# COMPENDIUM OF OPINIONS

## Volume XXVII

**Expert Advisory Committee**
**The Institute of Chartered Accountants of India**
*(Set up by an Act of Parliament)*
**New Delhi**

# Compendium of Opinions

(Volume XXVII)

of the

## Expert Advisory Committee

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

(This twenty seventh volume contains opinions finalised between February 2007 and January 2008. The opinions finalised upto September 1981 are contained in Volume I. The opinions finalised thereafter upto January 2007, are contained in Volumes II to XXVI)

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# Foreword

Financial statements are an essential ingredient of the financial reporting system of every enterprise. Financial statements communicate vital information about an enterprise's financial position and financial results which are of immense use to the various users of these statements to make sound economic decisions. To ensure that these financial statements meet their intended purpose, they are prepared on the basis of the generally accepted accounting principles and herein, comes the role of Chartered Accountants who facilitate the financial reporting process with their professional expertise.

With the constant movements in our economic environment resulting in new and complex business transactions across enterprises, fellow Chartered Accountants in the industry are often faced with difficulties while discharging their duties, especially in the application of the accounting and auditing principles in various unique and complex situations. To provide guidance and assistance to the Chartered Accountants in such a scenario, the Expert Advisory Committee of the Institute provides objective opinions to the various queries raised by them in matters dealing with the interpretation and application of various accounting and auditing standards, guidance notes and other pronouncements of the Institute.

I am happy to share that in its continuous endeavour of serving the members of the Institute, the Expert Advisory Committee has brought out this twenty-seventh volume of the Compendium of Opinions, containing opinions finalised by the Committee during the period February 2007 to January 2008.

I am convinced that like the other volumes, this volume of Compendium of Opinions will be immensely useful to the members and others concerned.

New Delhi — CA. Sunil H. Talati
February 4, 2008 — *President*

# Preface

I am pleased to present the twenty-seventh volume of Compendium of Opinions, containing opinions finalised by the Expert Advisory Committee between the period February 2007 and January 2008.

I would like to bring to the attention of the readers the fact that the opinions of the Expert Advisory Committee are the opinions of the Committee and are not necessarily the opinions of the Council of the Institute. It may also be noted that the Committee expresses its opinion on a query, in the light of the various facts and circumstances of the query furnished by the querist, the relevant laws and statutes and the applicable accounting/auditing principles prevailing on the date the Committee finalises the particular opinion. The date of finalisation of each opinion is indicated along with every opinion. Accordingly, the opinions must be read and understood in the light of any subsequent amendments and/or other developments in the applicable accounting/auditing principles or practices or the relevant laws that might affect the opinions.

It may also be noted that the Committee accepts various queries for its opinions only in accordance with the Advisory Service Rules prescribed by the Council of the Institute in this regard. These Rules are published in all the volumes of the Compendium of Opinions.

I would like to express my heartfelt gratitude to my learned colleagues on the Expert Advisory Committee for their sincere efforts, namely, CA. Abhijit Bandyopadhyay, (Vice-Chairman), CA. Sunil Talati (President), CA. Ved Kumar Jain (Vice-President), CA. Sanjeev Maheshwari, CA. V.C. James, CA. V. Murali, CA. S. Santhanakrishnan, CA. K. P. Khandelwal, CA. Manoj Fadnis, CA. Charanjot Singh Nanda, CA. Amarjit Chopra, Shri K.R. Maheshwari, CA. Pramod B. Kedia, CA. Tarak V. Shah, CA. Anil K. Khandelwal, CA. Charanjit S. Attra, CA. Deepakkumar R. Shah and CA. Aseem Chawla. I would like to especially thank Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary, Expert Advisory Committee, and other officers of the Technical Directorate for their valuable support and contribution to the Committee in finalising the opinions.

I am confident that the opinions contained in this volume, like the opinions contained in the earlier volumes, will be of great utility to the members and others concerned with the accounting and auditing profession.

New Delhi
February 4, 2008

CA. Atul C. Bheda
*Chairman*
*Expert Advisory Committee*

# Contents

***Query No. 1***

***Subject: Accounting for scheduled rent increases in case of an operating lease.***[1]

## A. Facts of the Case

1. The querist has stated that on 1st April, 2005, a company (hereinafter referred to as 'the lessee') took a premises on lease which qualifies as an operating lease under Accounting Standard (AS) 19, 'Leases', issued by the Institute of Chartered Accountants of India. The initial term of the lease is 3 years and it is renewable at the sole and exclusive option of the lessee for two further terms of 3 years each. As per the lease agreement, the total lease period cannot exceed 9 years.

2. The lessee does not have the right to terminate the lease during the first 33 months. Thereafter, the lessee has the right to cancel the lease after giving a written notice of 3 months to the lessor. The lessor does not have the right to terminate the lease throughout the 9 year period.

3. The lease payments will be escalated by 10% of the last lease rent at the end of every block of 3 years. Based on this, the schedule of lease rent is as follows:

| | |
|---|---|
| Years 1-3 | Rs. 5,00,000 p.m. |
| Years 4-6 | Rs. 5,50,000 p.m. |
| Years 7-9 | Rs. 6,05,000 p.m. |

4. According to the querist, in order to account for lease rentals, the company has to take a view whether the lease term is 3 years or 9 years. In this regard, the querist notes that AS 19 defines 'lease term' as follows:

> ***"The <u>lease term</u> is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without***

[1] Opinion finalised by the Committee on 23.3.2007.

> ***further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise."***

Thus, as per the querist, the issue is whether renewal of the lease agreement can be regarded as reasonably certain. In this regard, a view has been expressed that reasonable certainty of renewal exists if the rental during the period of renewal is expected to be considerably lower than the fair market rental at the date the option becomes exercisable, or if the lessee has made substantial expenditure on leasehold improvements which have useful life much in excess of the initial lease period. As per the querist, both these conditions are satisfied in this case.

5. The querist has further stated that in case the lease term is taken as 9 years, the issue of dealing with scheduled rent increases arises. In this regard, the querist has reproduced paragraphs 23, 24 and 40 of AS 19 which state the following:

> ***"23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.***
>
> 24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis."
>
> ***"40. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished."***

6. The querist has suggested two alternative views for the treatment of scheduled rent increases which are as follows:

- One view is that the increases in rent may only be considered as adjustment for inflation. Accordingly, the monthly rental for each 3 year block of the lease period should be with reference to the lease rent payable for that block in terms of the lease agreement. In support of this view, it is argued that from a substantive angle, the scheduled rent increases are in response to expected future increases in rentals in general. The increases represent higher cost of operating in future and it will, therefore, be inappropriate to allocate a part thereof to the current period.

- The other view is that the lessee will derive the same benefit from the leased premises over the lease term. It is not the benefit but the contractual cost of obtaining the benefit that will undergo a change due to scheduled rent increases. As the user's benefits do not change over the lease period, AS 19 gives no option but to charge the total rentals over the 9 year lease period on a straight line basis.

## B. Query

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

(i) Whether the renewal of the lease for two successive terms of three years each can be considered as being reasonably certain at the inception of the lease. What are the relevant factors and supporting evidence that should be considered in this regard for demonstrating reasonable certainty of renewal of lease? Whether it can be accepted that presence of substantial leasehold improvements and importance of the lease to the business provide evidence of reasonable certainty of renewal. Whether it is significant that even the increased rent during the period of renewal is expected to be fairly lower than the fair market rental at the date the option becomes exercisable. Whether reliance can be placed on the management representation (being the lessee) regarding their intention to renew the agreement.

(ii) If the renewal is considered reasonably certain and renewal period added to the lease term, how should the lessor and the lessee account for the lease rentals during the lease term? More specifically,

(a) Whether the scheduled rent increases over the lease term (9 years) should be spread over the lease term by means of recognition of lease rentals over the lease term on a straight line basis. In such a case, whether the monthly rental would be taken as average rental for total lease period (i.e., 9 years).

(b) Whether uneven lease rentals (which may be due to inflation) are permitted on the argument that this represents another 'systematic basis which is more representative of the time pattern of the user's benefit'. In such a case, the rent expense would be the lease rent payable for that period in terms of the lease agreement.

(c) How should the associated leasehold improvements in the same premises be amortised, more specifically, if the lease term is considered to be 3 years, whether the period of amortisation should be limited to it or whether the period of amortisation should be determined independent of the lease term.

**C. Points considered by the Committee**

8. The Committee restricts its opinion on the issue of the accounting for scheduled rent increases in the case of an operating lease and amortisation of leasehold improvements. The Committee presumes that the querist has correctly concluded that the lease in question is an operating lease and not a finance lease. The Committee has accordingly not addressed the issue of classification of the lease into an operating lease or a finance lease within the meaning of AS 19.

9. The Committee notes the definition of the term 'lease term' (reproduced in paragraph 4 above) and the requirements prescribed in paragraphs 23, 24 and 40 of AS 19, reproduced in paragraph 5 of the Facts of the Case.

10. The Committee is of the view that whether renewal of the lease agreement can be regarded as reasonably certain at the inception of lease should be determined on the basis of the facts and circumstances of the case. The factors to be considered in this regard would include but are not limited to those mentioned by the querist, e.g., the expectation that the rentals during the period of renewal are expected to be considerably lower than the fair market value of the rentals at the date the option by the lessee becomes exercisable, the lessee has made substantial expenditure on leasehold improvements which have useful life much in excess of the initial lease period and importance of the lease to the business. The Committee is of the view that the aforesaid factors mentioned by the querist provide a strong indication that the lease agreement would be renewed on the expiry of the 3-year and 6-year periods. The other factors can be that the lessee has entered into business commitments, the fulfilment of which would require renewing the lease of the premises beyond the initial lease term, uniqueness of purpose or location of the property, the availability of a comparable replacement property, ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates, any past practice in this regard in comparable circumstances, etc. Although, representation by the management indicating their intention to renew the lease after the initial lease term can be a factor, the auditor will have to consider other sufficient appropriate audit evidence indicating the existence of the aspects related to the factors as stated hereinbefore.

11. The Committee agrees with the second view stated by the querist in paragraph 6 of the Facts of the Case that the lessee is expected to derive the same benefit, in physical terms, from the leased premises over the lease term and, accordingly, the scheduled rent increases in the lease rental do not meet the criterion for recognising expense/income on a basis other than straight line basis over the lease term. In other words, the Committee agrees that the scheduled increases in the lease rentals as envisaged in paragraph 3 of the Facts of the Case do not indicate the time pattern of the user's benefit necessitating recognition of expense/income on account of lease payments on a systematic basis being representative of that pattern. The Committee is of the view that

the Standard does not recognise inflation as a factor representing the time pattern of the user's benefit. The Standard also does not incorporate adjustments to reflect the time value of money. The Committee is, accordingly, of the view that in case it is concluded on the basis of the definition of 'lease term' that the lease term is for 9 years, the total lease rental for the lease term should be spread over 9 years on straight line basis, thus, necessitating creation of a liability/receivable in the initial years when the lease payments are lower than the expense/income in this regard from the perspective of the lessee and the lessor, respectively.

12. With regard to amortisation of leasehold improvements over the lease term, the Committee is of the view that in case the leasehold improvements meet the definition of the term 'fixed asset' as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, the same should be depreciated over their useful life. The term 'useful life' is defined in paragraph 3.3 of Accounting Standard (AS) 6, 'Depreciation Accounting', as below:

> "3.3 *Useful life* is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise."

From the above, the Committee is of the view that in case it is expected that the lease term is 3 years, i.e., it is not reasonably certain at the inception of the lease that the lessee will exercise the option to renew the lease after 3 years, the cost of the fixed assets so created should be depreciated over 3 years because that is considered to be the 'useful life' of the asset. However, if the lease term is considered to be 9 years on the considerations stated in paragraph 10 above, the leasehold improvements should be amortised over the period of 9 years or over their useful life if less than 9 years.

## D. Opinion

13. On the basis of the above, the opinion of the Committee on the issues raised by the querist in paragraph 7 above, is as below:

(i) Whether the renewal of the lease for two successive terms of 3 years each can be considered as reasonably certain at the inception of the lease would have to be considered taking into consideration the factors stated in paragraph 10 above.

(ii) If the renewal of the lease term is considered reasonably certain and renewal period is added to the lease term, the lessor and the lessee should account for the lease rental on straight line basis during the lease term. In such a case,

   (a) the total lease rental over the 9 years period should be spread over the lease term by means of recognition of lease rentals over the lease term on a straight line basis. Accordingly, the monthly rental would be taken as average rental for total lease period, i.e., 9 years.

   (b) the uneven lease rentals are not permitted to be recognised as income/expense on the basis of the argument that the scheduled increases in the rentals represent another 'systematic basis' which is more representative of the time pattern of the user's benefit.

   (c) the associated leasehold improvements in the same premises, if recognised as a fixed asset within the meaning of AS 10, should be depreciated over their 'useful life', as defined under AS 6 (reproduced in paragraph 12 above). Thus, in case the lease term is considered to be 3 years, the period of depreciation is not independent of the lease term as the useful life has to be considered in the context of the lease term as discussed in paragraph 12 above.

## *Query No. 2*

***Subject: Depreciation on buildings, etc., constructed on leasehold land.*[1]**

### A. Facts of the Case

1. A government company has constructed buildings, roads, etc., on leasehold land, which was taken on lease from an Improvement Trust under a lease agreement which was initially for a period of 30 years only. The land allotment letter (a copy of which has been provided by the querist for the perusal of the Committee) indicates that the land shall be used for office and staff colony.

2. The querist has stated that under clause 2(b) of the 'Terms of Transfer in Leasehold Rights of Plots in the Layout of the Improvement Trust' (a copy of which is provided by the querist for the perusal of the Committee), it has been stated that "the lease shall be renewable at the option of the lessee for further terms of 30 years". Further, as per the allotment letter, the entire lease premium of Rs. 21 lakh was payable upfront and annual ground rent of 2% of lease premium, i.e, Rs. 42,000 is payable in advance and falls due on 1st June of each year.

3. The company has been charging depreciation on the buildings, etc., constructed on the leasehold land @ 1.63% on straight-line method (SLM) as per the rates given in Schedule XIV to the Companies Act, 1956 (the 'Act'), on the basis of which the useful life works out to be 58 years.

4. During the course of audit of accounts of the company for the year 2005-06, the government auditors have raised provisional comment on the issue relating to charging-off of depreciation on buildings, roads, etc., on the leasehold land. Their contention is that the depreciation on the buildings, etc., constructed on leasehold land should be charged over a period of 30 years only (i.e., over the lease period of the land) and not over a period of 58 years (i.e. @ 1.63% on SLM) as specified in the Act and followed by the company. According to them, the rate prescribed under the Act is applicable in respect of assets constructed on freehold land.

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[1] Opinion finalised by the Committee on 23.3.2007.

5. The provisional comment and the management's reply were as below:

| ***Audit Memo*** | ***Management's Reply*** |
|---|---|
| **Provisional Comment No.1** | |
| Profit & Loss Account - Depreciation - Rs.209.00 lakh | Profit & Loss Account - Depreciation -Rs.209.00 lakh. |
| Buildings, roads, parks and sheds of RJ-IV are constructed on 7.07 hectares of leasehold land taken from the Improvement Trust under two lease agreements entered in the year 1999-2000 for a lease period of 30 years commencing retrospectively from 1983-84. The lease period expires in the year 2014.<br><br>Depreciation on buildings, roads, parks and sheds is charged at the rate specified under Schedule XIV to the Companies Act, 1956, i.e., @ 1.63%. However, such rates are applicable only in respect of assets constructed on freehold land. All buildings and other structures constructed on leasehold land are to be charged off within the lease period.<br><br>Due to charging-off of depreciation at rates applicable to assets constructed on freehold land instead of charging off the cost of the | Buildings of RJ-IV have been constructed on leasehold land taken from the Improvement Trust under lease agreement which is initially for a period of 30 years. Under Clause 2(b) of the "Terms of Transfer in Leasehold Rights of Plots in the Layout of the Improvement Trust" which was forwarded by the Secretary, Improvement Trust at the time of allotment of land, it has been stated that "the lease shall be renewable at the option of the lessee for further terms of 30 years". As such, the company has the option to renew the lease for the further period of 30 years. Also, it is the standard practice in case of lease made by Government that normally it is initially made for 30 years and thereafter it is renewed for next term of 30 years. Moreover, the cost of the land, i.e., the lease rent is being amortised regularly over the lease period.<br><br>Further, the depreciation on buildings constructed on the |

| | |
|---|---|
| assets within the lease period, depreciation for the year 2005-06 is understated and profit for the year is overstated by Rs. 9.09 lakh. Further, this has resulted in understatement of depreciation charged and overstatement of previous year's profit by Rs. 60.05 lakh. | leasehold land has been charged consistently at the rate specified in Schedule XIV to the Companies Act, 1956, i.e., @ 1.63% on SLM (depreciable life being 58 years).<br><br>As such, the contention that there is understatement of depreciation and overstatement of profit for the year 2005-06 and for the earlier years is not correct.<br><br>In view of the above, the memo may kindly be dropped. |

The statutory auditors agreed with the above reply of the management.

6. The issue was discussed in detail with the Principal Director of Commercial Audit (the 'PDCA'). The PDCA agreed with the reply submitted by the company. However, while issuing a nil comment on the accounts, he advised that the matter may be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India for its opinion.

**B. Query**

7. The querist has sought the opinion of the Expert Advisory Committee as to whether depreciation charged by the company on buildings, etc., constructed on leasehold land @ 1.63% on SLM as specified in Schedule XIV to the Companies Act, 1956 is correct or it should be charged over a period of 30 years (i.e., the initial term of the lease).

**C. Points considered by the Committee**

8. The Committee, while expressing its opinion, has considered only the issue raised in paragraph 7 above and has not touched upon any other issue arising from the Facts of the Case, such as, amortisation of the lease premium.

9. The Committee notes the following paragraphs from Accounting Standard (AS) 6, 'Depreciation Accounting', issued by the Institute of Chartered Accountants of India:

> "5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:
>
> (i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
>
> (ii) expected useful life of the depreciable asset; and
>
> (iii) estimated residual value of the depreciable asset."
>
> "7. The useful life of a depreciable asset is shorter than its physical life and is:
>
> (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
>
> (ii) directly governed by extraction or consumption;
>
> (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
>
> (iv) reduced by obsolescence arising from such factors as:
>
> (a) technological changes;
>
> (b) improvement in production methods;
>
> (c) change in market demand for the product or service output of the asset; or
>
> (d) legal or other restrictions.

> 8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. ...”
>
> “13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management’s estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management’s estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.”

10. The Committee notes the management’s observations that it is a standard practice in case of leases made by Government that normally they are initially made for 30 years and thereafter they are renewed for a further period of 30 years. Having regard to the terms of the lease and the use of the leasehold land (i.e, office and staff colony), it seems that at the inception of the lease, the company intends to renew the lease for a further period of 30 years at the expiry of the initial period of 30 years.

11. The Committee notes that neither Schedule XIV to the Companies Act, 1956 (the ‘Act’) nor the main sections, viz., sections 205 and 350 of the Act state that the rates specified in Schedule XIV are applicable only to the assets constructed on freehold land. The Committee is of the view that the rates specified in Schedule XIV to the Act are equally applicable for assets constructed on leasehold land, subject to the considerations stated in paragraph 12 below.

12. From the above, the Committee is of the view that the management should estimate the useful lives of the relevant assets constructed on the leasehold land on the basis of considerations mentioned in paragraph 9 above. Thus, the useful life will be the expected period of the lease of the land, including the expected period of extension which is reasonably certain at the inception of

the lease. The depreciation rate should be worked out on that basis. If the rate so worked out is lower than the rate specified in Schedule XIV to the Act, the rate specified in Schedule XIV to the Act should be adopted. A lower rate can be adopted only if permitted by the Central Government in accordance with the provisions of the Act.

**D. Opinion**

13. On the basis of the above, the Committee is of the opinion that depreciation rate for buildings, etc., constructed on leasehold land should be determined in the manner stated in paragraph 12 above.

***Query No. 3***

***Subject: Accounting treatment of surplus realised on sale of rubber trees.***[1]

**A. Facts of the Case**

1. A company is a joint venture of the Government of India and the Government of Kerala holding 40% shares and 60% shares, respectively. The company is maintaining 2036 hectares of rubber plantations with the objective of settling Sri Lankan repatriates by providing them employment. The company is consistently making profit since 1980-81 and paying dividend from 1985-86 onwards to shareholders. According to the querist, rubber planting started in the estates of the company during the year 1972 and the same was completed in the year 1978. The expenditure incurred by the company for planting rubber trees and for their maintenance during the immature period had been accounted for as development cost and subsequently the same was capitalised to 'Plantations' when it became mature for tapping after 7 years of planting.

[1] Opinion finalised by the Committee on 23.3.2007.

2. The querist has stated that since the economic lives of the original rubber plantations were over, the company decided for replanting its plantations from 2001 onwards, and hence, the company sold the old rubber trees on its estates. According to the querist, the company has adopted the accounting policy of crediting the sale proceeds of rubber trees in excess of its original cost directly to capital reserve and to disclose the same in the financial statements as one of the significant accounting policies of the company.

3. The company finalised its accounts for the year 2005-06 and furnished the same to the Accountant General for audit under section 619(4) of the Companies Act, 1956. During the audit, the government auditors observed the following:

(i) Accounting Standard (AS) 10, 'Accounting for Fixed Assets' (paragraph 26) requires that gains or losses arising from the disposal of fixed assets which are carried at cost should be recognised in the profit and loss account.

(ii) As per Part II of Schedule VI to the Companies Act, 1956, the profit and loss account should clearly disclose the result of working of the company during the period of accounts and also disclose every material feature including credits or receipts and debits or expenses in respect of non-recurring transactions of an exceptional nature.

In view of the above, as per the government auditors, the accounting treatment of the company on sale of rubber trees was inappropriate.

4. The querist has stated that the company feels that the views expressed by the government auditors are not correct due to the following reasons:

(i) Forests, plantations and similar regenerative natural resources are excluded from the coverage of AS 10. Thus, the requirement under paragraph 26 of AS 10, ***"Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is***

***carried at cost should be recognised in the profit and loss statement"*** is not applicable in the case of sale of rubber trees in the plantations.

(ii) As per Accounting Standard (AS) 6, 'Depreciation Accounting', the plantations are excluded from the depreciable assets. Thus, no depreciation is charged on plantations. However, as the surplus arising from the disposal of rubber trees is material, the same has been disclosed in the schedule of 'Notes to Accounts' separately by the company.

(iii) It was decided in the case of 'Commissioner of Agricultural Income Tax Vs. Kailas Rubber Co., (1966) 60 ITR 435: 1966 KLT 486 SC: 1966 KLJ 664', that the sale proceeds of unyielding rubber trees are capital income. Accordingly, any capital profit is reflected in the balance sheet under 'Reserves and Surplus' as a capital reserve.

(iv) The company is not engaged in the business of selling plantations on a regular basis.

**B. Query**

5. The Accountant General informed the company to make necessary changes in the accounting policy of the company in respect of the sale of rubber trees in future. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the present policy adopted by the company, viz., crediting the sale proceeds of plantation trees in excess of its original cost, directly to capital reserve is in order or not.

