 37 as 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.***
>
> 37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date."

The Committee notes from the Facts of the Case that in the extant case, the company has taken forward/option contracts for hedging the ECB loan only and are not intended for trading or speculation purposes. Therefore, as per the above-reproduced provisions of AS 11, 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.

D. Opinion

10. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 5 above:

(i) No, the hedging cost incurred in connection with external commercial borrowings cannot be considered as 'borrowing cost' under the provisions of AS 16, as discussed in paragraphs 7 and 8 above.

(ii) 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, as discussed in paragraph 9 above.

ADVISORY SERVICE RULES OF THE EXPERT ADVISORY COMMITTEE

(Applicable w.e.f. 1st April, 2014)

1. Queries should be stated in clear and unambiguous language. Each query should be self-contained. The querist should provide complete facts and in particular give the nature and the background of the industry or the business to which the query relates. The querist may also list the alternative solutions or viewpoints though the Committee will not be restricted by the alternatives so stated.

2. The Committee would deal with queries relating to accounting and/or auditing principles and allied matters and as a general rule, it will not answer queries which involve only legal interpretation of various enactments and matters involving professional misconduct.

3. Hypothetical cases will not be considered by the Committee. It is not necessary to reveal the identity of the client to whom the query relates.

4. Only queries received from the members of the Institute of Chartered Accountants of India will be answered by the Expert Advisory Committee. The membership number should be mentioned while sending the query.

5. The fee charged for each query is as follows:

   (i) Rs. 75,000/- plus service tax (as applicable) per query where the query relates to:

      (a) an enterprise whose equity or debt securities are listed on a recognised stock exchange, or

      (b) an enterprise having an annual turnover exceeding Rs.50 crore based on the annual accounts of the accounting year ending on a date immediately preceding the date of sending the query.

   (ii) Rs. 37,500/- plus service tax (as applicable) per query in any other case.

   The fee is payable in advance to cover the incidental expenses. Payments should be made by crossed Demand Draft or cheque or Postal Order payable at Delhi or New Delhi drawn in favour of the Secretary, The Institute of Chartered Accountants of India.

6. Where a query concerns a matter which is before the Board of Discipline or the Disciplinary Committee of the Institute, it shall not be answered by the Committee. Matters before an appropriate department of the government or the Income-tax authorities may not be answered by the Committee on appropriate consideration of the facts.

7. The querist should give a declaration in respect of the following as to whether to the best of his knowledge:

    (i) the equity or debt securities of the enterprise to which the query relates are listed on a recognised stock exchange;

    (ii) the annual turnover of the enterprise to which the query relates, based on the annual accounts of the accounting year immediately preceding the date of sending the query, exceeds Rs. 50 crore;

    (iii) the issues involved in the query are pending before the Board of Discipline or the Disciplinary Committee of the Institute, any court of law, the Income-tax authorities or any other appropriate department of the government.

8. Each query should be on a separate sheet and five copies thereof, typed in double space, should be sent. The Committee reserves the right to call for more copies of the query. A copy of the query may also be sent on a floppy or through E-mail at eac@icai.in

9. The Committee reserves its right to decline to answer any query on an appropriate consideration of facts. If the Committee feels that it would not be in a position to, or should not reply to a query, the amount will be refunded to the querist.

10. The right of reproduction of the query and the opinion of the Committee thereon will rest with the Committee. The Committee reserves the right to publish the query together with its opinion thereon in such form as it may deem proper. The identity of the querist and/or the client will, however, not be disclosed, as far as possible.

11. It should be understood clearly that although the Committee has been appointed by the Council, an opinion given or a view expressed by the Committee would represent nothing more than the opinion or view of the members of the Committee and not the official opinion of the Council.

12. It must be appreciated that sufficient time is necessary for the Committee to formulate its opinion.

13. The queries conforming to above Rules should be addressed to the Secretary, Expert Advisory Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi- 110 002.