(ii) If it is considered not in order, what treatment the company should adopt for the same in future.

**C. Points considered by the Committee**

6. The Committee notes that the basic issue raised in the query

relates to accounting for sale of old rubber trees, whose economic lives are over. The Committee has, therefore, considered only this issue and has not touched upon any other issue which may arise from the Facts of the Case, such as, valuation of rubber plantations, the amount of depreciation to be provided, etc.

7. The Committee agrees with the querist that AS 10 and AS 6 are not applicable in the present case as these standards exclude from their scope, 'forests, plantations and similar regenerative natural resources'. The Committee, however, notes that the Guidance Note on Terms Used in Financial Statements defines 'Fixed Asset' as "*Asset* held for the purpose of providing or producing goods or services and that is not held for resale in the normal course of business." The Committee notes from the Facts of the Case that rubber plantations are being grown and held for their use in the production of rubber and are not ordinarily held for sale in the normal course of business. Accordingly, rubber trees are fixed assets. In this context, the Committee also notes paragraph 1 of AS 6 which is reproduced below:

> "1. This Statement deals with depreciation accounting and applies to *all depreciable assets*, except the following items to which special considerations apply:—
>
> (i) forests, plantations and similar regenerative natural resources;
>
> (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
>
> (iii) expenditure on research and development;
>
> (iv) goodwill;
>
> (v) live stock.
>
> This statement also does not apply to land unless it has a limited useful life for the enterprise." (Emphasis supplied by the Committee.)

8. The Committee notes from the above that paragraph 1 of AS 6 specifically mentions that AS 6 "applies to *all depreciable assets,*

*except* …”. Thus, the Standard itself recognises that the items which are excluded from its scope are also depreciable assets. Accordingly, rubber plantations are also depreciable assets. The Committee further notes that paragraph 3.11 of ‘Monograph on Accounting for Rubber Plantations’, issued by the Research Committee of the Institute of Chartered Accountants of India, which deals with amortisation of capital costs of rubber plantations, states as follows:

> “3.11 Amortisation of the capital cost of rubber plantations is, however, peculiar. Yet it does not call for a departure from the basic principles of depreciation accounting. This is in fact only an application of principles of depreciation accounting to a specific situation.”

From the above, the Committee is of the view that rubber plantations should be amortised on a systematic basis over their useful lives. Since the company has not charged depreciation on plantations as stated in paragraph 4(ii) above, it amounts to an error in the preparation of the financial statements of prior periods and accordingly, it should be accounted for as a ‘prior period item’ in the profit and loss statement of the period in which such adjustment is made as per the provisions of Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’.

9. The Committee also notes that paragraphs 12 and 14 of AS 5, which describe the nature of ordinary activities and the treatment of profit or loss arising therefrom state as follows:

> “***12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.”***

> “14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include:
>
> …

(c) disposals of items of fixed assets;

…”

The Committee notes from the above that the Standard specifically recognises disposals of items of fixed assets as an item of ordinary activities, and requires separate disclosure thereof in the statement of profit and loss, even though it may be non-recurring transaction of exceptional nature. In this regard, the Committee also notes that it is the sale proceeds in excess of the depreciated value or written down value of the plantations which is to be credited to the profit and loss account rather than the sale proceeds in excess of the original cost. The Committee also recognises that even though a profit may be considered of capital nature for income-tax purposes, yet, in the situations such as the present one, it should be reflected in the statement of profit and loss.

**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) The present policy of the company of crediting the sale proceeds of plantation trees in excess of its original cost, directly to capital reserve is not in order.

(ii) The company should recognise the surplus arising from disposal of rubber trees in the statement of profit and loss, as discussed in paragraph 9 above. The company should also amortise the rubber plantations on a systematic basis as discussed in paragraph 8 above.

***Query No. 4***

***Subject: Accounting treatment of income from property development to part finance a construction project.*[1]**

## A. Facts of the Case

1. A company, which is a joint venture between the Government of India and the Government of National Capital Territory of Delhi, is engaged in the business of construction, operation and maintenance of Mass Rapid Transit System (MRTS) in National Capital Region. While some phases of the system have already become operational, others are at various stages of construction. The funding plan approved by the Government of India provides for equity from both the governments and loan from Japan Bank for International Cooperation (JBIC). In addition, the plan also required the company to undertake property development and real estate activities to part finance the construction of the project and also to supplement operational revenues to enable repayment of the loan taken from JBIC. The relevant extract of the Cabinet decision is reproduced below:

> "…The balance of project cost over and above the equity and debt finance will be raised by … (name of the company) by way of revenue from property development, which has been estimated at 6% of the revised project cost at April, 1996 prices…"

2. According to the approved funding plan, the company was required to generate about Rs.300 crore for Phase-I from property development as part financing of MRTS project. It was also decided that the requisite land for the project including for property development would be given to the company at inter-departmental rates.

3. As a sequel to the above, Memorandum and Articles of Association of the company have a clause authorising the company to carry on all the relevant activities required for commercial development of the properties.

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[1] Opinion finalised by the Committee on 23.3.2007.

4. The company has been carrying on the property development activities in a number of modes depending upon the location, size and approved use of the parcel of land. At times, the company has also been engaging developers for certain lands on 'Build-Operate-Transfer' ('BOT') basis by handing over the site to them for a period of 30 years or so. In addition to the land parcels, certain commercial properties have been developed on the footprints of the stations in the form of shops, kiosks, stalls, etc., from which regular income is generated. According to the querist, income from all the above activities, right from inception have been considered as revenue profit, based on the terms and conditions of the contracts with various lessees and the BOT developers, under the overarching provisions of relevant Accounting Standards and the accounting policies disclosed in the financial statements of the company.

5. During the financial year 2005-06, the company has transferred the leasehold rights of two parcels of land measuring 16.802 acres and 2.972 acres for residential developments. These lands have been leased for 99 years and 90 years respectively to two different developers for total consideration of Rs.248.80 crore. This was the first instance wherein land was given to the developers for a longer period of 90 years and above, since these were residential developments and lease for any period less than this would have made the proposition ineffective.

6. The company treated the above said transactions of the lease of land as sale in consonance with the accounting policy as reproduced below:

> "10.4 Income from lease of land for property development pursuant to lease agreement for 60 years and above is recognised as sale on handing over of land to developers since it transfers substantially all the risks and rewards incident to ownership of land."
>
> "3.7 Cost of land at the time of handing over to developers pursuant to the lease agreement for 60 years and above is accounted for as inventory."

In addition to the above, in order to bring transparency and make full disclosure, Notes to Accounts also contained the following information:

> "5.6 One of the objects of the company is to undertake property development and real estate work for which surplus land, if any, could be used. Due to impracticability of segregation of such land, it is shown as 'Fixed Assets' till transaction is finalised as per accounting policy No. 3.7 & 10.4 of the company."

> "5.7 During the year, land costing Rs. 686.65 lakh was identified for property development, which was transferred from fixed assets to current assets."

7. During the course of audit of the accounts for the year 2005-06, the government audit party made an observation that since this profit is meant for meeting project cost as per the approved funding plan of the government, it should be treated as capital reserve. The stand of the company was that the funding plan is meant only for resource mobilisation. The accounting treatment of any transaction is to be dealt with as per the accounting standards, established norms and prevalent practices and as such the treatment accorded, considering the income as revenue, is a correct presentation. Property development is an authorised activity of the company as stipulated in the Memorandum and Articles of Association of the company. Full disclosure has also been made in the financial statements.

8. For better appreciation, the querist has reproduced the query of the government audit and the management's reply as below:

*Government audit party's query:*

*"Profit and Loss Account*

***Income -Real Estate (Schedule 9) Rs.296.22 crore***

This includes Rs.248.80 crore being the consideration for transfer of leasehold rights of 16.802 acres of land at Khyber Pass and 2.972 acres of land at Rithala (valuing Rs.6.87 crore) to licensees for a period of 99 years and 90 years respectively.

The Government of India, Ministry of Urban Affairs & Employment (Department of Urban Development), New Delhi, while according investment approval of Delhi MRTS project vide letter No. K-14011/59/88-UD-II dated 12.11.96 directed that the estimated 6% of the project cost is to be met by way of revenue from property development.

In view of the above, the profit on account of sale of the aforesaid land, which is meant for meeting the project cost, should have been treated as capital reserve.

Treating the same as revenue income of the year has resulted in understatement of capital reserve and loss by Rs.241.93 crore (248.80 – 6.87 crore)."

*Management's reply:*

"Audit in the Half Margin has drawn attention to the Notification No.K-14011 /59/ 88-UD II dated 12.11.1996 of Ministry of Urban Affairs & Employment as per which the balance of project cost over and above the equity and debt finance will be raised by the company by way of revenue from property development.

The government while approving the project has stipulated that a certain percentage of funds requirements will be raised through revenue from property development. Thus, it was a part of resource mobilisation plan so as to meet the cost of project. How the transaction is to be treated in the books of account is neither import of the funding plan nor intention of the government. Accounting treatment to transaction needs to be effected as per the requirements of Accounting Standards norms, conventions, customs and relevant enactments. The approved funding plan of the Government does not provide any implied authority to override such accounting treatment.

As per accounting guidelines based on various statutory requirements, capital reserve is created from the following sources:

— Capital contributed for shares in excess of their par or stated value;

— Gains on the revaluation of assets; and

— Any other gain or surplus of an exceptional nature that has not been earned during the regular course of business.

From the above it is very clear that income generated from property development activity of the company which is authorised by its Memorandum and Articles of Association as one of the objectives of the company can no way be canalised for creation of capital reserve. For ready reference, the relevant clause No. 72(3) of the Memorandum of Association is reproduced below:

"To realise the proceeds of any developed or under-developed properties of the company by transferring, selling, mortgaging, letting out on hire, leasing out, licensing, granting concession or otherwise deal in and/or dispose of all or any portion of immovable properties including advertising rights for properties immovable as well as movable, as may be thought desirable and to accept as consideration cash and consideration other than cash and to take back or re-acquire any property so disposed of by re-purchasing or leasing the same or obtaining a license for such price and on such terms and conditions as may be agreed upon."

It may please be noted that the approved financing plan has mentioned about generation of some percentage of total fund requirement from the property development leaving it to the company to best commercially exploit this source of resource mobilisation. Out of the many options available with the company to optimise revenue generation, decision is taken taking into consideration enumerable factors like location, land use, approvals from the various statutory authorities, etc. The company, on a case to case basis, decides to lease it for 6-12-30 years or more than 60 years. Whatever option is chosen, the income generated remains as a part of the business activities of the company for which Memorandum of Association authorises it. As a sequel, appropriate accounting policies have been disclosed for all such options in the balance sheet. It may not be possible to consider income generated from one option as an income from property development in consonance with various accounting standards and norms and income generated from the other options to be treated as capital reserve on the consideration of approved financing plan.

We shall also draw your kind attention to the ICAI's Compendium of Opinions- Vol. No. XX, Query No.22, on Accounting for the Development and Leasing of Industrial Estate. A Government company engaged in the business of developing an industrial estate, leased out industrial plot for a period of 60 years and 99 years. Query was raised as to how the company should take income of the lump sum premium received.

The opinion expressed by the Expert Advisory Committee of the ICAI was that the lease of land be treated as sale and thus the whole lease premium should be recognised as revenue in the profit and loss account in the year it becomes due on performance of the act giving rise to revenue and the related cost of acquisition of land and development expenditure thereon should be expensed in the same period.

It is also pertinent to note here that approval of funding plan warranting raising of revenue from property development does not impact any reduction in the cost of the project to the company. It is only a plan aimed at raising funds from a source to meet the overall cost of the project.

In view of the above submission, Audit is requested to drop the Provisional Comment."

9. Based on the above explanation, the point was eventually dropped by the Office of the C&AG. However, the company was advised to refer the issue to the Expert Advisory Committee of the Institute of Chartered Accountants of India for advice.

**B. Query**

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

(i) Whether in view of the specific object clause enshrined in Memorandum of Association, the accounting treatment effected by the company is in order.

(ii) Whether the amount generated from the above transaction can be treated as capital profit and if so, can it be transferred to capital reserve account without routing it through the profit and loss account.

(iii) Whether the decision of the government mandating the company to raise and use funds from property development for supplementing project cost authorises it to treat the income so generated directly to capital reserve account.

(iv) Whether the amount so received can be adjusted in the overall cost of the project by reducing the cost of assets by that amount.

**C. Points considered by the Committee**

11. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 10 above with respect to the leasing of two parcels of land and has not touched upon any other issue arising from the Facts of the Case, such as, timing and manner of reclassification of land as inventory, sources of creation of capital reserve, etc. The Committee also notes that the opinion on query no. 22 expressed by the Committee contained in the Compendium of Opinions-Volume XX mentioned in paragraph 8 above does not deal with treatment of lease income used to finance a construction project.

12. The Committee notes that there are two basic issues involved. First issue is treatment of the lease transaction. Second issue is treatment of the resulting profit and need for creation of capital reserve.

13. So far as the first issue is concerned, the Committee notes that the two parcels of land were given on lease for long periods, one for 99 years and another for 90 years, to the developers of residential properties. The Committee is of the view that in lease agreements of such long periods, it is generally expected that

either the lease period would be extended or the title will pass to the lessee at some agreed amount. Keeping in view the facts and circumstances of the query and prevalent commercial practices in India in this regard, in substance, the lease of the two parcels of land amounts to passing of the significant risks and rewards of ownership in the land to the lessee. Thus, it would be in the nature of sale of the two parcels of land and should be accounted for accordingly. In this regard, the Committee also takes note of the requirement of Schedule VI to the Companies Act, 1956 of showing leaseholds as an asset of the lessee. This requirement, according to the Committee, is a recognition of the principle of 'substance over form'. The cost of the land should be recognised as expense in the same period in which revenue from the lease of the two parcels of land is recognised keeping in view the matching principle.

14. As regards the second issue, the nature of the resulting profit is to be examined. In this connection, the Committee notes the following paragraphs from the Guidance Note on Treatment of Expenditure During Construction Period[2], issued by the Institute of Chartered Accountants of India:

> "8.1 It is possible that a new project may earn some income from miscellaneous sources during its construction or pre-production period. Such income may be earned by way of …. or from sale of products manufactured during the period of test runs and experimental production. Such items of income should be disclosed separately either in the profit and loss account, where this account is prepared during construction period, or in the account/statement prepared in lieu of the profit and loss account, i.e., Development Account/Incidental Expenditure During Construction Period Account/Statement on Incidental Expenditure During Construction (Refer to para 14.7). The treatment of such incomes for arriving at the amount of expenditure to be capitalised/ deferred, has been dealt with in para 15.2."

> "15.2 From the total of the aforesaid items of indirect expenditure would be deducted the income, if any, earned

[2] The Guidance Note has since been withdrawn pursuant to the decision of the Council at its 280th meeting held on August 7-9, 2008.

during the period of construction, provided it can be identified with the project."

15. The Committee is of the view that only income which arises incidentally during the execution of a project would go on to reduce the project cost. The fact that an income is used to finance a project cost does not determine its accounting treatment. The treatment of such income is governed by the applicable accounting principles. Thus, in the present case, merely because a part of the project cost is financed by revenue from real estate transactions, the project cost is not reduced. The Committee is of the view that income from the lease of the two parcels of land is not incidental to the MRTS project since it does not arise in the course of the execution of the project. Hence, this income would not go on to reduce the project cost.

16. The Committee notes the following paragraph from Accounting Standard 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India:

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

17. The Committee further notes the following paragraphs from the 'Guidance Note on Terms Used in Financial Statements":

> **"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*."

**"3.08 Capital Profit**

Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a *capital asset* over its *cost*. When the result of this computation is negative, it is referred to as **capital loss**."

**"3.04 Capital Assets**

*Assets*, including *investments*, not held for sale, conversion or consumption in the ordinary course of business."

18. The Committee also notes that Clause 7(1)(c) of Part III of Schedule VI to the Companies Act,1956 reads as below:

"(c) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;"

19. The Committee notes that at the time of sale-type lease, the parcels of land were current assets and not capital assets. The lease transactions were also authorised by the Memorandum of Association of the company and the Cabinet decision. Hence, on the basis of paragraphs 15 to 18 above, the Committee is of the following view:

(i) the resulting profit is a revenue profit earned during the ordinary course of business,

(ii) it should be included in the statement of profit and loss for the year, and

(iii) if the funding plan/Cabinet decision/terms of transfer of land to the company or Articles of Association of the company specifies the use of such profits for financing the MRTP project, thereby prohibiting declaration of dividend out of such profits, the said profits should be transferred to 'Capital Reserve' as an appropriation of the profits of the company.

20. The Committee further notes paragraphs 12 and 13 of AS 5, which state as follows:

> ***"12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.***
>
> 13. Although the items of income and expense described in paragraph 12 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements."

From the above, the Committee is of the view that since the lease transactions under consideration are of the nature described in the paragraphs 12 and 13 of AS 5 reproduced above, keeping in view the ordinary activities of the business, i.e., construction, operation and maintenance of MRTS, the same should be separately disclosed in the statement of profit and loss of the company in accordance with the requirements of these paragraphs.

**D. Opinion**

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

(i) The accounting treatment effected by the company is in order as explained in paragraphs 13 to 19 above. The company should, however, disclose the revenue from such activities separately in the statement of profit and loss as stated in paragraph 20 above.

(ii) The amount generated from the above transaction cannot be treated as capital profit. The profit earned from the transaction is a revenue profit to be included in the profit and loss account. However, if such profits can be used only for the purposes of the capital project and the use of such profits for other purposes is prohibited, thereby prohibiting declaration of dividend out of the said profit, the profits should be transferred to 'capital reserve' as an appropriation of the profits of the company.

(iii) Mere decision of the Government mandating the company to raise and use funds from property development for supplementing project cost does not require the company to take the income so generated directly to capital reserve account.

(iv) No, the amount so received cannot be adjusted in the overall cost of the project by reducing the cost of assets by that amount as explained in paragraph 15 above.

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***Query No. 5***

***Subject: Audit of circulation figures of publications.[1]***

**A. Facts of the Case**

1. A company was incorporated in the year 1948 under the Indian Companies Act, 1913, without share capital. It obtained a license subsequently in 1988 under section 25 of the Companies Act, 1956. Members of the company comprise the following categories:

- Publishers
- Advertising agencies
- Advertisers
- News agencies and associations

[1] Opinion finalised by the Committee on 14.5.2007.

2. The primary objective of the company, as contained in the Memorandum of Association of the company, inter alia, states as follows:

> "…to secure accurate circulation figures and data relating to all periodicals and media that sell advertising space and in regard to such publications to obtain information as to area of distribution and fix standard norms and methods for ascertaining the net sales figures and generally all information that will be of assistance to advertisers in estimating the value of any publication for advertising purposes and to record such information and circulate it to members of this company and generally to establish a bureau of information in regard to all publications and the circulation of them for the benefit of members of this company such service to be known as the "A.B.C." service or by such other name or description as the Council of this company may determine from time to time".

3. The querist has stated that a manual titled "Guide to ABC Audit" contains the prescribed company's audit guidelines which are required to be followed by all publisher members in order to avail an ABC certificate of circulation from the company. These audit guidelines are prescribed/revised by the company's council of management from time to time. The company's council of management is an elected body comprising:

| | | |
|---|---|---|
| Publisher representatives | .. | 8 (Eight) |
| Advertising agency representatives | .. | 4 (Four) |
| Advertiser representatives | .. | 4 (Four) |

4. The querist has further stated that a separate panel of auditors has been maintained to undertake the company's audits, namely, surprise checks and surprise recheck audits. (The querist has also provided, separately, proforma engagement letters containing terms of reference of the company's empanelled auditors in case of both, surprise checks as well as surprise re-check.) The auditors from this panel do not undertake any audit at the behest of the publisher members and are exclusively meant to undertake assignments given by the company. The querist has further clarified

by a separate letter that in case of a surprise recheck audit by the company's auditors, they recheck the circulation figures already certified by an empanelled firm of Chartered Accountants appointed by the publisher. The circulation figures as submitted to the company, duly audited, may undergo a change after a surprise recheck audit by company's auditors, if any deductions in circulation numbers are proposed on account of discrepancies observed. Circulation figures on recheck may be reduced from the original 'Net Paid Sales' earlier certified by the publisher auditors if it is found that company's audit guidelines have not been complied with. The company's approved auditors also report exhaustively on the maintenance of books and records, verification of actual printing at the press and factual information as gathered by them during their market visit, etc.

5. The querist has also informed that in case of a surprise recheck audit undertaken by the company's auditors, they are required to file with the company, the circulation figures certified by them in the prescribed format. The circulation figures certified by the company's auditors after surprise recheck audit could be the same circulation figures as were earlier certified by publisher auditors or revised circulation figures (plus or minus) now certified by the auditors after a surprise recheck audit. In case, the auditors are not satisfied with the publisher's maintenance of books and records, press and market visit, the auditors also have a choice not to certify the circulation figures of a member publication. According to the querist, the prescribed format for recheck audit certificate conducted by the auditors and the circulation certificate released by company's approved auditors retained by a publisher is the *same* (emphasis supplied by the querist). The prescribed audit guidelines are applicable both in case of audit carried out by company's approved auditors retained by the publisher and surprise recheck audit conducted by the recheck auditors appointed by the company.

6. As regards the surprise check by company's auditors, the querist has informed that these are carried out by the company on an ongoing basis for publisher members of the company. Surprise check report would contain company's auditors' factual observations during their press and market visit as well as their observations on

the publisher's books and records as factually observed by them. In surprise check audit, company's auditors are not required to certify the circulation figures of a member publication. Company's auditors normally report on any inadequacies observed by them in the publisher's books and records as well as during their press and market visit.

7. The querist has also stated that a publisher member of the company had launched a subscription scheme in a particular market place. According to the querist, the company's rule regarding payment of trade commission on subscription copies is as under:

| | | |
|---|---|---|
| Trade commission/delivery charges on subscription copies | : | 40% delivery charges calculated on the basis of subscription price in case of dailies. |
| | | 45% delivery charges calculated on the subscription price in case of other than dailies |

The concerned publisher member had launched several subscription schemes in a particular market place, details of which are as under:

| | Rs. | Rs. | Rs. | Rs. | Rs. |
|---|---|---|---|---|---|
| Cover price | 39.00 | 117.00 | 117.00 | 234.00 | 234.00 |
| Subscription price | 20.00 | 62.30 | 83.00 | 156.00 | 173.00 |
| Discount to subscriber | 19.00 | 54.70 | 34.00 | 78.00 | 61.00 |
| Subscription duration (months) | 1 | 3 | 3 | 6 | 6 |
| Trade Commission | 8.00 | 24.00 | 33.20 | 62.40 | 62.40 |
| % of subscription price | 40% | 38% | 40% | 40% | 36% |

The above details were checked and taken from the publisher's books and records by the empanelled auditors.

8. The querist has further stated that on a market visit by the empanelled auditors and their interaction with the hawkers/sub-

agents, the auditors observed that it was the practice of the trade that copies delivered to households in a particular city received a flat rate of 30% on the cover price as trade commission to deliver both the line copies as well as subscription copies. This observation was established through three separate market visits by three separate firms of empanelled auditors. However, the concerned publisher insisted in writing that the trade commission as per the above table was paid to the trade, as also recorded in the books and records. The publisher had entered into individual arrangements with the traders for payment of trade commission at the prescribed rates as mentioned in the books and records.

9. According to the querist, in the instant case, if the trade commission is calculated at the rate of 30% of the cover price for the above subscription copies, then the trade commission exceeds 40% on the subscription price. Normally, the publisher always discounts the subscription price for a particular period as the subscription payment is received in advance by the publisher.

**B. Query**

10. Under the circumstances, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) What should be the stand, the company and its empanelled firms of Chartered Accountants take when on a scrutiny of publisher's books and records, the trade commission is found to be in compliance with the existing rules of the company in this regard, however, on a market visit by the company's auditors and during their interaction with the sub-agents/hawkers, auditors ascertain albeit orally that the trade margins received by the sub-agents/hawkers were in excess of the prescribed trade margins by the company.

(ii) Under the circumstances as explained above, whether:

(a) the company and its empanelled auditors should rely only on the publisher's books and records produced before them thereby disregarding the evidence/observations from the market place gathered by them.

(b) considering the oral market evidence gathered by the company auditors and taking the same into account, the company and the company's auditors may not entirely rely on the publisher's books and records and consequently not certify the publisher's circulation figures pertaining to subscription copies. [It may be noted that no written evidence from sub-agents/hawkers is possible to be obtained in the early morning hours and the auditors have necessarily to rely only on their observations and interactions with the sub-agents/hawkers.]

(c) if the company as well as its empanelled auditors rely on their observations and interactions with the sub-agents/hawkers during their market visit and consequently, conclude not to certify the publisher's circulation figures, such a conclusion would be within the Auditing and Assurance Standards issued by the Institute of Chartered Accountants of India and also stand the test of legal scrutiny, if any.

**C. Points considered by the Committee**

11. The Committee notes that even though the querist has not specifically raised questions in respect of surprise check and surprise recheck, it appears from the Facts of the Case that the query basically relates to two kinds of assignments: (a) surprise check and (b) surprise recheck, which are entirely different in respect of their nature, purpose, manner of reporting, and scope of work to be performed, etc. Accordingly, the Committee has hereinafter dealt with these two kinds of assignments, separately, to express its opinion on the issues raised in paragraph 10 above.

*(a) Surprise check*

12. The Committee notes from paragraph 6 above that in case of surprise check, the company's empanelled auditors are required to provide a detailed surprise check report containing the factual observations during their press and market visit as well as their comments on the publishers' books and records as factually observed by them. In other words, the auditor does not certify the

circulation figures but only reports his findings by performing the agreed-upon procedures as per the terms of reference. In this regard, the Committee notes paragraphs 2 and 4 of Auditing and Assurance Standard (AAS) 32, 'Engagements to Perform Agreed-upon Procedures Regarding Financial Information'[2], issued by the Institute of Chartered Accountants of India, which state as follows:

> "2. In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement. For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements."
>
> **"4. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings."**

On the basis of the above, the Committee is of the view that the surprise check audit in the present case is of the nature of agreed-upon procedures engagement since here, the auditor is to just report his factual findings on the basis of his observations during the press visit and market visit; and his comments on the maintenance of publisher's books and records as factually observed by him.

13. As far as the scope and objective of such an engagement, the procedure to be followed and evidence gathered during the assignment are concerned, the Committee notes paragraphs 5, 8, 14, 15 and 16 of AAS 32 which are reproduced below:

[2] Auditing and Assurance Standard (AAS) 32 has since been renamed, renumbered and categorised as Standard on Related Services (SRS) 4400, 'Engagements to Perform Agreed-upon Procedures Regarding Financial Information'.

"5. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed by him in his report. Instead, users of the report assess for themselves the procedures and the findings reported by the auditor and draw their own conclusions from the work done by the auditor."

**"8. The auditor should conduct an agreed-upon procedure engagement in accordance with this AAS and the terms of the engagement."**

**"14. The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this AAS and the terms of the engagement.**

**15. The auditor should carry out the procedures agreed-upon and use the evidence obtained as the basis for the report of factual findings.**

16. The procedures applied in an engagement to perform agreed-upon procedures may include:

- Inquiry and analysis.
- Recomputation, comparison and other clerical accuracy checks.
- Observation.
- Inspection.
- Obtaining confirmations.

…"

From the above, the Committee is of the view that in such kinds of engagements, the auditor should carry out only those procedures as have been agreed upon. The Committee also notes from the letter of engagement in case of surprise check that the terms of reference require the auditor to ascertain the genuineness of circulation of a publication through verification of distribution of copies by visiting distribution centers both in the town of publication as well as outside publishing centers and also to verify actual commission being paid in the market place, i.e., to conduct market visit and check whether the same corroborates with publisher's records. Thus, the auditor in case of surprise check, should carry out the above-mentioned and other procedures as detailed out in the letter of his engagement and report on the factual findings observed by him. As far as reporting is concerned, the Committee notes paragraph 17 of AAS 32, which states as follows:

> "**17. The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.**"

14. On the basis of the above, the Committee is of the view that in case of surprise checks, the auditor should report on his factual findings/observations based on the evidences obtained during his audit after carrying out the audit in accordance with the terms of his engagement and various requirements of AAS 32. During his audit, he should document all his observations and findings which are important in providing evidence to support his report of factual findings as required by above-reproduced paragraph 14 of AAS 32.

*(b) Surprise re-checks*

15. The Committee notes from paragraphs 4 and 5 above that in case of surprise recheck, the empanelled company's auditors are required to certify the publication figures. In this regard, the Committee notes paragraph 2, 'Scope of Special Purpose Audit Reports and Certificates' of Guidance Note on Audit Reports and Certificates for Special Purposes, issued by the Institute of Chartered Accountants of India, which, inter alia, states as below:

> "2.1 Audit reports or certificates for special purposes may be issued in connection with:
>
> …

(e) Compilation of statistics or ascertainment of basic figures e.g., for the purpose of fixing quotas or levies."

From the above, the Committee is of the view that in case of surprise re-check, the auditor is issuing certificate for special purpose (the terms 'auditor' and 'audit' are used in a generic sense hereinafter to deal with the certification assignment) since as per the terms of letter of engagement of the auditor in case of surprise-rechecks, the auditor is required to certify the circulation figures submitted by the publisher with the company. The Committee is also of the view that in case of such audits, since the auditor is required to certify certain items of financial statements and is not required to review the financial statements as a whole, the scope of audit in such kind of assignment would be more intensive and specific as compared to general purpose audit. The Committee is further of the view that in such cases, even though the scope, objective and content of certificate is determined by the terms of engagement of auditor, the audit principles, procedures, methods and techniques of audit as prescribed by Auditing and Assurance Standards, issued by the Institute of Chartered Accountants of India would still be applicable, to the extent relevant.

16. The Committee notes from the proforma engagement letter in case of surprise re-check that the auditors are required to make a surprise visit to the market place, ascertain the trade terms at which copies are sold at various centers within the city and also report in detail on various points, including whether any amount has been paid to the agents / sub-agents over and above the normal trade commission. In the view of the Committee, to report on such matters, the auditors should obtain sufficient appropriate evidence to base their conclusions. In this context, the Committee notes paragraph 15 of Auditing and Assurance Standard (AAS) 1, 'Basic Principles Governing an Audit'[3], issued by the Institute of Chartered Accountants of India, which provides as follows:

"15. The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and

[3] Auditing and Assurance Standard (AAS) 1 has since been renamed, renumbered and categorised as Standard on Auditing (SA) 200, 'Basic Principles Governing an Audit'.

substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information."

17. The Committee further notes that Auditing and Assurance Standard (AAS) 5, 'Audit Evidence'[4], issued by the Institute of Chartered Accountants of India, explains 'Sufficient Appropriate Audit Evidence' in paragraphs 2 and 3, inter alia, as follows:

> "2. Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained; appropriateness relates to its relevance and reliability.
>
> 3. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The audit evidence should, in total, enable the auditor to form an opinion on the financial information."

18. The Committee also notes paragraphs 7 to 10 of AAS 5, which provide as follows:

> "7. The reliability of audit evidence depends on its source internal or external, and on its nature visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:
>
> - External evidence (e.g. confirmation received from a third party) is usually more reliable than internal evidence.
> - Internal evidence is more reliable when related internal control is satisfactory.
> - Evidence in the form of documents and written

[4] Auditing and Assurance Standard (AAS) 5 has since been renamed, renumbered and categorised as Standard on Auditing (SA) 500, 'Audit Evidence' which has subsequently been revised. The Revised Standard is effective for audit of financial statements for periods begining on or after April 1, 2009.

representations is usually more reliable than oral representations.

- Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

8. The auditor may gain increased assurance when audit evidence obtained from different sources or of different nature is consistent. In these circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, further procedures may have to be performed to resolve the inconsistency.

9. The auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation.

10. When the auditor is in reasonable doubt as to any assertion of material significance, he would attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence he should not express an unqualified opinion."

19. From the above, the Committee is of the view that in the present case, since the internal evidence in the form of records, documents and representations by the management is inconsistent with external oral representations by sub-agents/hawkers and observations of the auditors, the auditors should consider performing additional appropriate audit procedures, on the basis of their past experience, knowledge and nature of the business carried on by the enterprise so as to obtain corroborative sufficient appropriate audit evidence for the purpose of certifying the circulation figures. For example, the auditor should try to obtain written confirmations from the sub-agents/hawkers regarding the trade terms. In case they are unable to reach any conclusion, the auditors should exercise their own judgement and skills on the basis of degree and extent of reliability of available audit evidence so as to certify the circulation figures and should make appropriate and adequate disclosures considering the various points to be covered as prescribed in the engagement letter of the auditors, the audit guidelines for the company's auditors as contained in the

manual 'Guide to ABC Audit' and various notifications issued by the company from time to time on audit procedures for the auditors. The auditor may also decide not to certify the circulation figures in case he is not satisfied with the publisher's maintenance of books and records, and on the basis of his findings from the press and market visit.

## D. Opinion

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

(i) In case of surprise check, the auditor should report on the factual findings observed by him during his audit after carrying out the audit in accordance with the terms of his engagement and various requirements of AAS 32 as discussed in paragraph 14 above. In case of surprise re-checks, the company's empanelled auditor should exercise his judgement and skills to base the certificate of circulation figure, considering the degree of reliability of audit evidences obtained. He may also consider performing certain additional procedures to obtain corroborative sufficient appropriate audit evidences in respect of inconsistencies observed between the evidences obtained as stated in paragraph 19 above. In case, he is unable to reach any conclusion, he may decide not to issue the certificate for circulation figure of the publication. The company may have to take stand based on the information as aforesaid applying its own judgement in the facts and circumstances of the case. The company may also consider obtaining additional corroborative evidences by calling for separate investigation, as per its terms of assignment with the publisher.

(ii)(a) In the case of surprise checks, the question of reliance upon the publisher's books and records does not arise as the auditor only has to report on his factual findings/ observations during his assignment. In case of surprise re-check, the evidences obtained/observations from the market place should not be disregarded, rather, these should be corroborated with the other evidences by performing additional procedures, e.g., obtaining written confirmations from hawkers/sub-agents, as discussed in paragraph 19 above and if that is not possible, the matter should be adequately disclosed in the certificate issued for surprise re-check. As far as reliance by the company is concerned, the company may have to take stand based on the information as aforesaid applying its own judgement in the facts and circumstances of the case. The company may also require separate investigation to obtain additional corroborative evidences, as discussed in (i) above.

(b) The questions of reliance on publisher's books and issuance of certificate do not arise in case of surprise check, as discussed in (i) and (ii)(a) above. In case of surprise re-check, if it is not possible to obtain written evidence, the oral evidence may be relied upon after judging its reliability in the facts and circumstances of the case, as recognised in AAS 5 also. Accordingly, the auditors should not issue a clean certificate with respect to the circulation figures if they are convinced about the reliability of the observations/evidence gathered from the market place. The company's reliance would depend upon the certificate provided by the auditors.

(c) The question of certifying does not arise in case of surprise check as the auditor has only to report on his factual findings/observations during his assignment as discussed in (i), (ii)(a) and (ii)(b) above. In case of surprise re-check, if the auditors rely on their observations and interactions with the sub-agents/hawkers in the facts and circumstances of the case, not certifying the publisher's circulation figures in the circumstances would be within the Auditing and Assurance Standards. Regarding the legal stand on such practice, the Committee does not express any opinion since as per Rule 2 of the Advisory Service Rules of the Expert Advisory Committee, the Committee does not answer queries involving legal interpretation of various enactments.

## *Query No. 6*

***Subject: Creation of provision for non-fund based facilities.*[1]**

## A. Facts of the Case

1. A nationalised bank is covered under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970. Its main function is acceptance of deposits and making advances to various customers. The querist has stated that during the course of business, some loan accounts become non-performing and stop generating income. Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances have been prescribed by the Reserve Bank of India (RBI), being regulator of banks. The Master Circular issued by RBI, dated 1st July, 2005, elaborates the provisioning requirements for 'Fund based accounts'. However, RBI guidelines are silent with regard to provisioning in respect of 'Non-fund based facilities'.

2. The querist has further mentioned that the Master Circular of the RBI requires reporting on non-performing assets (NPAs) to the RBI in the following format:

1. Gross advances
2. Gross NPAs
3. Gross NPAs as a percentage of gross advances
4. Total Deductions (i+ii+iii+iv)
   (i) Balances in Interest Suspense Account
   (ii) DICGC/ECGC claims received and held pending adjustment
   (iii) Part payment received and kept in suspense account
   (iv) Total provisions held
5. Net advances (1 – 4)

[1] Opinion finalised by the Committee on 14.5.2007.

6. Net NPAs (2 – 4)

7. Net NPAs as a percentage of net advances

For the purpose of the above reporting, 'gross advances' mean all outstanding loans and advances including advances for which refinance has been received but excluding rediscounted bills, and advances written off at Head Office level (technical write-off).

3. According to the querist, it is clear from the above that gross advances to be reported to the RBI only comprise loans and advances (i.e., funded facilities) and not non-funded facilities. It is only logical that the NPAs will cover only those facilities which are included in gross advances.

**B. Query**

4. In the light of the above circular, the querist has sought the opinion of the Expert Advisory Committee on the following issues with regard to Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute of Chartered Accountants of India:

(a) In respect of the borrowal accounts (secured by tangible assets) classified as non-performing assets, where letters of credit (LCs) and letters of guarantee (LGs) are outstanding, whether provision is to be made in the books of the account of the bank, for such outstanding LCs and LGs, particularly, when the liability in respect of such LCs/LGs has not been crystallised.

(b) Whether the answer will be different if no tangible security is held by the bank.

**C. Points considered by the Committee**

5. The Committee notes that the basic issue raised in the query relates to whether provision in respect of non-funded exposures, such as, LCs and LGs is required to be made under the requirements of AS 29, the borrowal accounts related to which have been classified as non-performing assets. The Committee, while expressing its opinion, has considered only this issue and

has not touched upon any other issue arising from the Facts of the Case.

6. The Committee notes the definition of the term 'provision', the recognition criteria with regard thereto and the definition of the term 'contingent liability' as per AS 29 which are reproduced below:

> "***A provision is a liability which can be measured only by using a substantial degree of estimation."***
>
> ***"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."***
>
> "***A contingent liability is:***
>
> > ***(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or***
> >
> > ***(b) a present obligation that arises from past events but is not recognised because:***
> >
> > > ***(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or***
> > >
> > > ***(ii) a reliable estimate of the amount of the obligation cannot be made."***

The Committee notes from the above that a provision is required to be made only when the definition of the term ‘provision’ and recognition criteria in respect thereof as per AS 29 are satisfied. If these conditions are not satisfied, these items should be disclosed as contingent liabilities as per the provisions of AS 29.

7. The Committee is of the view that a borrowal account becoming an NPA, does not necessarily mean that LCs or LGs related to that borrowal account will also become NPA. Hence, it requires assessment on case-to-case basis, in the facts and circumstances of each case and keeping in view the past experience in respect of such NPAs as to whether a provision is warranted as per the requirements of AS 29 or a disclosure as contingent liability is required as discussed above.

**D. Opinion**

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

(a) In respect of LCs/LGs which relate to borrowal accounts (whether secured by tangible assets or not) which are NPAs, provision is required to be made only when the conditions as stipulated in AS 29 are satisfied as discussed in paragraph 7 above. In case the provision is required to be made on the aforementioned basis, the realisable value of the security should be adjusted while determining the amount of provision required to be made.

(b) With respect to whether provision is required to be made, the answer will not be different whether or not a tangible security is held by the bank, although, the amount of provision required to be made may differ, if no tangible security is held, as stated in (a) above.

## *Query No. 7*

***Subject: Provision for provident fund liability on accrued encashable earned leave liability.[1]***

### A. Facts of the Case

1. A wholly owned Government of India undertaking under the Department of Defence Production, Ministry of Defence, registered under the Companies Act, 1956, manufactures a wide range of products, like super alloys, titanium alloys, maraging steel, molybdenum, etc., for strategic sectors, like space, aeronautical, nuclear power, and for commercial sectors, like furnace, instrumentation, electronics, communications, petroleum, petrochemicals, fertilisers, etc. The company's turnover (including excise duty, less returns) in the financial year 2005-06 was Rs.15,297 lakh.

2. As per the provisions of the company's leave rules, all permanent employees are eligible for 2½ days of earned leave for every 30 days of service. The leaves thus earned by the employee can either be utilised or encashed, subject to the terms of the leave encashment rules. An employee is entitled to encash 50% of the leaves standing to his credit, subject to a minimum of 10 days, calculated on the basis of the last pay drawn as on the date of encashment. The leave encashment can be availed by an employee once in a financial year. (Copy of the company's leave rules has been furnished by the querist for the perusal of the Committee.) With effect from 1-1-2005, the earned leave encashment was also reckoned as wages/salary for the purpose of provident fund contributions. (Copy of circular dated 9-5-2005 issued by the personnel department of the company has been furnished by the querist for the perusal of the Committee.)

3. The querist has stated that he has been informed by the company that the company was accounting for leave encashment, on cash basis up to the year 1994-95. From the year 1995-96, with a view to conform to the mandatory requirements of accounting for transactions on accrual basis, the company adopted accrual

[1] Opinion finalised by the Committee on 14.5.2007.

basis of accounting for leave encashment liability. The accounting policy which is now being followed for leave encashment is as under:

> "Provision for leave encashment liability to employees is made on the basis of actuarial valuation as at the year end."

Consequently, the provision for leave encashment liability as on the date of balance sheet is being provided on the basis of actuarial valuation, which, according to the querist, is in consonance with Accounting Standard (AS) 15.

4. As informed by the querist, the actual expenditure incurred on leave encashment/utilisation is debited to the profit and loss account during the year. The actual liability as at the end of the year is provided for/withdrawn based on the opening balance standing to the credit of leave encashment provision account.

5. A decision has been taken by the company with effect from 1-1-2005 that a matching contribution of 12% towards provident fund will be made on the leave encashed by the employee. This decision was taken based on the communication dated 29-4-2003 from Employees' Provident fund Organisation that the leave encashment constitutes pay. Accordingly, the company has been making the matching contribution of 12% towards provident fund as and when leave is encashed by the employee. The querist has been informed that this is being followed in other defence public sector undertakings also.

6. At the end of every year, the company provides information to the actuary giving details of name of the employee, employee's staff number, date of birth, date of joining, salary particulars (basic plus dearness allowance), and earned leave to the credit of employee as on 31$^{st}$ March, to enable calculation of actuarial value of the accrued encashable leave salary liability. As on 31-03-06, an amount of Rs. 510.76 lakh was provided towards accrued liability on leave encashment. This represents the provision made for leave encashment liability to the employees on the basis of actuarial valuation as at the year-end and does not include the provident fund contribution of the employer.

7. The querist has informed that the government auditors, while auditing the accounts for the year 2005-06, have commented that there is an understatement of liabilities to the extent of Rs. 61 lakh as on 31-3-2006, due to non-provision of employer's liability at 12% towards contribution to provident fund on the accrued leave liability of Rs. 510.76 lakh as on 31-3-2006, keeping in view the fundamental principle of accrual basis of accounting.

8. According to the querist, the liability on account of employer's provident fund contribution on the accrued leave encashment liability does not arise on account of the following:

(a) In terms of accounting policy of the company, liability towards leave encashment to the employees is made on the basis of actuarial valuation, which is in consonance with AS 15.

(b) The company's contribution towards provident fund on leave encashment is in the nature of 'matching contribution'.

(c) The definition of 'matching contribution' as extracted by the querist from a website is "the amount, if any, a company contributes on an employee's behalf to the employee's retirement account *usually tied to the employee's own contribution"*. This establishes the fact that the liability of the company would devolve only *at the time of encashment of leave by the employee and is tied to his contribution to provident fund on such leave encashment.* (Emphasis supplied by the querist.)

(d) The amount on account of provident fund, if brought into books, cannot be retained and the individual provident fund accounts of the employees cannot be credited with the employer's share only as there is no matching employee contribution.

## B. Query

9. Keeping in view the above, the querist has sought the opinion of the Expert Advisory Committee as to whether provision is required

to be made towards employer's provident fund liability on the accrued leave liability as at the year-end.

## C. Points considered by the Committee

10. The Committee, while expressing its opinion, has considered only the issue raised in paragraph 9 above and has not touched upon any other issue arising from the Facts of the Case. The Committee has also not examined as to whether the provident fund benefit is a defined benefit plan or a defined contribution plan as the required information is not available in the Facts of the Case. Further, the Committee notes that the querist has not stated as to whether AS 15 mentioned in the Facts of the Case refers to AS 15 (1995), 'Accounting for Retirement Benefits in the Financial Statements of Employers' or AS 15 (revised 2005), 'Employee Benefits'. However, these matters do not affect the determination of issue as to whether provision is to be created towards provident fund contribution on the accrued leave liability.

11. The Committee notes that with effect from 1-1-2005, the company has decided that earned leave encashment is also to be reckoned as wages/salary for the purpose of provident fund contributions of both, employees and employer. This is as per the circular dated 9-5-2005 issued by the personnel department of the company.

12. The Committee is of the view that accrual being one of the fundamental accounting assumptions, the cost of providing benefits to employees in return for the services rendered by them in an accounting period should be accounted for in that period. The underlying principles of AS 15 (1995) as well as AS 15 (revised 2005) are based on the aforesaid principle. AS 15 recognises that a liability towards employee benefits should be provided as and when the services are rendered.

13. The Committee is of the view that though the 'matching contribution' of 12% towards employer's contribution to provident fund on leave encashment is paid to the relevant trust or a similar entity only on actual leave encashment, it accrues as and when the underlying liability towards leave encashment accrues. Accordingly, the provision for provident fund contribution should

include provident fund contribution in respect of accrued leave liability.

14. The Committee is of the view that mere creation of a provision on accounting considerations does not necessarily mean that the individual provident fund account of the employees should be credited. Credit to individual provident fund account of the employees is based on the terms and conditions of the Provident Fund Scheme.

15. The Committee notes that as regards quantum of provident fund contribution to be provided on accrued leave liability, depending upon whether the provident fund benefit is a defined benefit plan or a defined contribution plan, the relevant measurement rules of AS 15 will apply.

**D. Opinion**

16. On the basis of the above, the Committee is of the opinion that provision is required to be made towards estimated employer's contribution to provident fund on the accrued leave liability as at the year-end.

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***Query No. 8***

***Subject: Disclosure of internal consumption in the profit and loss account.[1]***

**A. Facts of the Case**

1. A company was incorporated on 16th August, 1984 and is mainly in the business of procuring, transmission, processing and marketing of natural gas. The company has an authorised share capital of Rs. 1,000 crore and the paid up capital is Rs. 845.65

[1] Opinion finalised by the Committee on 14.5.2007.

crore. The Government of India holds approximately 57% equity of the company at present.

2. The company owns and operates (i) over 6,000 Kms of gas pipeline which currently transmits about 79 MMSCM per day of natural gas, (ii) seven gas based LPG manufacturing plants in different parts of the country with an annual installed capacity of more than 1 million MT of LPG, (iii) an integrated gas based petrochemical plant for producing polymers and, (iv) LPG pipelines of over 1,800 Kms for transmission of LPG. The company has a number of accounting units which record and maintain the accounts for the respective business activities carried out by them. The company has also integrated its business activities and is involved in the projects and operations, such as, city gas distribution, oil & gas exploration and production, and telecom business for sale of bandwidth. The company has recently implemented SAP- ERP and divided its business activities into 10 business segments and reports its financial results as per Accounting Standard (AS) 17, 'Segment Reporting', under the following business segments:

(i) Gas transmission

(ii) LPG transmission

(iii) Gas trading

(iv) LPG & other liquid hydrocarbons production

(v) Petrochemicals production

(vi) City gas distribution

(vii) Power sector

(viii) Exploration and production activities for oil and gas

(ix) Telecom (sale of bandwidth)

(x) Un-allocable (includes corporate office, zonal offices, etc.)

3. The company purchases natural gas from a company and joint venture companies in various states which is transmitted

through gas pipelines for sale to various gas consumers, such as, power and fertiliser plants. Besides sale of gas to its customers, the gas is also used by the company (a) as feed stock in its gas processing plants for production of LPG and polymers and (b) as fuel for running its compressors installed along the gas pipelines (for transmission of gas to long distance) and generation of power in its processing plants for captive needs.

4. The querist has stated that the natural gas received is processed in the LPG and petrochemical plants where higher fraction of hydrocarbon is extracted for production of LPG and other petrochemical products. The balance gas having lower hydrocarbon fractions goes back in the gas pipeline and is sold to various customers. The LPG, the liquid hydrocarbon products and other petrochemical products produced are sold at market price. The quantity of natural gas consumed (having higher fraction of hydrocarbons to produce the LPG, liquid hydrocarbons and other polymer products) is accounted for in the books as mentioned in paragraph 7 below.

5. The gas activity is related to the following four business segments as under:

(a) Gas Transmission, i.e., business of transportation of gas through gas pipelines by way of transmission charges revenue.

(b) Gas Trading, i.e., business of purchase and sale of gas activity.

(c) LPG and Liquid Hydrocarbon (LHC) processing, i.e., business of manufacture and sale of LPG and LHC by consuming gas as feed stock and fuel.

(d) Polymer processing, i.e., business of manufacture and sale of polymer by consuming gas as feed stock and fuel.

6. According to the querist, at the time of purchase of natural gas from the suppliers, the account 'Purchase of Gas' is debited with corresponding credit to supplier. The purchase is disclosed separately on the face of profit and loss account. This purchase

account is debited by the concerned accounting unit purchasing and receiving the natural gas from the gas suppliers under the business segment 'Gas Trading'.

7. As mentioned above, the company consumes natural gas as feed stock (i.e., raw material) for its processing plants (LPG and Polymer) and as fuel in the compressor stations along the gas pipelines and in the plants. The natural gas consumed as feed stock by LPG and polymer plants for production of LPG and polymer respectively, is debited to raw material cost under the business segments 'LPG' or 'Petrochemicals', as the case may be, with a corresponding credit to internal consumption account under business segment 'Gas Trading'. Similarly, natural gas consumed as fuel in compressor stations along gas pipelines (to push gas), in 'LPG' or 'Petrochemical' plants is debited to fuel cost under the business segments 'Gas Transmission', 'LPG' or 'Petrochemical', as the case may be, with a corresponding credit to internal consumption account under business segment 'Gas Trading'.

8. The amount credited to 'internal consumption' is shown separately under 'Income' in the profit and loss account. The amount of internal consumption is not clubbed with or included in 'Sales' and is shown separately.

9. The gas consumed by the company as feed stock (raw material) and as fuel is included under 'Expenditure'. In Schedule 10, "Manufacturing, Transmission, Administration, Selling and Distribution and other Expenses", the cost of natural gas consumed as feed stock is separately shown as 'Raw Material consumed' and the cost of natural gas consumed as fuel stock is separately shown under 'Power, Fuel and Water charges'.

10. The querist has also stated that an entry tax is levied by the State Government on consuming the natural gas at a Petrochemical Plant and a Compression Station and the cost of natural gas booked as raw material in the said plant is inclusive of entry tax. Therefore, raw material and internal consumption will not match to the extent of entry tax paid by the Petrochemical Plant and the Compression Station.

11. The querist has stated that during the course of limited review for the quarter ended 30.09.2006, the statutory auditors have made the following observation with respect to depiction of internal consumption under 'Income' in the profit and loss account vide their letter dated 24.10.2006 as follows:

> "The inter branch transfers do not result in inflow of cash, receivables, etc., from sale of goods or from rendering of services and thus are not revenue within the definition of AS 9, 'Revenue Recognition'. Simply because it is not included in sales and shown separately, it does not, in our opinion, bring it within the spirit and substance of the definition of the word "Revenue" of AS 9. While interpreting the same, it should be seen whether the same falls under the definition and not the explanatory words.
>
> The management is of the view that since it is not included in sales, they have complied with the recognition of revenue as per AS 9.
>
> We, as submitted above, do not subscribe to the view taken by the management and are of the opinion that it does not comply with the definition of revenue. The management wishes to take opinion from the Institute of Chartered Accountants of India on the same. We have, therefore, agreed that the matter be thrashed out before the next quarter."

12. The company, in response to the above observations, has clarified as under:

(a) Disclosure of internal consumption of gas is shown separately from sales as income in the profit and loss account with corresponding disclosure under 'Raw Material Consumption' and 'Power, Fuel and Water Charges' in Schedule 10- Manufacturing, Transmission, Administration, Selling and Distribution and other Expenses.

(b) The company is following this practice consistently and disclosure of each item of income / expenses is made separately. It also helps in preparation of segment-wise financial reporting according to the provisions of AS 17, 'Segment Reporting', as internal consumption is the income of 'Gas Trading' business segment, while gas consumed for the production of LPG, liquid hydrocarbons and petrochemicals as feed stock (raw material) is shown as raw material consumed in Schedule 10. Similarly, gas consumed as fuel to compress gas and/or generate power for running the plant is a fuel expense and is clubbed and shown under power, fuel and water charges and also shown in Schedule 10. Both the raw material cost and fuel cost are expenses of the Gas Transmission, LPG and Petrochemical business segments.

(c) This practice is being followed since quite a long time by the company and the statutory auditors and the C&AG had not objected to this disclosure ever before.

13. The querist has stated that subsequently, the statutory auditors in their letter dated 16.11.2006 have, inter alia, stated as below:

"The natural gas received is processed in the LPG and petrochemical plants and higher fraction of hydrocarbon is extracted to produce LPG and petrochemicals. LPG, Petrochemicals and other liquid hydrocarbons are sold at higher values after processing. The gas with the lower hydrocarbons goes back to the pipelines and is sold to the customers. As per your letter dated 14th November, 2006, it is the higher fraction of natural gas extracted which constitutes the shrinkage which is accounted for as raw material for production of LPG etc. which is shown as internal consumption with the corresponding entries in the expenses. Since the shrinkage utilised has already been accounted for as sale of LPG and other petrochemical products, accounting for the same as internal consumption amounts to double booking of income and expenses. However, gas consumption as fuel for power generation to run the processing plant and compressor station and HVJ and other pipe system will continue to be accounted as fuel. Transportation charges, which is a main income of the company, includes profit elements. The profit element should be excluded in arriving at the prices at which the same is to be accounted for as fuel. Since the higher fraction of hydrocarbon is not internal consumption, the same is also not liable to be included in the segment reporting except and to the extent it is used in fuel for plants' operations".

14. In this regard, in addition to the views expressed in paragraph 12 above the following points are also submitted by the querist for consideration of the Committee:

(a) Clause 2 of Part II of Schedule VI to the Companies Act, 1956 states, inter alia, as follows:

"2. The profit and loss account –

(a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account"

(b) Clause 3 of Part II of Schedule VI to the Companies Act, 1956 states as follows:

"3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:

(i) …

(ii) (a) In the case of manufacturing companies,—

(1) The value of the raw materials consumed, giving item-wise break-up and indicating the quantities thereof..."

(c) The consumption of raw material during the financial year 2005-06 was Rs. 1,476 crore, out of the total 'Manufacturing, Transmission, Administration, Selling and Distribution and other Expenses' of Rs. 2,894 crore which is more than 50% of cost of expenses. If the cost of gas consumed as fuel is added, the share of cost of gas used as raw material and fuel will be approximately 70% of total 'Manufacturing, Transmission, Administration, Selling and Distribution and other Expenses'. Considering the substantial materiality aspect, it is felt that it is prudent as per the provisions and spirit of the Companies Act, 1956 and AS 17 to disclose it separately.

**B. Query**

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

(i) Whether the disclosure of internal consumption of gas separately from 'Sales' on the 'Income' side of the profit and loss account with corresponding debit to 'Raw Material consumed' and 'Power, Fuel and Water Charges' on the 'Expenses' side of the profit and loss account by the company as deliberated above in paragraphs 6 to 9 is correct and in compliance with AS 9.

(ii) In case the answer to (i) above is in the negative, an appropriate method of accounting and disclosure to be followed by the company for such internal consumption of gas which will comply with the requirements of AS 9, AS 17 and clause 2 of Part II of Schedule VI to the Companies Act, 1956, may kindly be suggested.

**C. Points considered by the Committee**

16. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 15 above and has not touched upon any other issue arising from the Facts of the Case, such as, valuation of internal consumption, etc.

17. The Committee notes that the basic issue involved in the query is whether the natural gas used by the company in the manufacture of various products and as fuel can be separately shown on the income side of the profit and loss account with corresponding debit to raw materials consumed and power, fuel and water charges on the expense side of the profit and loss account.

18. The Committee notes from the Annual Report of the company for the financial year 2005-06 that it exhibits opening stock, purchases and closing stock of inventory on the face of the profit and loss account. To the extent these items relate to natural gas, their net effect represents total of (i) cost of gas resold 'as such' and (ii) consumption of gas used as (a) feed stock in the production of LPG and petrochemical products and (b) fuel in compressor stations for transmission of gas to long distance and generation of power in processing plants for captive needs.

19. In the view of the Committee, gas used in the production of LPG and petrochemical products can be termed as 'consumption' and not as 'internal consumption', since in these cases, as a result of such consumption, finished products emerge.

20. The Committee notes that there are two methods of presentation of material consumption in the profit and loss account. One method would be to present opening stock, purchases and closing stock and to depict the net effect as consumption. The other method would be to depict the consumption directly under appropriate heads like raw materials, fuel, etc. However, both methods cannot be simultaneously adopted with a compensating credit for consumption in the profit and loss account, which the company is presently doing. In the view of the Committee, this amounts to double booking of consumption in the profit and loss account, the effect of which is nullified by the compensating credit to the profit and loss account.

21. While the methods described in paragraph 20 are the methods of presentation, as regards 'disclosure' requirements of consumption of materials in accordance with Part II of Schedule VI to the Companies Act, 1956, 'Statement on the Amendments to Schedule VI to the Companies Act, 1956' (hereinafter referred to as the 'Statement'), issued by the Institute of Chartered Accountants of India, gives detailed guidance. The Committee also notes the following portion from the 'Statement':

> "6.10 In the case of industries where there are several processes, materials may move from process to process, so that the finished product of one department constitutes the

raw materials of the next. Since the notification clearly requires consumption data to include only purchased intermediates or components and also having regard to the fact that the consumption of raw materials for production of such intermediates would have to be accounted as raw materials consumed, it follows that internal transfers from one department to another should be disregarded in determining the consumption figures to be disclosed."

The above portion of the 'Statement' also supports the principle that inter-divisional transfers should not be considered for disclosure of consumption.

22. Incidentally, the Committee notes that the company is engaged not only in 'manufacturing' activity but also in 'trading activity', since, a portion of gas is also sold. The Committee notes that clause 3(ii)(b) of Part II of Schedule VI to the Companies Act, 1956 requires, in the case of trading companies, disclosure of the purchases made and the opening and closing stocks, giving break-up in respect of each class of the goods traded in by the company and indicating the quantities thereof. The manner of disclosure in respect of trading activities (opening stock, closing stock and purchases) has also been explained in the 'Statement'.

23. The Committee is of the view that requirements of clause 2 of Part II of Schedule VI to the Companies Act, 1956 to the effect that the profit and loss account shall be made out as clearly to disclose the result of the working of the company during the period covered by the account can be met only by avoiding double booking of consumption. Similarly, the disclosure requirements of clause 3 of Part II of Schedule VI do not lead to the conclusion that there should be double booking of consumption for the reasons stated in paragraphs 20 and 21 above.

24. The Committee is of the view that inter-segment transfer entries should be ignored while generating the financial statements of the enterprise as a whole, even though these have to be considered for segment reporting purposes under AS 17. This will ensure that there is no double booking of the consumption and at the same time statistical information required to be disclosed under Part II of Schedule VI to the Companies Act, 1956 would be available without

including any profit element. For this purpose, depending upon the basis of inter-segment pricing, some adjustments may be needed so that apart from quantitative information, financial value of information disclosed is proper. In this regard, 'Statement' gives detailed guidance. In other words, the Committee is of the view that merely for the purposes of AS 17, it is not appropriate to bring various elements of inter-segment transfers in the financial statements of the enterprise as a whole. Segment reporting can be done on the basis of the information otherwise available with the company.

25. The Committee is of the view that as per the definition of the term 'revenue' as contained in AS 9 which is reproduced below, inter-division transfers do not constitute revenue:

> "4.1 *Revenue* is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

The Committee notes that as per an Announcement issued in 2005 by the Institute of Chartered Accountants of India titled 'Treatment of Inter-divisional Transfers', the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard 9. Since, the company has not reflected the internal consumption as 'revenue', the requirements of AS 9 are not violated. However, to show 'internal consumption' on the income side of the profit and loss account is not appropriate even otherwise as discussed in the above paragraphs.

**D. Opinion**

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

(i) The disclosure of consumption of gas separately from 'Sales' on the 'Income' side of the profit and loss account with corresponding debit to 'Raw Material consumed' and 'Power, Fuel and Water Charges' on the 'Expense' side of the profit and loss account by the company is not correct even though it is not shown as 'revenue' within the meaning of AS 9.

(ii) An appropriate method of accounting and disclosure to be followed by the company for such consumption of gas, in compliance with the requirements of AS 9, AS 17 and clause 2 of Part II of Schedule VI to the Companies Act, 1956, has been discussed in paragraphs 25, 24 and 23 above, respectively.

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***Query No. 9***

***Subject: Valuation of leave under AS 15 (revised 2005).[1]***

## A. Facts of the Case

1. A company is a premier professional electronics company under the Ministry of Defence, Government of India, having its shares listed on the major stock exchanges in India. The turnover of the company for the financial year 2005-06 is Rs. 3,536 crore.

2. The querist has stated that the employees of the company are entitled to three types of leave: annual leave (AL), sick leave (SL) and casual leave (CL). Casual leave is credited to employees in April and can be utilised during the financial year. No carry-over of the casual leave is permitted, and hence, according to the querist, is not being considered for the purpose of valuation under

[1] Opinion finalised by the Committee on 14.5.2007.

Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits', issued by the Institute of Chartered Accountants of India (ICAI).

3. SL is credited at the rate of 20 days (half-pay) on the first day of April to all employees. AL is credited based on the number of years of service, as follows:

| | |
|---|---|
| Service less than 6 years | 22 days |
| Service of 6 – 12 years | 24 days |
| Service of 12 – 18 years | 27 days |
| Service above 18 years | 30 days |

The credit is given in two instalments, 50% on 1st April and the balance on 1st October.

4. Employees are allowed to carry forward the unutilised leave relating to both annual and sick leave. The maximum number of AL balance that can be carried forward as on 31st March is 300 days. There is no limit to the number of days of sick leave that can be carried forward. While AL is encashable during service, SL is not. The employees are entitled to encash the entire balance of AL subject to retaining one-year's entitlement. On retirement, including voluntary retirement (not on resignation), balance of SL, subject to a maximum of 300 days (150 days full pay) can be encashed.

5. The querist has stated that under the pre-revised AS 15, 'Accounting for Retirement Benefits in the Financial Statements of Employers', the company ascertained the liability relating to AL and SL on an actuarial basis, and the incremental liability was debited to the profit and loss account. No funding is done towards this provision. The revised AS 15 defines short-term employee benefits as ***"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"*** (paragraph 7). As mentioned above, the employees of the company are entitled to *avail* the entire leave (AL / SL) balance to their credit. Hence, the company is of the opinion that provision needs to be made for the entire balance at the credit of the employee (emphasis supplied by the querist).

6. AS 15 (revised 2005) also brings out that short-term employee benefits, inter alia, include "short-term compensated absences (such as paid annual leave) *where the absences are expected to occur within twelve months* after the end of the period in which the employees render the related employee service" (paragraph 8(b)) (emphasis supplied by the querist).

7. The querist, vide his subsequent letter, informed the Committee that the company has started implementing the provisions of AS 15 (revised 2005) from 1/4/2006 and the quarterly results have been prepared following AS 15 (revised 2005). The querist has further mentioned that even though the Council of the Institute has decided to postpone the effective date of AS 15 (revised 2005) to accounting years commencing on or after 7/12/2006, since the earlier application of the proposed Accounting Standard by enterprises is always encouraged, the company may like to continue to follow AS 15 (revised 2005) from 1st April, 2006 onwards.

**B. Query**

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

(i) Whether the company should treat the leave benefits as short-term employee benefits and debit the profit and loss account with the entire amount of leave credited to the employees account during the year (as mentioned earlier) since encashment / availment is possible in line with paragraph 7 of AS 15 (revised 2005) or the company needs to continue the actuarial valuation of leave balances as on 31st March and provide for the incremental liability, since in practice all the employees do not encash / avail the leave.

(ii) Whether the company will need to follow differential treatment for AL / SL, since AL is encashable during service, but SL is encashable only on retirement, *though* both can be availed fully during service (emphasis supplied by the querist).

**C. Points considered by the Committee**

9. The Committee, while answering this query, has restricted itself to the issues raised in paragraph 8 above and has not touched upon any other issue arising from the Facts of the Case, such as accounting treatment that should have been provided from the angle of pre-revised AS 15, transitional provisions, treatment of casual leaves, etc.

10. The Committee notes that the definition of the term 'short-term employee benefits' as reproduced in paragraph 5 above states as below:

> ***"Short-term employee benefits*** ***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."***

11. The Committee also notes that paragraph 8 of AS 15 (revised 2005) provides as below:

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

12. On the basis of the above, the Committee is of the view that short-term employee benefits include only those compensated absences which accrue to the employees and are expected to be availed (or encashed, as the case may be) within twelve months after the end of the period in which the employees render the related service. Thus, those compensated absences which can be and are also expected to be carried forward for any further period cannot be termed as 'short-term employee benefits'. In this context, the Committee also notes the definition of the term 'Other long-

term employee benefits' as contained in AS 15 (revised 2005) which is reproduced below:

> ***"<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."***

13. The Committee notes from the Facts of the Case that the AL and SL entitlement of the employees of the company can be carried forward for more than twelve months after the end of the period in which employees render the related service, which can be either availed or encashed, as the case may be. Therefore, the benefit arising to the employees on account of AL and SL falls within the category of 'other long-term employee benefits'. However, in case the past trend indicates that the employees will settle the benefit accruing to them on account of AL and SL within the twelve months after the end of the period in which the employees render the related service, the same would fall within the category of 'short-term employee benefits'. However, this does not seem to be the case in the case of the company.

14. With respect to the recognition and measurement of other long-term employee benefits, the Committee notes that AS 15 (revised 2005) provides that the same should be measured on actuarial basis using the Projected Unit Method. The Standard contains detailed requirements in this regard in paragraphs 129 and 130.

15. The Committee is further of the view that whether the leaves are encashed or availed, both are considered as employee benefits within the provisions of AS 15 (revised 2005). Therefore, the provisions of the said Standard would apply in both the cases. However, their measurement basis may be different, which would be taken care of in the actuarial valuation of the employee benefits.

## D. Opinion

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

(i) The annual leave and sick leave benefit should be treated as 'other long-term employee benefits' in accordance with the provisions of AS 15 (revised 2005) and should be provided for on actuarial basis as explained in paragraph 14 above.

(ii) Since AL and SL, both fall within the category of 'other long-term employee benefits', the treatment would be the same for both kinds of leaves. However, their measurement basis may be different which would be taken care of in the actuarial valuation.

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***Query No. 10***

***Subject: Accounting for foreign exchange rate variation (FERV) in respect of foreign currency loans restated at the balance sheet date and recoverable from State Electricity Boards later on actual payment basis.[1]***

**A. Facts of the Case**

1. 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. With the growing investment in power sector, it also undertakes construction of new transmission systems linked with the generating units as well as systems strengthening schemes of the existing networks.

2. The company has borrowed foreign currency loans to partly finance its capital expenditure on construction of new projects. The principal and interest on the loans are repaid in the agreed foreign currencies as per the terms of the various loans. According

[1] Opinion finalised by the Committee on 14.5.2007.

to the querist, as per the requirements of Accounting Standard (AS) 11 (pre-revised as well as revised), the outstanding loans are restated at the year-end on the prevailing exchange rates as on that date (i.e., 31st March of each year). The resulting foreign exchange rate variation (FERV) is being accounted for as under:

(i) FERV in respect of loans utilised for import of capital equipments is adjusted in the carrying cost of various fixed assets and the same is depreciated over the remaining useful life of the asset as depreciation in accordance with the requirements of Accounting Standard (AS) 6, 'Depreciation Accounting', issued by the Institute of Chartered Accountants of India.

(ii) FERV in respect of loans utilised for capital equipments (other than imported) is treated as under:

  (a) *Limited to domestic borrowing cost:* FERV limited to domestic borrowing cost is treated as part of borrowing cost and the same is accounted for as per the provisions of Accounting Standard (AS) 16, 'Borrowing Costs', issued by the Institute of Chartered Accountants of India, i.e., capitalised during construction period and charged to revenue thereafter.

  (b) *FERV above the domestic borrowing cost:* Such FERV in respect of loans contracted prior to 1/04/2004 is adjusted in the carrying cost of the related fixed assets and the same is depreciated over the residual useful life as per pre-revised AS 11 (1994). FERV in respect of loans contracted w.e.f. 1/4/2004 is charged to revenue after commissioning of the project in accordance with AS 11 (revised 2003).

3. The querist has further stated that the tariff for the transmission systems constructed by the company is governed by the regulatory authority, i.e., Central Electricity Regulatory Commission (CERC) in accordance with the tariff norms fixed from time to time. The tariff is based on the capital cost of the project and it comprises:

*(i)* *Fixed capacity charges*, such as, return on equity, interest on loans, depreciation, O&M charges and interest on working capital. The fixed capacity charges are billed once in a month on fixed dates as $1/12^{th}$ per month of the annual normative fixed capacity charges.

*(ii)* *Reimbursements*: These include income tax and FERV which are reimbursed on actual basis. The relevant provisions of tariff norms regarding FERV are given as below:

> "Extra Rupee liability towards interest payment and loan repayment corresponding to the normative foreign debt or actual foreign debt, as the case may be, in the relevant year shall be permissible provided it directly arises out of Foreign Exchange Rate Variation and is not attributable to the generating company or the transmission licenses or its suppliers or contractors. Every generating company and the transmission licensee shall recover Foreign Exchange Rate Variation on a year to year basis as income or expense in the period in which it arises and Foreign Exchange Rate Variation shall be adjusted on a year to year basis."

As such, the FERV is recovered from the beneficiaries on actual payment basis and the same is billed as and when it is incurred (usually once or twice in a year).

4. According to the querist, the above accounting treatment results in mismatch between the expenditure and revenue since FERV accrued due to restatement of loans is charged to revenue either in the form of interest, depreciation or FERV as explained in paragraph 2 above, whereas FERV recovery is accounted for on actual payment basis as per the tariff norms. Moreover, the FERV charged to the profit and loss account in different forms as explained in paragraph 2 above may not actually materialise since the exchange rates on the actual repayment dates may be different from the rates based on which liability has been created. This leads to fluctuation in the financial results of the company from year to year whereas the net impact over the tenure of loan is nil.

The above accounting treatment affects the profit and loss account of the company on year to year basis since the amount debited or credited in a particular year will be set-off in the subsequent years as the FERV is passed through to customers as per the regulatory norms over the total tenure of the loans and should be seen in the light of paragraph 2.5 of the Guidance Note on Accrual Basis of Accounting, issued by the Institute of Chartered Accountants of India, which is reproduced below:

> "2.5 The following are the essential features of accrual basis of accounting:
>
> (i) Revenue is recognised as it is earned.
>
> (ii) Costs are matched either against revenues so recognised or against the relevant time period to determine periodic income, and
>
> (iii) Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written-off as a loss."

5. To overcome the above situation, the querist has suggested the following treatments:

(i) The foreign currency loan should be translated at the closing rates.

(ii) The differential debit or credit should be treated as recoverable/payable in the balance sheet, given the nature of the transaction and the contractual reimbursement rights as per the tariff norms of the regulatory authority.

Alternatively, if it is considered that the above accounting treatment is not in line with AS 11,

(i) the amount debited or credited in the profit and loss account due to FERV in the form of interest, depreciation and FERV (as explained in paragraph 2 above) should be depicted as 'deferred foreign currency fluctuation asset/liability' under the current assets or liabilities in the balance sheet by corresponding debit/credit to the profit and loss account as 'deferred income/expenditure from foreign currency fluctuation', to the extent the same is recoverable as per the tariff norms of the Regulatory Commission.

(ii) The amount billed on year to year basis to the State Electricity Boards on account of FERV reimbursement would be adjusted against the balance in the 'deferred foreign currency fluctuation asset/liability'.

As per the querist, by following the above practice, the recognition of foreign exchange differences in the profit and loss account, arising on account of restatement of foreign currency loans as at the balance sheet date, will be matched with a corresponding 'deferred income/expenditure from foreign currency fluctuation' and reflected as 'deferred foreign currency fluctuation asset/liability' in the financial statements following the matching principle.

**B. Query**

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

(i) Whether the accounting treatment suggested in paragraph 5 above would be in accordance with the provisions of AS 11 and the Guidance Note on Accrual Basis of Accounting.

(ii) From which year, the proposed accounting treatment is to be implemented, i.e., whether with effect from (w.e.f.) the current financial year or w.e.f. 1/04/2000, i.e., the year from which AS 16 and Accounting Standards Interpretation (ASI) 10, 'Interpretation of paragraph 4(e) of AS 16' became effective?

(iii) In case the proposed accounting treatment is to be implemented retrospectively, whether the impact of previous years is to be considered as prior period item or to be accounted for under the natural heads of current financial year.

## C. Points considered by the Committee

7. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 6 above and has not touched upon any other issue arising from the Facts of the Case, such as, the appropriateness of the accounting policy of the company in respect of foreign exchange rate variation as stated in paragraph 2 above.

8. The Committee notes from the 'Facts of the Case' that the electricity tariff comprises two parts, namely, fixed capacity charges and reimbursements. The Committee is, however, of the view that from the accounting point of view, there is no distinction between the two parts since these comprise the sale consideration for the power supplied to the customer. In the view of the Committee, the nature of the components of the tariff from the accounting point of view is such that the amount of certain expenses considered for the purpose of fixation of tariff is different from the expenses recognised in accordance with the generally accepted accounting principles in the financial statements resulting into excess revenue in certain years and lesser revenue in certain other years.

9. The consequence of the above peculiarities of tariff fixation in the electricity companies is that there would be a divergence between the accounting income, i.e., the income computed by applying the generally accepted accounting principles and the income computed by applying the tariff fixation requirements. With a view to reflect a true and fair view of the profit (loss) for the period, the revenues and expenses need to be matched. The Committee is of the view that the matching can be achieved in respect of the situations mentioned in above paragraphs by recognising a deferred liability in the cases where excess revenue arises in the initial years because higher costs are considered for tariff purposes as compared to those recognised in the financial statements, which gets reversed in the later years when the expenses for tariff purposes become lower as compared to those recognised in the financial statements. Similarly, the matching can be achieved in respect of the situations, where an expense is recognised earlier in the financial statements as compared to that for tariff purposes, by recognising a deferred asset subject to the

consideration of prudence, i.e., the realisability of the asset is reasonably certain or where the company has a history of business losses, the realisability of the asset is virtually certain, also keeping in view the contractual reimbursement rights as per the tariff norms of the regulatory authority. In respect of the situations where the differences between the expenses/revenue do not get reversed in the subsequent years, no effect is required to be given.

10. Regarding the issue raised by the querist in the present case related to accounting for foreign exchange rate variation in respect of the foreign currency loan, which is recognised in the financial statements on the balance sheet date for accounting purposes in one year but is recovered in a later year for tariff purposes, two situations would arise:

(a) Foreign exchange rate variation which is included in the cost of fixed assets, keeping in view the requirements of Schedule VI to the Companies Act, 1956 and Accounting Standards Interpretation (ASI) 10, 'Interpretation of paragraph 4 (e) of AS 16', and

(b) Other FERV which is charged to the profit and loss account.

11. Under these two situations, the views of the Committee based on paragraph 9 above as well as the relevant accounting standards are as follows:

(i) Foreign currency variation on the foreign currency outstanding loan as on the balance sheet date should be arrived at by applying the closing rate as per the requirements of AS 11. The said variation should be adjusted in the cost of the fixed asset or recognised in the profit and loss account, as appropriate, keeping in view the requirements of Schedule VI, ASI 10, AS 11 and AS 16. The other accounting treatments given below apply in the situation of foreign exchange loss. The treatment would, accordingly, have to be modified appropriately in the situation of foreign exchange gain.

(ii) (a) In respect of the situation discussed in paragraph 10(a) above, i.e., where the FERV being a loss is adjusted in the cost of a fixed asset, the company should create a 'deferred foreign currency fluctuation asset', subject to the consideration of prudence as discussed in paragraph 9 above, with a corresponding credit to 'deferred income from foreign currency fluctuation' which should be shown on the assets side and liabilities side of the balance sheet, respectively.

(b) In respect of the situation discussed in paragraph 10(b) above, i.e., where the FERV being a loss is charged to the profit and loss account, the company should create a 'deferred foreign currency fluctuation asset' with a corresponding credit to the profit and loss account subject to the consideration of prudence as discussed in paragraph 9 above.

(iii) In the situations discussed in (ii)(a) above, an amount equivalent to the depreciation on the foreign currency variation component of the cost of the fixed asset should be transferred from the 'deferred income from foreign currency fluctuation' to the credit of the profit and loss account of the relevant year to achieve matching of cost with the revenue.

(iv) 'Deferred foreign currency fluctuation asset' created in both types of situations, should be credited when amount in this regard is received from the SEB. Any balance in the said asset account should be transferred to the relevant profit and loss account.

12. The Committee is of the view that the above treatment meets the requirements of accrual basis of accounting including the matching principle while recognising the peculiarities of the electricity companies in respect of tariff fixation.

13. The Committee, however, notes that on 7/12/2006, the Ministry of Company Affairs, Government of India, has notified the Accounting Standards 1 to 7 and 9 to 29 as recommended by the Institute of Chartered Accountants of India, which are specified in the Annexure to the Companies (Accounting Standards) Rules, 2006. Accounting Standard (AS) 11, as contained in the Annexure

to these Rules, while prescribing the accounting treatment in respect of recognition of exchange differences, states in paragraph 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…"*** and also contains a footnote which, inter alia, states that "the accounting treatment of exchange differences contained in this Standard is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956". Accordingly, in the view of the Committee, with effect from accounting periods commencing on or after 7/12/2006, the foreign exchange differences arising in respect of fixed assets purchased from abroad would also have to be recognised in the profit and loss account, which were hitherto, debited to the cost of fixed asset in view of the requirements of Schedule VI to the Companies Act, 1956. Accordingly, the treatment prescribed in paragraph 11 above which relates to recognising FERV in the profit and loss account would be relevant.

14. As far as the issues raised in paragraph 6(ii) and (iii) are concerned, the Committee notes that paragraph 4(e) of AS 16 became applicable from the date when AS 16 came into force and ASI 10 deals only with the interpretation of the same. Accordingly, paragraph 4(e) of AS 16 should be interpreted in the way stipulated in ASI 10 from the date the Standard came into force. Therefore, in the view of the Committee, insofar as the capitalisation of FERV in respect of foreign currency loan as per the requirements of AS 16 read with ASI 10 is concerned, the accounting treatment prescribed above in respect thereof should be applied from the date AS 16 became applicable to the company with retrospective effect. The adjustments arising from the retrospective implementation should be treated as 'prior period items' and should be accounted for keeping in view the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India. The disclosure of the amounts arising therefrom may be included in the natural heads provided the nature thereof and the relevant amounts are disclosed in the

notes to accounts, so that their impact on the profit or loss can be perceived. These can also be reflected as a separate item in the statement of profit and loss. In this regard, the Committee notes paragraph 15 of AS 5, which states as follows:

> ***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***

**D. Opinion**

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

(i) The accounting treatment of foreign exchange rate variation in respect of foreign currency loans restated at the balance sheet date but recoverable from the state electricity boards at a later date on actual payment basis should be in accordance with the recommendations contained in paragraphs 10, 11 and 13 above.

(ii) The accounting treatment suggested above in respect of capitalisation of FERV as per the requirements of AS 16 read with ASI 10 should be implemented from the date AS 16 became applicable to the company from retrospective effect as discussed in paragraph 14 above.

(iii) The adjustments arising from the retrospective implementation of the above-suggested accounting treatment should be accounted for as 'prior period items', as per the requirements of AS 5. For disclosure purposes, the amounts may be included in the natural heads provided the nature thereof and the relevant amounts are disclosed in the notes to accounts, so that their impact on the profit or loss can be perceived, or these can be reflected as a separate item in the statement of profit and loss as discussed in paragraph 14 above.

***Query No. 11***

***Subject: Amortisation of value of publishing title.[1]***

## A. Facts of the Case

1. A listed company is in the publication business since its inception and publishes a daily newspaper. It commenced its business after taking over the running business of a partnership firm, acquiring all assets and liabilities, except the 'publishing title', which continued to be owned by the partnership firm which, at the time of transfer of business to the company, granted the rights to use the publishing title for a consideration which was payable annually on recurring basis.

2. The querist has stated that in the financial year 1996-97, the firm also sold the publishing title to the company for a lump sum consideration of Rs. 17 crore. The said publishing title is about 65 years old. The company accounted for the consideration paid as a fixed asset upto its financial year ended on 31st March, 2002.

3. The querist has further stated that during the period from financial year 1996-97 to 2001-02, the company did not amortise the value of this asset at all. However, under section 35A of the Income-tax Act, 1961, the company has been allowed, since beginning, deduction from income @ 1/14, in view of the deemed life of the asset as 14 years, as per the provisions of the said section. According to the querist, this life is only for the purposes of tax allowance and in no way, can be assumed to be the actual useful life for accounting purposes because it is a well-settled principle that tax and accounting treatments are quite independent and one does not affect the other.

4. In the financial year ended on 31st March, 2003, the company wrote-off the entire amount of Rs. 17 crore by debit to the profit and loss account to comply, as per the querist, with the practice and guidelines of the Institute of Chartered Accountants of India, then prevalent in respect of intangible assets and suggesting write-off of intangible assets in 3-5 years, although in the opinion of the

[1] Opinion finalised by the Committee on 14.5.2007.

company's Board of Directors, the value of this asset had considerably appreciated since acquisition of the title. Appropriate disclosure of such write-off and the opinion of the Board of Directors was made by way of note to the accounts.

5. The querist has stated that in the financial year ended on 31st March, 2005, in the light of Accounting Standard (AS) 26, 'Intangible Assets', issued by the Institute of Chartered Accountants of India, becoming applicable to the company w.e.f. 1st April, 2003, the company reviewed the accounting treatment given in the financial year 2002-03 and came to the conclusion that the write-off needed reversal in terms of paragraphs 20 and 99 of AS 26 and reinstatement of this asset is required in the books since economic benefits from this asset were expected to flow in future. Accordingly, the value of the publishing title was reinstated in the books partly by credit to general reserve and partly by credit to deferred tax asset, making appropriate disclosure regarding reinstatement, reasons for such reinstatement and also accounting treatment given in the books of account by way of notes to the accounts. The amount credited to deferred tax asset represented the write-off of deferred tax asset created at the time of complete write-off of publishing title in March 2003, which was remaining unadjusted till 31st March, 2005.

6. According to the querist, while the company has been continuing to claim the deduction under section 35A of the Income-tax Act, 1961, the company has not been amortising the value of publishing title after its reinstatement in the books in the financial year 2004-05 on the following grounds:

(i) The asset, for which consideration was paid, is appreciating in value year after year, which is evident from the following:

   (a) Valuation of the publishing title was done by the experts in 2000, i.e., after 4 years from the date of purchase and the value was assessed at Rs. 288 crore as against Rs. 17 crore paid in the financial year 1996-97.

(b) The company had made an Initial Public Offer (IPO) in February, 2006 and its current enterprise value is Rs. 2000 crore approximately, out of which the value of tangible assets was Rs. 650 crore approximately, implying thereby that the value of publishing title, being intangible asset was over Rs. 1300 crore.

(ii) AS 26 requires determination of following in order to be in a position to amortise the value of intangible assets, such as a publishing title:

(a) The useful life of an intangible asset on best estimate basis,

(b) Residual value,

(c) Depreciable amount which is the difference between the cost of an asset and its residual value, and

(d) Systematic amortisation which means that the amortisation can not be *ad hoc*/arbitrary.

In the view of the company, if either (a) or (b) is not determinable, or any of these two can not be scientifically/ properly determined, or in other words, formulae prescribed for amortisation can not be applied, there can not be a "systematic" amortisation and, therefore, amortisation is neither possible nor desirable in terms of AS 26, because if it is done, it will be a "forced" amortisation as against "systematic" amortisation and will vitiate true and fair view of the accounts, which can not be the intention of any Accounting Standard.

(iii) Useful life as defined in AS 26 is not determinable as "the period of time over which an asset is expected to be used by the enterprise" can not be quantified even on prudent basis as required by paragraph 68 of AS 26, even after taking into consideration, the factors, such as those listed in paragraph 64 of AS 26. There is no way to limit the life of publishing title and particularly because the value of title, as detailed above, has been appreciating considerably and with the growing literacy, prosperity and economy of the country, expectations are that in foreseeable future the useful life of a publishing title in the country will not be over and the value thereof will significantly appreciate with every passing year. The querist has drawn the attention of the Committee to the illustrative list of factors, particularly clause (b) of paragraph 64 of AS 26, to be considered for determining the useful life. As per the querist, none of the factors can help in estimating useful life, except "public information on estimates of useful lives of similar types of assets that are used in a similar way". In this connection, it may be noted that there are publishing titles, which are nearly 200 years old and enjoy much higher value than the value of publishing title of the company and are still going very strong with no signs or indications available of their useful lives lasting in foreseeable future. In fact, it is typical of newspaper industry that the older is the title, the higher is the value.

(iv) Residual value as defined under AS 26 is ***"the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal***". As stated above, the publishing title purchased at Rs. 17 crore nearly 10 years ago has current value of over Rs. 1300 crore and this value is expected to increase further with every passing year in foreseeable future. Even if the company attempts to arbitrarily attach a useful life to the publishing title, the expected value at the end of such useful life will be several times higher than its present book value and thus, the company will have a negative depreciable amount. It may be noted that there is an active market for the asset, it is probable that such a market will exist at the end of useful life so determined and it is determined with reference to that market. Therefore, in the view of the company, its value can never be assumed to be zero at any point of time.

7. In view of the above facts and circumstances, the querist has stated that the company does not find itself competent to estimate useful life and residual value. Also, the company has not been

able to identify anyone who can advise or assist it in estimating the useful life of the publishing title and to the best of its knowledge, there is no scientific method/ expert available to estimate the useful life of a publishing title even on prudent basis.

8. As per the querist, the auditors of the company are of the view that:

(i) each intangible asset has its useful life and, accordingly, useful life of the title must be determined,

(ii) useful life is always finite and can never be infinite in view of paragraph 68 of AS 26, and

(iii) value of publishing title should be amortised over its useful life and non-amortisation amounts to non-compliance of AS 26.

**B. Query**

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

(i) Whether it is mandatory to ascertain finite life for an intangible asset.

(ii) Whether the company is justified in not amortising the value of publishing title.

(iii) If not, how can the useful life as well as residual value as defined by AS 26 be determined?

(iv) Whether the life of 14 years, deemed for allowing deduction of amount paid for title under section 35A of the Income-tax Act, 1961 can be construed as useful life.

(v) Whether the residual value can ever be assumed to be zero.

(vi) If useful life and residual value, both are determined under the constraints explained above, whether it will be fair and whether the amortisation based on such determination will not be arbitrary as against "systematic", and not vitiate the true and fair view of the accounts.

(vii) Under the given circumstances, whether it will be proper and in accordance with AS 26, not to amortise the value and disclose it alongwith the reasons for non-amortisation. The querist has drawn the attention of the Committee to paragraph 67 of AS 26, which states that if the presumption that the useful life of an intangible asset generally does not exceed 10 years is rebutted, disclosure to that effect should be made.

**C. Points considered by the Committee**

10. The Committee notes from the definition of the term 'fixed asset' as given in paragraph 6.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, and the Facts of the Case as stated in paragraph 2 above that the publishing title when it was acquired and at present, is of the nature of fixed asset. Accordingly, in the view of the Committee, even before AS 26 came into effect, the accounting treatment in respect of publishing title would have been governed by AS 10. The Committee further notes that since AS 10 does not require any specific accounting treatment in respect of 'publishing titles', the general provisions applicable in respect of fixed assets would have been applicable to it. Further, in the view of the Committee, the allocation of the cost thereof less residual value, i.e., amortisation of depreciable amount thereof would have been governed by Accounting Standard (AS) 6, 'Depreciation Accounting', issued by the Institute of Chartered Accountants of India. The Committee further notes that AS 6 requires that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. In this regard, the Committee notes the definition of the terms 'useful life' and 'depreciable amount', as provided under paragraphs 3.3 and 3.4 of AS 6, which state as follows:

*AS 6*

"3.3 *Useful life* is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3.4 *Depreciable amount* of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value."

11. The Committee also notes from the above that AS 6 excludes only 'goodwill' from the application of the Standard and that the term 'depreciation' includes 'amortisation'. Accordingly, the Committee is of the view that even before AS 26 came into force, AS 6 required determination of useful life and residual value of the title, and the allocation of the depreciable amount over its useful life. Thus, in the view of the Committee, the company should have amortised the depreciable amount of publishing title over its useful life keeping in view the provisions of the then prevailing AS 6. Thus, it is not correct to state, as stated by the querist in paragraph 4 above, that the guidelines issued by the Institute of Chartered Accountants of India, suggested write-off of intangible assets within 3-5 years.

12. The Committee further notes from the Facts of the Case that the company has reinstated the value of publishing title relying upon the provisions of paragraphs 20 and 99 of AS 26. The Committee notes that paragraph 20 deals with 'initial' recognition and, therefore, does not apply in case of reinstatement. The Committee further notes paragraph 99 of AS 26, containing the transitional provisions required to be made on the date of AS 26 coming into effect, which, states as follows:

***"99. Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Statement and the period determined under paragraph 63 has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.***

***In the event the period determined under paragraph 63 has not expired on the date of this Statement coming into effect and:***

***(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.***

***(b) if the remaining period as per the accounting policy followed by the enterprise:***

***(i) is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,***

***(ii) is longer as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.”***

13. The Committee notes from the above, that the Standard requires restatement of the carrying amount of an intangible item on the Standard coming into effect only when the enterprise is following an accounting policy of not amortising an intangible item or the remaining period of amortisation as per the accounting policy followed by the company is higher than the useful life determined under paragraph 63 of AS 26. The Committee notes

from the Facts of the Case that on the date of Standard coming into effect, there is no carrying amount of the publishing title existing in the books of account. Accordingly, paragraph 99 of AS 26 also does not apply for reinstatement of publishing title.

14. The Committee is, however, of the view that the reinstatement is permissible as a prior period item as per the provisions of AS 5 since to write it off was an error as stated in paragraph 11 above. However, the reinstatement would have to be made at the value at which the asset would have appeared in the books of account, if the correct accounting treatment had been followed from the beginning as per the requirements of AS 6 and AS 10.

15. As far as determination of useful life is concerned, the Committee notes the definition of the term 'useful life' as given in paragraph 6 of AS 26 and paragraphs 63, 64, 66, 67 and 68 of AS 26, which state as follows:

> ***"<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 Statement 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."

16. On the basis of the above, the Committee is of the view that AS 26 envisages that the useful life of an intangible asset has to be finite, howsoever long it may be. 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 a publishing title in the country will not be over. In the view of the Committee, the useful life of a publishing title depends upon many factors, apart from the growing literacy, prosperity and economy of the country, as stipulated by the querist, such as, the competition in the print media industry, demand for the product, expectations of the consumers, etc. Thus, not only the factor listed in clause (b) of paragraph 64 of AS 26 is relevant, but also the other factors listed in that paragraph need to be considered while determining the useful life of the publishing title.

17. The Committee is of the view that paragraph 67 does not remedy non-amortisation; it only requires disclosures where the useful life is considered more than ten years. Such a disclosure is required, if, for instance, the company considers the life of the title is, say 30 years, then disclosures are warranted under paragraph 67.

18. As regards the determination of residual value is concerned, the Committee notes paragraphs 75 to 77 of AS 26 which state as follows:

"***75. The residual value of an intangible asset should be assumed to be zero unless:***

***(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or***

***(b) there is an active market for the asset and:***

***(i) residual value can be determined by reference to that market; and***

***(ii) it is probable that such a market will exist at the end of the asset's useful life.***

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not subsequently increased for changes in prices or value."

The Committee notes that the querist has not informed about whether there is any commitment by a third party to purchase the asset at the end of its useful life. From the Facts of the Case, it appears that there is no such commitment. The Committee notes that although the querist has mentioned that active market exists for the title and is expected to exist at the end of its life, the Committee does not agree with the querist in view of the fact that the characteristics of an 'active market' as commonly understood in the commercial and accounting parlance, do not exist. The Committee notes that as per AS 26, an active market is "***a market where all the following conditions exist:***

***(a) the items traded within the market are homogeneous;***

***(b) willing buyers and sellers can normally be found at any time; and***

***(c) prices are available to the public."***

Further, the fact that the title has been valued, does not indicate that 'active' market exists. Also, the fact of the value of the title being much in excess of the original cost and its likely increase in future has no relevance in the case of historical cost accounting on which AS 26 is based. The purpose of historical cost accounting is to allocate the original cost of the asset over its useful life irrespective of its fair value. Accordingly, the residual value of the asset should be taken at zero.

## D. Opinion

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

(i) Yes, as per the requirements of AS 26, the life of an intangible asset has to be ascertained.

(ii) No, the company is not justified in not amortising the value of publishing title.

(iii) The useful life and residual value should be determined keeping in view the principles of AS 26, as discussed in paragraphs 15 to 18 above.

(iv) The life deemed for allowing deduction under the Income-tax Act is not necessarily the useful life for the purposes of AS 26. The useful life should be determined keeping in view the requirements of AS 26 as discussed in paragraphs 15 and 16 above.

(v) As per the requirements of AS 26, the residual value is assumed to be zero as discussed in paragraph 18 above.

(vi) The useful life and residual value determined as per the requirements of AS 26 would be fair and the amortisation based on such determination would be systematic and would portray the true and fair view of accounts within the purview of the extant generally accepted accounting principles (GAAPs).

(vii) No, as per the requirements of AS 26, it would not be proper, not to amortise the value of publishing title and disclosing it along with the reasons, taking the plea of paragraph 67 of AS 26.

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***Query No. 12***

***Subject: Reversal of consultancy fees.[1]***

**A. Facts of the Case**

1. A public sector undertaking is engaged in rendering comprehensive consultancy services in the field of hospital planning, design, detail engineering, quality control, project management and monitoring as well as procurement, supply, installation and commissioning of medical equipments for the projects assigned to it by the Ministry of Health & Family Welfare, Ministry of External Affairs, private and public sector organisations as well as various state governments. Being a consultant, the company's main activities in procurement projects are as under:

(i) To prepare tender documents.

(ii) Advertisement in newspaper for inviting tenders.

(iii) Selling of tenders.

(iv) Receipt of tenders and technical evaluation of the bids.

(v) Opening of price bids.

(vi) Final evaluation of bids.

(vii) Approval of clients.

[1] Opinion finalised by the Committee on 14.5.2007.

(viii) Placement of orders.

(ix) Follow-up for supplies.

(x) Release of payments to suppliers.

(xi) Rendering of account to the client.

2. The querist has stated that based on the above activities undertaken by the company, the company has devised its accounting policy, in which 70% of the consultancy fees is accounted for at the time of placement of orders on suppliers, i.e., on completion of activities (i) to (viii) above and balance 30% on completion of supplies, i.e., activities (ix) to (xi) above.

3. The querist has informed that in one of the projects, the company placed orders for and on behalf of the Ministry of Health & Family Welfare, amounting to Rs.18,15,84,000/- for which the specified consultancy fee was 2%. Against the said orders, the company booked 70% of the specified consultancy fee on placement of orders. However, against the above orders, the amount booked for supplies made is Rs.7,05,97,989/-, as the supplies against the said orders are suspended due to inferior quality of material and the matter is under arbitration. Accordingly, the company booked the remaining 30% of consultancy fees only on Rs.7,05,97,989/- on completion of supplies.

4. According to the querist, the Comptroller and Auditor General of India (C&AG) has raised the following issues on non-reversal of consultancy fee of Rs.16.17 lakh, which was booked at the time of placement of order at the rate of 2% of 70% of the unexecuted value of Rs.11,55,06,100/-:

> "Order for purchase of 10 lakh bed nets for National Anti-Malaria Programme was placed by the company during 2000-01 at an estimated cost of Rs.18,15,84,000/-, against which the company has booked purchases amounting to Rs.7,05,97,989/- when the procurement was suspended due to inferior quality of nets. The Ministry of Health & Family Welfare has rejected all the nets and has withheld the payment to the company. The case is pending in arbitration.

It was observed that the company has booked consultancy fee of Rs.26,69,285/- @ 2% of 70% of ordered amount at the time of issue of purchase order and Rs.4,44,768/- @ 2% of 30% on Rs.7,05,97,989/- after receipt of nets as per accounting policy no. 4A(b)(ii). As the goods supplied were only for Rs.7,05,97,989/-, the consultancy fee of Rs.23,10,122/- booked @ 2% of 70% on the unexecuted value of Rs.11,55,06,100/- should have been reversed. Non-reversal of the same has resulted in overstatement of 'Advances' under 'Current Assets' (NAMP A/c) by Rs.23,10,122/-."

5. In response to the C&AG comments, the company has replied that the consultancy fee in respect of bed nets supplies has been correctly booked as per the accounting policy of the company. As per the accounting policy of the company, 70% fee is due on placement of supply order which has accordingly been booked and the balance of 30% fees has been booked in proportion of supplies which are accounted for in the books of account. Since the supplies have not been accepted in full, the balance fees of 30% has not been accounted for on the unaccounted amount of supplies. Moreover, the case is under arbitration and as such, the question of reversal of fees does not arise until the award of arbitration. Further, as per the accounting policy, where there is a revision in the cost of the project, the consultancy income is reflected in the accounting year in which this fact is known, and as such, the necessary adjustment required, if any, will be made in the year of final arbitration award. Accordingly, the consultancy fees has correctly been accounted for as per the company.

6. The querist has also stated that this matter is *sub-judice* since 2001 and is pending in the Court of Arbitration. Therefore, to add or reduce on this account will be wrong on the part of the company. Also, as per the accounting policy of the company, which lays down that where there is revision in the cost of the project, the consultancy income is reflected in the accounting year in which this fact is known, as the necessary adjustment required, if any, will be made in the year of the final arbitration award. The C&AG auditors have asked to reverse the total fees on unsupplied portion of supplies, whereas the company's contention is that it has performed its duties and accordingly, booked its fees on the basis

of activities performed, which is in line with its accounting policy. The company has also proposed to approach the Institute of Chartered Accountants of India (ICAI) and assured that necessary adjustment required, if any, will be made after receipt of the expert opinion in this regard from the ICAI.

**B. Query**

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the action of the company in this regard is correct and has specifically raised the following issues:

(i) When the services are rendered, but due to certain reasons which are beyond the control of the company, the supplies of goods have been suspended/cancelled, whether the company is entitled for fees to the extent it has completed its activities.

(ii) Is it advisable to change the financial statements when the matter is *sub-judice*?

**C. Points considered by the Committee**

8. The Committee notes that the basic issue raised in the query relates to reversal of consultancy fees already recognised at the time of placement of orders, against which supplies have not been accepted by the clients due to inferior quality of materials. 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, the accounting policy of the company to recognise consultancy fees to the extent of 70% at the time of placement of orders and the balance at the time of supplies made against the order; booking of sales and purchases, if any, by the company; whether or not the company is legally entitled for the fees which is sub-judice; etc.

9. The Committee notes from the Facts of the Case that the amounts in respect of unexecuted value of order, consultancy fees recognised in respect thereof and other figures as stated by the C&AG in their comments do not match with the figures calculated in accordance with the amounts/percentages mentioned by the querist. The Committee is, therefore, not commenting upon the

calculations of various figures and is focusing its opinion on the accounting treatment made in respect of those figures. Further, it is not clear whether the company is recognising the remaining 30% of consultancy fees on supply of the orders made or on acceptance of the same by the clients as the querist has used unexecuted/unaccounted/unsupplied terms for that portion of supplies interchangeably.

10. The Committee also notes the following paragraphs of Accounting Standard (AS) 9, 'Revenue Recognition', issued by the Institute of Chartered Accountants of India:

> "9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
>
> 9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.
>
> 9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded."

Thus, in the view of the Committee, if at the time of booking of revenue, revenue is not measurable or it is unreasonable to expect ultimate collection thereof, revenue recognition should be postponed to the extent of non-measurability and uncertainty as to collection. Since in the present case, the company has recognised 70% of its revenue at the time of placement of orders, presuming that at the time of booking of such revenue, the revenue was measurable and it was not unreasonable to expect ultimate collection, the Committee is of the view that since the uncertainty with regard to collection of revenue has arisen subsequent to the recognition of revenue, a separate provision to the extent of uncertainty should be made rather than to reverse the revenue already recognised in accordance with the provisions of AS 9. Thus, in the present case, the company should make a separate provision to the extent the collectability of revenue is uncertain.

## D. Opinion

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

(i) When the company has rendered the services and performed its duties, the revenue is e*arned* in respect of services performed and the same should be recognised in the books of the company provided the conditions for recognition of revenue as per the provisions of AS 9 have been fulfilled. However, if subsequent to recognition of revenue, certain uncertainties arise in respect of the measurability and collection of revenue, a separate provision to the extent of uncertainties should be made, as discussed in paragraph 10 above.

(ii) When the revenue earlier booked has been recognised keeping in view the provisions of AS 9, a separate provision is more appropriate rather than changing the financial statements. Change in the financial statements is appropriate only when it is required by any Accounting Standard or the generally accepted accounting principles and is not dependent merely on the fact that the matter is sub-judice.

***Query No. 13***

***Subject: Presentation of 'book overdraft' in the books of account.[1]***

## A. Facts of the Case

1. A public sector company is engaged in rendering comprehensive consultancy services in the field of hospital planning, design, detail engineering, quality control, project management and monitoring as well as procurement, supply, installation and commissioning of medical equipments for the projects assigned to it by the Ministry of Health & Family Welfare, Ministry of External Affairs, private and public sector organisations as well as various state governments.

2. The querist has stated that during the course of its business, the company issues cheques to its vendors/contractors/suppliers against the work done. As per the querist, the company has flexi-deposits linked with various banks along with the current and savings accounts for separate corpus. Cheques are being issued from the current/savings bank account and as per the requirement of funds, the flexi-deposits are being encashed and the proceeds are transferred to the current/savings bank account for release of payments by the banks.

3. The querist has further stated that sometimes the cheques issued to vendors/contractors/suppliers are not presented for payment on a particular date, say, on 31st March every year, which results in credit balance in the current/savings account in the books of the company, which is generally termed as 'book overdraft'. On the other hand, physical balance in the form of flexi-deposits exists in the bank's books as well as in the books of the company on that particular date. As per the querist, the book overdraft is prominently shown by the company under the head 'Current Liabilities and Provisions' whereas, flexi-deposits are shown under the head 'Cash & Bank Balances'. This practice is being followed consistently by the company since a number of years.

[1] Opinion finalised by the Committee on 14.5.2007.

4. According to the querist, the Comptroller and Auditor General of India (C&AG) has raised the following issues in respect of cash and bank balances of Rs. 202.65 crore, shown under the head 'Current Assets, Loans and Advances' on the 'Assets' side of the balance sheet:

(a) Provisional comment

The 'cash and bank balances' is overstated by Rs. 4.20 crore due to inclusion of amount of cheques issued but not presented for payment before 31st March, 2006. As the company had issued the cheques before 31st March, 2006, the same should have been deducted from cash and bank balances (flexi-accounts) instead of showing separately as book overdraft under the head current liabilities and provisions.

This has resulted in overstatement of cash and bank balances by Rs. 4.20 crore with corresponding overstatement of current liabilities by the same amount.

(b) Final comment

Further, they have revised their comments as follows:

"The 'cash and bank balances' is overstated by Rs. 5.01 crore due to inclusion of cheques of Rs. 5.01 crore, issued before 31st March, 2006. The company instead of reducing the cash and bank balances has treated them as 'book overdraft'. Consequently, current liabilities are also overstated by the same amount".

5. The querist has informed that the company's replies were as follows:

(a) Against provisional comment

"The credit balance in bank account of the company as book overdraft under the current liabilities results as cheques are not being presented for payment and the amount is not being utilised but physical bank balance exists against the same. This practice is being followed continuously for last number of years.

As per the Compendium of Opinions - Vol. I, issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), the bank overdraft can be included under the sub-head of sundry creditors.

The same interpretation has accordingly been viewed here also and book overdraft has been shown under the head 'Current Liabilities and Provisions' by prominently disclosing under the sub-head.

Further, primarily flexi-deposits are opened for any shortfall in the current accounts and the banks are authorised to use amount from flexi-deposits.

As on 31st March, 2006, it is not known when the cheques will be presented in the bank and the position of the current account will be known only after presentation of the cheques.

The method of recording these financial entries is well recognised accounting method and this method has been consistently followed in all the previous years.

In view of above, the provisional comments may be dropped."

(b) Against final comment

"Credit balance in the bank accounts in the books of the company include cheque issued but not presented for payment which has been disclosed as 'book overdraft' under the head 'Current Liabilities' and bank balance in deposit account has been disclosed under the head 'Current Assets' in accordance with the general accounting principles. This disclosure has been consistently followed by the company for last more than two decades, in line with accounting policies followed in other public sector undertakings and private sector companies. The matter will be referred to ICAI for opinion in this regard."

## B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to whether the practice followed by the company of showing 'book overdraft' under the head 'Current Liabilities' is correct. Alternatively, whether amount of book overdraft can be adjusted from the head 'Cash & Bank Balances', including flexi-deposits, whereas the said flexi-deposits are physically not encashed as on a particular date, i.e., on 31.3.06 and consequently, decreasing the corresponding side of current liabilities also.

## C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to disclosure of cheques issued to vendors/contractors/ suppliers but not yet presented for payment, which results in the credit balance in the current/savings bank account in the books of the company, i.e., book overdraft. 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, disclosure of flexi-deposits, etc. From the facts of the query, the Committee presumes that the flexi-deposits are separate deposit accounts and the amounts therefrom are transferred to the current/savings account in case of overdraft.

8. The Committee notes that one of the basic principles of preparation of the financial statements is to record transactions and events that occur in or relate to the accounting period for which the financial statements are prepared. Thus, where the accounting period ends on $31^{st}$ March, all transactions and events that take place upto $31^{st}$ March should be reflected in the financial statements as of that date. Therefore, the Committee is of the view that cheques issued upto $31^{st}$ March but not presented for payment upto $31^{st}$ March should be accounted for in the period in which they are issued. Thus, the vendors/contractors/suppliers should be debited and the bank account should be credited in respect of cheques issued upto $31^{st}$ March but not presented for payment upto $31^{st}$ March, even though it results in credit balance, i.e., 'book overdraft' in the cash book of the company whereas the physical balance against those cheques is still lying in the bank accounts as per the bank pass book. In the view of the Committee,

these cheques are only an item of reconciliation between the cash book and the pass book of the company and do not have any accounting effect on the financial statements prepared on the accrual basis of accounting. This aspect is addressed by preparing a statement normally termed as 'Bank Reconciliation Statement'.

9. As far as the presentation of such credit/negative balance of bank account in the books of the company is concerned, the Committee notes that 'Instructions in accordance with which assets should be made out' with respect to item 7(B), 'Bank Balances', of Part I of Schedule VI to the Companies Act, 1956, inter alia, states as follows:

> "In regard to bank balances, particulars to be given separately of –
>
> (a) the balances lying with Scheduled Banks on current accounts, call accounts, and deposit accounts".

From the above, the Committee notes that Schedule VI requires disclosure of balances of various types of bank accounts lying with the bank as on the balance sheet date.

10. The Committee further notes from the Facts of the Case that the negative balance in the current/savings bank account can be set-off against the positive balances of flexi-deposits lying with the bank. Thus, in the view of the Committee, as on the date of the balance sheet, the present obligation of the company in respect of bank overdraft can be set-off against the balance lying in the flexi-deposit account. Thus, in substance, as far as the company is concerned, the position is that the composite bank balance including the balance in flexi-deposit account of the company is positive, even though, the physical set-off has not been made on the date of the balance sheet. With regard to disclosure of the balances, the Committee is of the view that in the present case, in respect of the cheques not presented for payment upto the balance sheet date, the company should disclose the negative balance in the current/savings bank account as per cash book and the same should be shown as a set-off against the balance of flexi-deposit account in the inner column, under the head 'cash and bank balances' on the 'Assets' side of the balance sheet. However, in

the view of the Committee, it would not be incorrect to disclose the negative balance in the bank account, i.e., bank overdraft under the head 'Current Liabilities and Provisions' on the 'Liabilities' side of the balance sheet.

11. The Committee also notes that in the opinion (Query no. 1.31 of Compendium of Opinions – Vol. I) referred to by the company while supporting its accounting treatment in paragraph 5 above, it has been opined that in case the bank does not have a right of set-off of negative balance in one account against positive balance in another account, it would not be appropriate to set-off the overdrawn balance against the other positive balances lying with the banks and showing it under 'cash and bank balances' on the 'Assets' side of the balance sheet. However, since in the present case, the banks have the right to adjust the negative balance in current/savings account with the positive balance in the flexi-deposit account, it would be more informative and useful for the users of the financial statements to disclose the negative bank balances as a set-off from flexi-deposit account in the manner explained in paragraph 10 above.

## D. Opinion

12. On the basis of the above, the Committee is of the opinion, subject to the presumption stated in paragraph 7 above, that in respect of cheques issued upto 31$^{st}$ March but not presented for payment upto 31$^{st}$ March, resulting into credit/negative balance in the current/savings bank account in the books of the company which can be adjusted by making a transfer from the balance lying in the flexi-deposit accounts, it would be more informative and useful for the users of the financial statements to disclose the said negative balances as a set-off from flexi-deposit account in the manner explained in paragraph 10 above. However, disclosure of the said negative balances as 'book overdraft' under the head 'Current Liabilities and Provisions' on the 'Liabilities' side of the balance sheet would not be incorrect.

***Query No. 14***

***Subject: Accounting treatment of stocks of empty bottles.[1]***

## A. Facts of the Case

1. A company, whose entire equity share capital is held by a State Government, purchases Indian made foreign liquor (IMFL) and beer and sells the same through retail vending shops run by it. It has also run bars during the year 2003-04, and from February 2004 the right to sell eatables and collection of empty bottles in the bars attached to the retail shops has been leased to private persons.

2. The company sold IMFL and beer to the customers, some of whom consumed them in the bars run by it. While leaving the bar, the consumers left the empty bottles in the bars and the company came into the possession of these empty bottles. These empty bottles are disposed off by the company. The company has laid down detailed procedures for the maintenance of records, tenders to be called for the disposal of empty bottles, etc.

3. During the year ended 31.3.2004, when the company was running the bars, the stock of empty bottles had been brought into accounts as closing stock in the profit and loss account at net realisable value and had been disclosed as inventories in the balance sheet as on 31.3.2004. With regard to this stock of empty bottles remaining unsold, the company is following this accounting policy consistently and has disclosed the value of stock of empty bottles remaining unsold as on the date of balance sheet as closing stock as on 31.03.2005 and 31.03.2006.

4. The querist has informed that the C&AG is of the opinion that the stock of empty bottles is not the property of the company since it sold IMFL and beer and the sale proceeds include the price for empty bottles of IMFL and beer also. Hence, the company is not the legal owner of the empty bottles. As per the querist, the C&AG contends that this stock of empty bottles should not be brought into the books of account as an asset and should be disclosed by way of notes. The C&AG further contends that even if the stock of

[1] Opinion finalised by the Committee on 14.5.2007.

empty bottles is brought into the books as an asset, it should be shown as stock suspense on the liabilities side and *should be accounted for as income only when such stock is sold* (emphasis supplied by the querist).

5. In this connection, the querist has stated that as per paragraph 49 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, an asset has been defined 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."

6. The querist has further stated that as per paragraph 17 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', issued by the Institute of Chartered Accountants of India, one of the major considerations governing the selection and application of accounting policies is as under:

> "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."

7. On the basis of paragraphs 5 and 6 above, the querist has submitted that, in substance, the stock of empty bottles belongs to the company since it is a resource controlled by the company arising out of past events and from which future economic benefits are expected to flow to the company.

8. The querist has further reproduced the definition of income as per paragraph 69 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, as below:

> "(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."

According to the querist, in other words, if an event results in an enhancement of assets, it should be considered as increase in economic benefits during the accounting period and treated as income.

9. Considering the foregoing, the querist has stated that the value of the stock of empty bottles as on the date of balance sheet results in an increase in economic benefits during the accounting period in the form of enhancements of assets and hence, the value of stock of empty bottles *should be considered as income as per the above definition* (emphasis supplied by the querist).

10. The relevant details and particulars for the accounting year 2005-06 for which the opinion is sought are furnished hereunder:

| | | Rs. (in crore) |
|---|---|---|
| (a) | Sales for the year | 7314.66 |
| (b) | Stock of Empty Bottles as on 31.03.2006 | 1.24 |
| (c) | Net Profit for the year (after tax)<br>(after considering the stock of empty bottles) | 0.78 |

11. The querist has provided a copy of the reply of the company to the preliminary comments of the C&AG on the accounts for the year 2004-05 for the perusal of the Committee. The relevant paragraphs are reproduced below:

> "10. Regarding the valuation of stock of empty bottles, the cost of procuring the bottles in the bar can not be determined with substantial accuracy and hence the stock of empty bottles has been brought into accounts at estimated net realisable value." Querist has also referred to the opinion published at page IV-8 of Volume IV of the Compendium of Opinions, issued by the Expert Advisory Committee.
>
> "18. As per Accounting Standard (AS) 5, '*Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies*', ***"<u>Ordinary activities</u> are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in***

> ***furtherance of, incidental to, or arising from, these activities".***"
>
> "19. Hence, we wish to state that stock of empty bottles is incidental to and in furtherance of and also arises out of ordinary activities of the business of running bars as part of the business of the company and any stock arising out of carrying on any activity undertaken by the company as part of the business can be considered as inventory. Hence, the stock of empty bottles can also be considered as inventory and the disclosures of the stock of empty bottles as inventory in the profit and loss account and balance sheet are in accordance with the Accounting Standards and the generally accepted accounting principles."

12. The querist has stated that for the various reasons/explanations stated in the above paragraph,

(a) the stock of empty bottles has to be determined at net realisable value, and

(b) the stock of empty bottles has to be disclosed as inventories.

**B. Query**

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

(a) Whether the stock of empty bottles is an asset of the company.

(b) If so, whether the stock of empty bottles existing as on the date of the balance sheet is to be considered as inventories of the company.

(c) If the answer to (b) above is positive, whether the stock of empty bottles existing as on the date of the balance sheet is to be valued at net realisable value and considered as income to be shown in the profit and loss account or is to be considered as a stock suspense account on the liabilities side of the balance sheet.

(d) If the answer to (a) above is in the negative, what would be the accounting treatment to be given.

**C. Points considered by the Committee**

14. The Committee notes the definition of the term 'asset' as per the 'Framework for the Preparation and Presentation of Financial Statements', which has also been reproduced by the querist in paragraph 5 above. The Committee also notes paragraph 51 of the Framework that states as follows:

> "51. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form…"

15. Keeping in view the above and the facts of the case provided by the querist, the Committee is of the view that the stock of empty bottles is a resource controlled by the company arising out of past events. The empty bottles left by the customers come into the possession of the company during the course of running the bars and though the customers are the legal owners of the empty bottles, by leaving the bottles with the company after consuming the contents thereof, the customers, in effect, waive their legal rights. Having thus once come into the possession of the empty bottles, according to the generally accepted accounting principle of substance over form, the company has the control over the future economic benefits that are expected to flow to it from the sale of the empty bottles. In determining the existence of an asset, the legal ownership of the asset is not essential; what is essential is the economic ownership, i.e., the right to obtain the future economic benefits flowing from the resource to the company. Thus, the stock of empty bottles is an asset of the company.

16. The Committee notes the definition of the term 'ordinary activities' as reproduced in paragraph 11 above. The Committee also notes paragraph 3 of Accounting Standard (AS) 2, 'Valuation of Inventories', that defines inventories as follows:

> ***" Inventories are assets:***
>
> ***(a) held for sale in the ordinary course of business;***

> ***(b) in the process of production for such sale; or***
>
> ***(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."***

17. On the basis of the above, the Committee is of the view that the stock of empty bottles falls within the meaning of the term 'inventories' as per AS 2, as the company holds the stock of empty bottles for sale in its ordinary course of business of running bars.

18. The Committee notes paragraph 5 of AS 2 as reproduced below:

> ***"5. Inventories should be valued at the lower of cost and net realisable value."***

19. In respect of the above, the Committee is of the view that the practice of valuing the stock of empty bottles at net realisable value in the absence of determination of the cost of procuring the bottles with reasonable accuracy is not correct. According to AS 2, the stock of empty bottles, which is the inventory of the company, should be measured at the lower of its cost or net realisable value. In the present case, it appears that the cost of purchase of IMFL and beer is inclusive of the cost of bottles and the selling price thereof is also not exclusive of the cost of bottles, because bottles are the primary packing material without which their contents cannot be sold in the type of sale activity described by the querist. Accordingly, empty bottles do not appear to cost anything to the company. In such a case, the generally accepted accounting principles under historical cost accounting require that the asset should be reflected at the nominal value of Re. 1. The Committee is, therefore, of the view that if the cost of bottles is nil to the company, the stock should be reflected at Re. 1. Further, since the event of sale of empty bottles has not taken place on the balance sheet date in respect of the bottles in stock, the income recognition on that date would be inappropriate. Without examining the appropriateness of the earlier opinion of the Committee referred by the querist in paragraph 11 above, the Committee notes that the facts and circumstances of that query are different from those of the present query.

## D. Opinion

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

(a) The stock of empty bottles is an asset of the company being a resource controlled by the company as a result of past events from which future economic benefits are expected to flow to it.

(b) The stock of empty bottles existing at the balance sheet date is the inventory of the company.

(c) The stock of empty bottles should be valued at the lower of cost and net realisable value. The same is not considered as income. In case, the cost of empty bottles is nil, as discussed in paragraph 19 above, the total stock of bottles should be reflected at the nominal value of Re.1.

(d) The correct accounting treatment of the stock of empty bottles is as stated in (a), (b) and (c) above. No other treatment is appropriate.

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***Query No. 15***

***Subject: Accounting for advance lease premium and scheduled increases in lease rent in case of an operating lease.*** [1]

## A. Facts of the Case

1. A company has obtained a running hydropower project from the Government of Maharashtra Water Resource Department

[1] Opinion finalised by the Committee on 14.5.2007.

(GOMWRD) on a long term lease. The lease is termed as 'Advance Lease, Operate, Maintain and Transfer Basis'. The period of lease is 30 years after completion of which, or in case of earlier termination at the time of termination, the plant has to be handed over to the Government. The 'quoted price' as per the notification of award for the use of plant for 30 years is Rs. 322.70 crore whose net present value on the date of transfer of the leased project (leased asset) as per the terms of the notification is Rs. 92.011 crore. The company is required to make an upfront/down payment of Rs. 60 crore to take the possession of the leased asset and the balance amount of net present value being Rs. 32.011 crore is to be paid in instalments as per the chart given in paragraph 2 below. The total thereof comes to Rs. 322.70 crore which is the quoted price referred to above.

2. The company is required to pay Rs. 60 crore as upfront/down payment on agreement and further payments are to be made by way of yearly instalments over the lease period of 30 years to serve as a source of revenue to GOMWRD as given in the table below:

| Year on Agreement | Amount in Rs. crore. | Year | Amount in Rs.crore | Year | Amount in Rs. crore |
|---|---|---|---|---|---|
| 1 | 60.00 | 11 | 1.00 | 21 | 17.00 |
| 2 | - | 12 | 1.00 | 22 | 17.20 |
| 3 | - | 13 | 3.00 | 23 | 20.00 |
| 4 | 0.50 | 14 | 3.00 | 24 | 20.00 |
| 5 | 0.50 | 15 | 3.00 | 25 | 20.00 |
| 6 | 0.75 | 16 | 3.00 | 26 | 20.00 |
| 7 | 0.75 | 17 | 3.00 | 27 | 20.00 |
| 8 | 1.00 | 18 | 12.00 | 28 | 20.00 |
| 9 | 1.00 | 19 | 17.00 | 29 | 20.00 |
| 10 | 1.00 | 20 | 17.00 | 30 | 20.00 |
| | | | Total (Rs. in crore) | | 322.70 |
| Total: Rs. Three hundred and twenty two crore and seventy lakh | | | | | |

3. The querist has stated that the lease is not a finance lease as it does not comply with any of the criteria laid down in Accounting Standard (AS) 19, 'Leases', issued by the Institute of Chartered Accountants of India, for classification of lease as finance lease. Therefore, the lease has been classified as an operating lease.

4. The querist has suggested two possible accounting treatments for this lease, which are as under:

Option I: The quoted price being the total amount of instalments as per the chart given in paragraph 2 above be shown in the balance sheet as 'Advance Lease Premium' or 'Advance Lease Charges' at Rs.322.70 crore and the corresponding liability at the equivalent amount less down payment of Rs. 60 crore, i.e., Rs. 262.70 crore be shown in the balance sheet as liability towards lease rentals and on the yearly payment, the liability will become nil at the end of the 30$^{th}$ year. The Advance Lease Premium of Rs. 322.70 crore be written off over the lease term of 30 years, i.e., annually Rs. 10.76 crore.

The querist is of the view that this treatment would result in expensing every year a fixed amount. As the capacity of the plant of generating electricity will continue to remain the same throughout the period of lease, and related yearly lease premium being constant, inconsistent results would be avoided and results would show true and fair view.

Option II: Out of the total payment, upfront/down payment of Rs. 60 crore be capitalised as lease premium in the balance sheet and Rs. 2 crore be written off every year in the statement of profit and loss so as to write it off completely over the period of 30 years. The instalments as per the chart given in paragraph 2 above, be charged to the statement of profit and loss every year as and when incurred.

The querist is of the view that as per this treatment, in the initial period of 12 to 15 years, including the moratorium period of two years, the accounting results may show profit and thereafter, it will start showing losses as the amount of instalments as per the chart is increasing at later stage whereas the generation of electricity remains constant as there is no addition to the capacity of the plant.

**B. Query**

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

(a) Which of the above mentioned accounting treatments should be followed by the company so as to comply with AS 19.

(b) In case any of the above suggested accounting treatments is considered not sufficient to comply with the requirements of AS 19, the Committee is requested to advise the correct accounting treatment.

**C. Points considered by the Committee**

6. The Committee has not examined the classification of lease into finance lease or operating lease presuming that the querist has correctly classified the lease as operating lease. Further, the Committee has examined the query only from the point of view of accounting treatment of advance lease premium/down payment and increasing lease rentals in case of operating lease and has not touched upon any other issue arising from the Facts of the Case.

7. The Committee notes paragraphs 23 and 24 of AS 19, which provide as below:

***"23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.***

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised

as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis."

8. The Committee notes from the facts of the case that the electricity generation capacity of the plant remains constant over the lease period, i.e., the benefit derived by the lessee, in terms of electricity units generated by the plant, remains constant over the lease term. Therefore, the Committee is of the view that the increasing lease rentals do not represent the time pattern of the user's benefit. The Committee is, accordingly, of the view that the total lease rent to be paid over the lease term, including the upfront payment of Rs. 60 crore, should be charged to the statement of profit and loss on straight line basis over the lease term of 30 years. The difference between the amount charged to the statement of profit and loss and the amount actually paid, should be recognised as receivable/payable, as the case may be. The Committee is of the view that recognising Rs. 322.70 crore as advance lease charges in the balance sheet, as proposed by the querist under option I in paragraph 4 above, is not in accordance with the requirements of AS 19. Similarly, capitalising the down payment of Rs. 60 crore, as proposed by the querist under option II in paragraph 4 above, is also not correct.

## D. Opinion

9. On the basis of the above, the opinion of the Committee on the issues raised by the querist in paragraph 5 above, subject to the presumption stated in paragraph 6 above, is as below:

(a) None of the options mentioned by the querist in paragraph 4 above is correct.

(b) The total lease rent to be paid over the lease term, including the upfront payment of Rs. 60 crore, should be charged to the statement of profit and loss on straight line basis over the lease term of 30 years. The difference between the amount charged to the statement of profit and loss and the amount actually paid, should be recognised as receivable/payable, as the case may be.

***Query No. 16***

***Subject: Auditor's qualification on issue of bonus shares out of revaluation reserve.[1]***

## A. Facts of the Case

1. A company is a listed company. It is a leading supplier of multilayer film for flexible packaging industry and other speciality applications. Its brief history is as under:

- The company was incorporated as private limited company on 7th May, 1981.
- It was converted into closely held public limited company in June 1994.
- The company made its Initial Public Offer (IPO) in November 1994.

2. The querist has stated that the company had created revaluation reserve of Rs. 2.11 crore as on 31st March, 1994 based on revaluation of its certain assets. The part of the revaluation reserve was subsequently utilised for issue of bonus shares in the ratio of 3:1 as on 29th June, 1994. Subsequently, IPO was made for 10 lakh shares of Rs.10/- each at a premium of Rs.30/- per share. The present break-up of paid up capital is as under:

| | | (Rs. in lakh) |
|---|---|---|
| (a) | Shares issued for cash at par | 50.00 |
| (b) | Bonus shares issued out of general reserve | 50.00 |
| (c) | *Bonus shares issued out of revaluation reserve* | *100.00* |
| (d) | Public issue at a premium of Rs.30/- per share | 100.00 |
| | | 300.00 |

[1] Opinion finalised by the Committee on 9.8.2007.

3. The querist has further stated that the then Department of Company Affairs issued a Circular in September 1994 prohibiting the issue of bonus shares out of revaluation reserve. The Institute of Chartered Accountants of India (ICAI) published a Guidance Note on Availability of Revaluation Reserve for Issue of Bonus shares in November, 1994. A reference was made to the Expert Advisory Committee of the Institute of Chartered Accountants of India in February 1996 seeking the opinion on the following issues:

"(i) Whether the qualification in auditor's report as per the aforesaid Guidance Note should be *"one time"* or *"life time"*.

(ii) Whether adequate disclosure by way of notes to the accounts with regard to the amount of revaluation and its subsequent utilisation as stipulated under Schedule VI would be sufficient and that no further qualification in auditor's report is needed in the *subsequent year's* annual accounts.

(iii) If the Committee is of the view that the qualification should continue for lifetime, what should be the illustrative manner of the qualification in the subsequent year's audit report?" (Emphasis supplied by the querist.)

4. According to the querist, the Expert Advisory Committee, after considering the provisions of Part I of Schedule VI to the Companies Act, 1956 and the Circular of the Department of Company Affairs (DCA) had, inter alia, given the following opinion:

> "(i) and (ii) The qualification in auditor's report should *continue in subsequent years* also. *Only disclosure by way of notes* to the accounts as regards the amount of revaluation reserve and its utilisation for the purposes of bonus shares *is not sufficient."* (Emphasis supplied by the querist.)

It also suggested the manner of the qualification in the subsequent year's audit report. Following the above opinion of the Expert Advisory Committee, auditors of the company have been regularly qualifying the auditors' report in the following manner:

> "The company when it was unlisted had issued bonus shares on 29th June, 1994 for Rs.10 million (10,00,000 equity shares of Rs.10/- each) by capitalising part of its revaluation reserve. Accordingly, the paid-up equity share capital of the company stands increased by Rs.10 million and the revaluation reserve stands reduced by that amount. The issue of bonus shares as aforesaid is contrary to the circular issued by the Department of Company Affairs issued in September, 1994 and the recommendations of the Institute of Chartered Accountants of India issued in November, 1994."

5. The audit committee of the company is of the opinion that the aforesaid qualification has no legal sanctity considering the fact that the DCA circular as well as the Guidance Note came into effect much after the event of capitalisation and the recent ruling of Supreme Court of India has upheld that the Companies Act specifically permits utilisation of reserve arising out of revaluation of assets for the purpose of issue of fully-paid up bonus shares and as long as the Articles of Association of the company permits such capitalisation, it is a valid and legal transaction. Therefore, the audit committee has requested the auditors to drop the qualification prospectively by making a reference to the Expert Advisory Committee for reconsideration of its earlier opinion dated September 23, 1996.

6. The querist has stated that there is a strong case for reconsideration of the opinion to the effect that the qualification in auditor's report *in the year of issue of bonus shares* out of revaluation reserve is *sufficient* and in the subsequent years, the same qualification should not be continued for the following reasons (emphasis supplied by the querist):

(a) As per section 210 of the Companies Act, 1956, the audited accounts should clearly disclose the results of the working of a company for the year. The overall consideration should be that the *financial statements for the year* should reflect a true and fair view as per section 211 of the Act. (Emphasis supplied by the querist.)

(b) To reflect a 'true and fair' view, it is necessary for the company to show separately, *in the year of revaluation* *and thereafter for a period of five years,* the amount of increase made in the fixed assets and the corresponding credit in revaluation reserve account, as required in Part I of Schedule VI to the Companies Act. If bonus shares are issued out of such revaluation reserve, then, on the 'Liabilities' side under the head "Share Capital', a note should appear that, of the shares, so many shares are allotted as fully paid bonus shares out of revaluation reserve. *Such note should continue to appear in the balance sheet as long as share capital is reflected.* (Emphasis supplied by the querist.)

(c) The object for which a company revalues its fixed assets, is to show in the balance sheet their replacement cost at the date of the balance sheet.

(d) As per the Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets, issued by the Institute of Chartered Accountants of India, depreciation should be provided on the basis of revalued figure. However, a company has an option to adjust the additional depreciation relatable to revaluation against Revaluation Reserve. This is clear from paragraph 9 of the Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets which states as follows:

> "9. A question may arise, as to whether the additional depreciation provision required in consequence of revaluation can be adjusted against 'Revaluation Reserve'. As stated earlier, depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the account after revaluation. However, for certain statutory purposes e.g., dividends, managerial remuneration etc., only depreciation relatable to the historical cost of the fixed assets is to be provided out of the current profits of the company. In the circumstance, the additional depreciation relatable to revaluation may be adjusted against 'Revaluation Reserve' by transfer to Profit and Loss Account. In other words,

as per the requirements of Part II of Schedule VI to the Companies Act, the company will have to provide the depreciation on the total book value of the fixed assets (including the increased amount as a result of revaluation) in the Profit and Loss Account of the relevant period, and thereafter the company can transfer an amount equivalent to the additional depreciation from the Revaluation Reserve. Such transfer from Revaluation Reserve should be shown in the Profit and Loss Account separately and an appropriate note by way of disclosure would be desirable. *Such a disclosure would appear to be in consonance with the requirement of Part I of Schedule VI to the Companies Act, prescribing disclosure of write-up in the value of fixed asset for the first five years after revaluation.* (Emphasis supplied by the querist.)

(e) Furthermore, the contention that in subsequent years, there would be excess charge to the profit and loss account to the extent of additional depreciation on revalued assets, due to capitalisation of revaluation reserve by issue of bonus shares in the earlier year would not survive, if one refers to paragraph 12 of the Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets, which reads as under:

> "12. The revaluation of fixed assets is normally done in order to bring into books the replacement cost of such assets. This is a healthy trend as it recognises the importance of retaining sufficient funds through additional depreciation in the business for replacement of fixed assets. As such, it will be prudent not to charge the additional depreciation against revaluation reserve, though this may result in reduction of distributable profits. This practice would also give a more realistic appraisal of the company's operations in an inflationary situation."

(f) The Hon'ble Supreme Court in the recent decision in the case of Bhagwati Developers vs. Peerless General

Finance and Investment Co. and Others (2005) Comp LJ 377 (SC) has held that there is no specific bar under the Companies Act for issue of bonus shares out of Revaluation Reserve. As for the DCA circular, the Court said that the Department's communiqué was advisory in nature, without any mandatory effect.

(g) The Central Council of the ICAI at its recent meeting, while appreciating and accepting the decision of the Supreme Court, has decided to suggest to the Ministry of Company Affairs that changes be made in the law to ensure that companies are not allowed to issue bonus shares out of revaluation reserves.

(h) The ICAI's Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares is silent on the applicability of the qualificatory report to years *subsequent to the year of capitalisation* of revaluation reserve. In contrast, the *'Statement on Treatment of Interest on Deferred Payments'* does require that a note in the balance sheet of a company in subsequent years should appear and the auditor should refer to such note in his report to the members (emphasis supplied by the querist).

(i) An illustrative manner of the qualification as recommended by the Institute also suggests that it is a one time qualification and has no relevance in subsequent years because issue of bonus shares refers to *event* which has *happened* in a *particular period* covered by the audit report (emphasis supplied by the querist).

(j) Schedule VI, Part I, prescribing the form of balance sheet while dealing with revaluation of fixed assets requires that where the fixed assets are revalued and the sums have been added by writing-up the assets, every balance sheet subsequent to such writing up shall show the increased figure with the date of increase in place of original cost. Each balance sheet for the first five years subsequent to the date of writing-up shall also show the amount of increase made.

(k) The Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares is ambiguous on the issue whether qualification is "one time" or "life time". The bonus shares once issued will form part of the share capital for the life of the company and cannot be deleted unless company goes for reduction of capital. Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares in paragraph 5 states as under:

> "5. Share capital represents the amount of money or money's worth received from the owners and the capitalisation of earned profits or other gains arising out of an arm's length transaction. It has, therefore, been a cardinal principle that only such profits as are earned or the relevant capital receipts (e.g., share premium), as are realised, can be capitalised."

This, according to the querist, would indirectly signify that the qualification at the most can continue till such time that the revaluation reserve is actually converted into money or money's worth upon the sale and realisation of revalued assets. Alternatively, the amount equivalent to revaluation reserve has to be provided and set aside by way of additional depreciation from the realised profits of the company to the extent of revalued amount.

(l) The management of the company contend that the then prevailing provisions of the Companies Act, 1956 did not prohibit or restrict the company from capitalising its revaluation reserves by issue of bonus shares. The capitalisation did not involve any release of the company's assets to its shareholders, and in fact it froze any possibility of its distribution, except in the event of winding up. Further, the Memorandum and Articles of Association of the company also provided for and permitted the capitalisation of revaluation reserves by issue of bonus shares. The bonus shares were issued when the company was a closely held company, to whom the guidelines for issue of bonus shares by public company, as framed by SEBI, did not apply at the relevant time.

**B. Query**

7. In view of the facts and circumstances of the case and the legal position as confirmed by the recent Supreme Court decision, the querist has requested the Expert Advisory Committee to reconsider its earlier opinion and confirm that qualification is one time qualification in the year of issue of bonus shares and that adequate disclosure by way of notes to the accounts with regard to amount of revaluation and its subsequent utilisation as stipulated under Schedule VI would be sufficient compliance and that no further qualification in auditors' report is called for in the subsequent years.

**C. Points considered by the Committee**

8. The Committee notes paragraphs 4, 5 and 6 of Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares, which provide as follows:

> "4. It may be noted that the excess of the revalued amount over the net book value of fixed assets, which is credited to revaluation reserve, is created as a result of a book adjustment only. The revaluation reserve does not result from an arm's length transaction; it represents an expert's perception of value. The revaluation reserve thus does not represent a realised gain.
>
> 5. Share capital represents the amount of money or money's worth received from the owners and the capitalisation of earned profits or other gains arising out of an arm's length transaction. It has, therefore, been a cardinal principle that only such profits as are earned or the relevant capital receipts (e.g. share premium), as are realised, can be capitalised.
>
> 6. In view of the above, in the opinion of the Institute of Chartered Accountants of India, bonus shares cannot be issued by capitalisation of revaluation reserve. If any company (including a private or a closely held public company) utilises revaluation reserve for issue of bonus shares, the statutory auditor of the company should qualify his audit report. An illustrative manner of the qualification is given below:

> "The company has issued bonus shares for Rs. ________ (__________equity shares of Rs. ___________ each) by capitalising its revaluation reserve. Accordingly, the Paid-up Equity Share Capital of the company stands increased by Rs. ________ and the revaluation reserve stands reduced by that amount. The issue of bonus shares as aforesaid is contrary to the recommendations of the Institute of Chartered Accountants of India.
>
> Subject to the above __________"."

9. The Committee notes that, subsequently, the Supreme Court in the case of "Bhagwati Developers vs. Peerless General Finance and Investment Company and Others" has allowed the utilisation of the reserve arising from the revaluation of fixed assets for the purpose of issuing fully paid-up bonus shares in the case of closely held/ private and unlisted companies where the Articles of Association of those companies specifically allow for such utilisation, as the SEBI guidelines which prohibit such issue of bonus shares out of revaluation reserve do not apply to issue of securities by private/closely held and other unlisted companies. The Committee also notes that the Supreme Court in the said case has also recognised the fact that the Circular issued by the Department of Company Affairs (now, Ministry of Corporate Affairs), regarding 'Prohibition of Issue of Bonus Shares by Revaluation of Fixed Assets' does not have any mandatory effect and is merely advisory in nature for private/closely held and unlisted companies. The Committee further notes from the Facts of the Case that at the time of issue of bonus shares out of revaluation reserve, the company was a closely held company and the Memorandum and Articles of Association of the company specifically allowed for such issue of bonus shares. Accordingly, the Committee is of the view that the above decision of the Supreme Court would be relevant in the present case.

10. The Committee notes that the Council of the Institute has issued an Announcement relating to "Disclosures in cases where a Court/Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard", which states as follows:

"Paragraph 4.2 of the 'Preface to the Statements of Accounting Standards' (revised 2004) provides as under:

> "4.2 The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements."

In the case of Companies, Section 211(3B) of the Companies Act, 1956, provides that "Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:

(a) the deviation from the accounting standards;

(b) the reasons for such deviation; and

(c) the financial effect, if any, arising due to such deviation."

In view of the above, if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

1. A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/Tribunal Order.

2. Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.

3. The financial impact, if any, arising due to such a difference.

It is recommended that the above disclosures should be made by enterprises other than companies also in similar situations."

11. The Committee also notes that the Council has also issued an announcement, 'Clarification regarding Authority Attached to Documents Issued by the Institute', which clarifies the status of a Guidance Note and an Accounting Standard as follows:

"5. 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are *recommendatory* in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary." (Emphasis supplied by the Committee.)

"7. The 'Accounting Standards' and 'Statements on Standard Auditing Practices'[2] issued by the Accounting Standards Board and the Auditing Practices Committee[3], respectively, establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards and that auditors carry out their audits in accordance with the generally accepted auditing

[2] 'Statements on Standard Auditing Practices' have since been renamed as 'Auditing and Assurance Standards' which have subsequently been reclassified and renumbered as Standards on Quality Control, Auditing, Review, Other Assurance and Related Services. The new format of classification and renumbering of Standards is applicable from 1st April, 2008.

[3] The 'Auditing Practices Committee' has been renamed as 'Auditing and Assurance Standards Board'.

practices. They become mandatory on the dates specified either in the respective document or by notification issued by the Council.[4]"

12. The Committee notes that Accounting Standards are mandatory while Guidance Notes are recommendatory. Accordingly, on a harmonious interpretation of the above announcements, the Committee is of the view that the accounting treatment prescribed by the Guidance Notes which are only recommendatory in nature do not override the accounting treatment sanctioned in an order of Court/Tribunal which, as per the Announcement reproduced in paragraph 10 above, overrides the Accounting Standards that are mandatory in nature.

13. On the basis of the above, the Committee is of the view that the auditors of the company should not qualify the company's accounts on the matter of issuance of bonus shares out of revaluation reserve after the issuance of Supreme Court decision provided the company has made, in its financial statements, the disclosures required as per the Announcement reproduced in paragraph 10 above. Also, compliance should be made with regard to Schedule VI requirements such as disclosure of the source from which shares are issued, in each balance sheet.

**D. Opinion**

14. On the basis of the above, the Committee is of the opinion that after the issuance of Supreme Court decision allowing issue of bonus shares out of revaluation reserve, the auditor should not qualify the accounts of the company in this regard, provided the company has made, in its financial statements, the disclosures required as per the Announcement reproduced in paragraph 10 above. Further, the requirements as to Schedule VI to the Companies Act, 1956 have to be complied with as discussed in paragraph 13 above.

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[4] Subsequent to the publication of this Clarification, the Council has made various Accounting Standards mandatory.

***Query No. 17***

***Subject: Accounting treatment for post-retirement medical benefit scheme.***[1]

## A. Facts of the Case

1. A corporation is a public sector undertaking incorporated under the Warehousing Corporations Act, 1962 for the purpose of storage of agriculture produce, seeds, fertiliser, food grains and other notified commodities belonging to individuals, co-operative societies and other institutions. It employs a work force of 6413 employees as on 31.3.2006. The corporation has been providing to its retired employees, post-retirement medical benefits since 1994, which have been revised from time to time. Under the original scheme, the corporation was making payment for OPD expenses and also for indoor hospitalisation, based on the claims of the retired employees. The expenses towards post-retirement medical scheme were being charged to profit and loss account every year on the basis of actual payments made, i.e., the corporation has been following the method of pay-as-you-go. The nominal contributions received from the employees are credited to the medical expenses account. This system was followed till the financial year 2004-05.

2. The post-retirement medical scheme was amended in the financial year 2004-05, and the following changes were brought out:

(i) The OPD expenditure of Rs.12,000 p.a., which was being reimbursed in the old scheme will continue to be paid by the corporation to the retired employees based on their claims.

(ii) For indoor hospitalisation, it was decided to buy an annual mediclaim insurance policy from an insurance company which covers a benefit of Rs. 1,00,000 per annum for retired employees including their spouses. The corporation has taken insurance policy to cover the above indoor hospitalisation expenses on annual basis and is paying the required insurance premium.

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[1] Opinion finalised by the Committee on 9.8.2007.

3. The querist has stated that the post-retirement medical scheme falls under the term 'defined benefit plan'. The benefit under the post-retirement medical scheme, will be vested with the existing employees, only after their retirement, who voluntarily opt for the scheme by paying the required contribution.

4. The querist has further stated that the corporation had been providing for liability for gratuity and leave encashment based on actuarial valuation whereas for post-retirement medical benefits, the corporation had been following pay-as-you-go basis up to the financial year 2004-05.

5. As per the querist, the actuary of the corporation advised that the corporation has not been getting actuarial valuation for post-retirement medical benefits for its employees, the liability for which is required to be provided for in the books of account as per pre-revised Accounting Standard (AS) 15, 'Accounting for Retirement Benefits in the Financial Statements of Employers', issued by the Institute of Chartered Accountants of India, and, therefore, necessary steps should be taken in the matter while finalising the financial statements/balance sheet as on 31.3.2006.

6. The querist has stated that while finalising the accounts for the year 2005-06, keeping in view the provisions of pre-revised AS 15 and also the application of Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits', which was to become applicable from 1.4.2006, it was thought prudent to go for actuarial valuation in the year 2005-06 and to provide for the liability towards post-retirement medical benefits based on actuarial valuation, both for retired employees who have opted for the scheme and also for employees existing as on 31.3.2006.

7. Actuarial valuation of the liability towards post-retirement medical benefit was as under:

| | |
|---|---|
| Liability upto 31.3.2005 | Rs. 88.14 crore |
| Liability upto 31.3.2006 | Rs. 97.78 crore |
| Incremental liability for the financial year 2005-06 | Rs. 9.64 crore |

The liability for the year 2005-06 amounting to Rs. 9.64 crore was absorbed in the current year whereas the liability upto 31.3.2005, i.e., Rs. 88.14 crore which was a past service cost of both retired and existing employees, was decided by the Board of Directors to be distributed over a period of 5 years w.e.f. 2005-06. Accordingly, Rs. 17.63 crore was charged to the profit and loss account for the year 2005-06 and the balance amount of Rs. 70.51 crore was carried forward as deferred revenue expenditure to be written-off in the next four years. According to the querist, in the financial year 2005-06, the pre-revised AS 15 was followed since new AS 15 was applicable w.e.f. 1.4.06.

8. As per the querist, since the liability for the post-retirement medical benefit was provided for the first time based on the actuarial valuation, the accounting policy of the corporation in respect of AS 15 was suitably amended and due disclosure was made in the notes to accounts as under:

***Significant Accounting Policy***

> "No. 15: - The provision for Gratuity, Leave Encashment and Post Retirement Medical Benefits is made on actuarial valuation."

*Notes forming part of accounts*

> "Note No.14: - 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 up to 31.3.2006 in terms of AS-15 (pre-revised), which is applicable up to 31.3.2006. However, in order to have more accounting transparency and to implement the revised AS-15, it has been decided to provide for the liability for all employees (retired and retiring). The liability for the year 2005-06 amounting to Rs. 934.99 lakh has been charged to revenue and Rs. 29.01 lakh has been capitalised. Further, the differential amount of Rs. 8814 lakh will be amortised in equal instalments over a period of five years effective 2005-06. The remaining amount of Rs. 7051.20 lakh has been reflected under Deferred

Revenue Expenditure. The liability has been determined on actuarial basis."

9. The querist has stated that the pre-revised AS 15 deals with past service cost and review of actuarial method used or assumptions adopted. Paragraphs 22 and 23 of AS 15 (pre-revised) provide as follows:

"22. Views differ as to how to account for this cost. One view is that this cost should be recognised as soon as it has been determined. Others believe that the entitlement giving rise to past service cost is in return for services to be rendered by employees in future and therefore this cost ought to be allocated over the periods during which the services are to be rendered.

23. In making an actuarial valuation, the actuary may sometimes effect a change in the actuarial method used or in the assumptions adopted for determining the retirement benefit costs. Any alterations in the retirement benefit costs so arising are charged or credited to the statement of profit and loss for the year or, alternatively, spread over a period not more than the expected remaining working lives of the participating employees. A change in the actuarial method used for determining the retirement benefit costs constitutes a change in an accounting policy and is disclosed accordingly."

10. As per the querist, the revised AS 15 also deals with past service cost, paragraph 94 of which reads as under: -

***"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."***

11. The querist has also stated that the average age of the corporation's employees is around 50-55 years and the benefits become vested only when the employees retire. Accordingly, the

corporation took decision to write-off the past service cost over the average of left-over period of service, i.e., 5 years.

12. As per the querist, the heavy liability of Rs. 88.14 crore for the period upto 31.3.2005 arose due to increase in number of employees opting for the scheme as the same became more lucrative due to increase in indoor treatment benefits which can be seen from the following table:

Entitlement of medical benefits per annum in rupees :

| Period | 1994 to June 97 (Rs.) | July 97 to Aug 97 (Rs.) | Sept. 97 to 2003-04 (Rs.) | 2004-05 onwards (Rs.) |
|---|---|---|---|---|
| Outdoor Treatment | 4000/- | 10000/- | 12000/- | 12000/- |
| Indoor Treatment | 8000/- | 20000/- | 30000/- | 100000/- (Mediclaim Insurance Policy) |

13. During the course of audit of the accounts for the financial year 2005-06, the auditor took a view that the entire past service cost should have been charged to the profit and loss account for the year 2005-06 which was contested by the corporation. Based on the assurance that the matter will be referred to the Institute of Chartered Accountants of India for obtaining the opinion, this issue was dropped from the audit report for the year 2005-06.

**B. Query**

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

(i) Whether the past service cost of Rs. 88.14 crore which arose due to actuarial valuation done by the corporation for the first time in the year 2005-06 should be absorbed over a period of 5 years, i.e., the average period of service to be rendered by the employees, since, according to the querist, no distinction was made in the pre-revised AS 15 for vested and non-vested benefits.

(ii) Whether unamortised expenditure of past service cost of

Rs.70.51 crore has been rightly treated as deferred revenue expenditure and carried forward in the balance sheet as on 31.3.2006. If not, what should be the accounting treatment of the past year liability on account of post-retirement medical benefit, and how should the unamortised expenditure be carried on in the books of account of the corporation.

**C. Points considered by the Committee**

15. The Committee while expressing its opinion has considered only the issues raised in paragraph 14 above and has not touched upon any other issue arising from the Facts of the Case, such as, whether or not the post retirement medical scheme falls under 'defined benefits plan', accounting policy of the company in respect of gratuity and leave encashment benefit provided to its employees, etc.

16. The Committee notes from the Facts of the Case that upto the financial year 2004-05, the company had not been providing for its liability under post-retirement medical benefit and was following pay-as-you-go method for such kind of liabilities. In this regard, the Committee notes paragraphs 12 and 17 of the extant AS 15 (issued in 1995) which state as follows:

> "12. The cost of retirement benefits to an employer results from receiving services from the employees who are entitled to receive such benefits. Consequently, the cost of retirement benefits is accounted for in the period during which these services are rendered. Accounting for retirement benefit cost only when employees retire or receive benefit payments (i.e., as per pay-as-you-go method) does not achieve the objective of allocation of those costs to the periods in which the services were rendered."
>
> "17. In respect of gratuity benefit and other defined benefit schemes, the accounting treatment depends on the type of arrangement which the employer has chosen to make.
>
> (i) If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate

charge to the statement of profit and loss for the year is made through a provision for the accruing liability. The accruing liability is calculated according to actuarial valuation. However, many enterprises which employ only a few persons do not calculate the accrued liability by using actuarial methods. They calculate the accrued liability by reference to some other rational method e.g. a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) In case the liability for retirement benefits is funded through creation of a trust, the cost incurred for the year is determined actuarially. Many employers undertake such valuations every year while others undertake them less frequently, usually once in every three years. If actuarial valuations are conducted every year, the annual accrual of retirement benefit cost can be easily determined. If, however, the actuarial valuations are not conducted annually, the actuary's report specifies the contributions to be made by the employer on annual basis during the inter-valuation period. This annual contribution (which is in addition to the contribution that may be required to finance unfunded past service cost) reflects proper accrual of retirement benefit cost for each of the years during the inter-valuation period and is charged to the statement of profit and loss for each such year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the shortfall is charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess is treated as a pre-payment.

(iii) In case the liability for retirement benefits is funded through a scheme administered by an insurer, it is usually considered necessary to obtain an actuarial certificate or a confirmation from the insurer that the contribution

> payable to the insurer is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall is charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess is treated as a pre-payment."

From the above, the Committee is of the view that the company was not correct in accounting for such benefits as per 'pay-as-you-go method' and should have provided for such liability in either of the ways suggested in the above-reproduced paragraph 17 of AS 15. Accordingly, the company should rectify its error by treating it as 'prior period item' in accordance with the provisions of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', in the reporting period.

17. The Committee further notes that w.e.f. 2004-05, the company has also brought certain changes in its post-retirement medical scheme. In this regard, the Committee notes paragraph 29 of AS 15 (issued 1995) which states as follows:

> "***29 Any alterations in the retirement benefit costs arising from -***
>
> ***(a) introduction of a retirement benefit scheme for existing employees or making of improvements to an existing scheme, or***
>
> ***(b) changes in the actuarial method used or assumptions adopted,***
>
> ***should be charged or credited to the statement of profit and loss as they arise in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items***

> ***and Changes in Accounting Policies'[2] . Additionally, a change in the actuarial method used should be treated as a change in an accounting policy and disclosed in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.***

18. The Committee notes from the Facts of the Case that the company was following the pay-as-you-go method for accounting for post-retirement medical benefits upto the financial year 2004-05 and not on the basis of actuarial valuation as required under AS 15 (1995). The Committee also notes from paragraph 7 that the actuarial valuation of liability towards post-retirement medical benefits upto 31st March, 2005, was Rs. 88.14 crore. The Committee notes that this amount is determined based upon the scheme as modified in the financial year 2004-05. The Committee is of the view that a past service cost with regard to change in the scheme would be the difference between the actuarial liability based upon the pre-revised scheme and the actuarial liability as per the revised scheme. In other words, the entire amount of Rs. 88.14 crore does not represent past service cost; it represents the actuarial liability not provided for in the past and, therefore, requires a correction of the error. In any case, the past service cost which should have been determined as stated above should also have been charged to the profit and loss account as per paragraph 29 of AS 15, reproduced in paragraph 17 above.

19. The Committee is of the view that the provisions of Accounting Standard 15 (revised 2005), 'Employee Benefits', do not apply for the financial year ending 31st March, 2006. Accordingly, paragraph 94 of revised AS 15 is not relevant.

**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 14 above:

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[2] AS 5 has been revised in February 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

(i) Rs. 88.14 crore cannot be absorbed over a period of 5 years. The same should be charged as a prior period item as discussed in paragraph 16 and as a past service cost as discussed in paragraph 18 above.

(ii) In view of the response to (i) above, this issue does not arise.

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***Query No. 18***

***Subject: Creation of deferred tax liability on special reserve created under section 36(1)(viii) of the Income-tax Act, 1961.***[1]

**A. Facts of the Case**

1. A company is engaged in the business of providing housing loans to individuals and builders. The company is registered under the Companies Act, 1956 and also notified as housing finance company under the National Housing Bank (NHB) Act, 1987. As per the querist, the company has shown excellent results for the financial year ended 31-03-2006. During the year, the company has the net profit before tax of Rs. 25.06 crore (52.34% growth), total loan outstanding of Rs. 1100 crore (22.37% growth) and capital adequacy ratio of 12.08%. The company is operating with 28 branches all over India.

2. The querist has stated that the company has been creating and maintaining a special reserve under section 36(1)(viii) of the Income-tax Act, 1961[2] (hereinafter referred to as 'the Act') to take tax benefits. The company has accumulated special reserve of Rs. 51.98 crore as on 31.03.2006. Under this section, the company is allowed deduction to the extent of 40% of the profits of the

[1] Opinion finalised by the Committee on 9.8.2007.
[2] Clause (viii) of section 36(1) has since been revised.

business of providing *long-term finance* for construction/purchase of houses for residential purposes in India (emphasis supplied by the querist). Section 36(1)(viii) of the Act is reproduced below for ready reference:

"36. (1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28 —

…

(viii) in respect of any special reserve created and maintained by a financial corporation which is engaged in providing long-term finance for industrial or agricultural development or development of infrastructure facility in India or by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes, an amount not exceeding forty per cent of the profits derived from such business of providing long- term finance (computed under the head "Profits and gains of business or profession" before making any deduction under this clause) carried to such reserve account:

**Provided** that where the aggregate of the amounts carried to such reserve account from time to time exceeds twice the amount of the paid-up share capital and of the general reserves of the corporation or, as the case may be, the company, no allowance under this clause shall be made in respect of such excess.

*Explanation* — In this clause, —

(a) "financial corporation" shall include a public company and a Government company;

(b) "public company" shall have the meaning assigned to it in section 3 of the Companies Act, 1956 (1 of 1956);

(c) "Government company" shall have the meaning assigned to it in section 617 of the Companies Act, 1956 (1 of 1956);

(d) "infrastructure facility" means —

(i) an infrastructure facility as defined in the Explanation to clause (i) of sub-section (4) of section 80-IA, or any other public facility of a similar nature as may be notified by the Board in this behalf in the Official Gazette and which fulfils the conditions as may be prescribed;

(ii) an undertaking referred to in clause (ii) or clause (iii) or clause (iv) of sub-section (4) of section 80-IA; and

(iii) an undertaking referred to in sub-section (10) of section 80-IB;

(e) "long-term finance" means any loan or advance where the terms under which moneys are loaned or advanced provide for repayment along with interest thereof during a period of not less than five years".

3. The querist has further stated that section 41(4A) of the Income-tax Act, 1961 provides that in case the special reserve is utilised /withdrawn, the same shall become taxable in the year in which it is so utilised /withdrawn. Hence, deduction claimed on special reserve in the year of its creation becomes taxable in the year of its withdrawal/ utilisation.

4. During the course of audit of accounts of the company for the year ending 31st March, 2006, the Comptroller and Auditor General of India (C&AG) audit party had expressed reservation with regard to non-creation of deferred tax liability on special reserve created under section 36(1)(viii) of the Income-tax Act, 1961. The comment of the C&AG is as under:

"The company has not made provision for deferred tax liability amounting to Rs. 17.50 crore created and maintained under section 36(1)(viii) of the Income-tax Act, 1961 as required by the Accounting Standard (AS) 22 read with the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India. This has resulted in understatement of provision for deferred tax liability and overstatement of profit after tax by Rs. 17.50 crore."

5. The company takes note of the definition of the term 'timing differences' as given in Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India, which is reproduced below:

> "***Timing differences*** ***are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."***

6. The company is of the view that every year special reserve is created by way of an appropriation of profits and not charged to the profit and loss account, while the same is deducted to ascertain the taxable income. Thus, it creates difference between taxable income and accounting income in the year of creation of special reserve. Deduction claimed on special reserve in the year of its creation becomes taxable in the year of its withdrawal/utilisation.

7. The querist has argued that AS 22 only requires creation of deferred tax liability on temporary timing differences, such as, methods of charging depreciation, derecognition of income of NPAs (which are capable of reversal on realisation), provision for NPAs (capable of reversal on account of becoming regular), etc. Nowhere a reserve created under the provisions of the Income-tax Act, can be called a temporary timing difference, which will fluctuate every year due to withdrawals, etc. All transfers to reserves and surplus are on different footing as compared to depreciation or NPA provision or derecognition of income on NPAs, which can change every year. Further, according to the querist, the company has not withdrawn any amount from special reserve during the last 18 years since the date of its incorporation. Moreover, as per section 29C of the NHB Act, housing finance companies are required to transfer 20% of the net profit to special reserve and it cannot withdraw any amount except for the purposes specified by the

NHB. Provision of section 29C of the NHB Act, 1987 are reproduced herein below for ready reference:

> "29C. (*1*) Every housing finance institution which is a company shall create a reserve fund and transfer therein a sum not less than twenty per cent of its net profit every year as disclosed in the profit and loss account and before any dividend is declared.
>
> *Explanation.* - A housing finance institution creating and maintaining any special reserve in terms of clause *(viii)* of sub-section *(1)* of section 36 of the Income-tax Act, 1961, may take into account any sum transferred by it for the year to such special reserve for the purposes of this sub-section.
>
> (*2*) No appropriation of any sum from the reserve fund including any sum in the special reserve which has been taken into account for the purposes of reserve fund in terms of sub-section *(1)*, shall be made by such housing finance institution except for the purpose as may be specified by the National Housing Bank from time to time and every such appropriation shall be reported to the National Housing Bank within twenty-one days from the date of such withdrawal:
>
> Provided that the National Housing Bank may, in any particular case and for sufficient cause being shown, extend the period of twenty-one days by such further period as it thinks fit or condone any delay in making such report.
>
> …"

8. The querist has stated that this has also been well established in the industry and many companies which are transferring an amount to special reserve are treating it as of permanent nature and no deferred tax liability has been created on it. As per the querist, the C&AG's insistence to create deferred tax liability on special reserve does not reconcile with the intention behind AS 22, which aimed at matching of accounting income and taxable income.

9. According to the querist, creation of deferred tax liability on special reserve would reduce the accounting profit of the company immediately in the year of creation, which in the absence of

withdrawal would continue to be shown in the balance sheet of the company in the subsequent periods. If deferred tax liability is to be created, then why would any company create a special reserve as in any case the net worth due to deferred tax liability would decline. Further, it would affect the balance sheet of the company and would reflect a distorted picture of financial position of the company in technical terms, while in real terms creation of deferred tax liability doesn't involve any cash outflow. In this way, it takes away the benefit of deduction under section 36(1)(viii) of the Income-tax Act, 1961 and frustrates the purpose of introducing this section by the legislature.

10. Keeping in view the above facts and its wider ramification for housing finance companies (HFCs), the company considers the special reserve *as permanent difference* and is not in favour of creating deferred tax liability on special reserve (emphasis supplied by the querist).

**B. Query**

11. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the company is required to create the deferred tax liability on the special reserve created and maintained under section 36(1)(viii) of the Income-tax Act, 1961 as on 31.03.2006, which will become chargeable to tax under section 41(4A) of the Act, only on the withdrawal therefrom in subsequent years (which, according to the querist, in the case of the company, has never happened in the last 18 years since the date of its incorporation).

**C. Points considered by the Committee**

12. The Committee notes section 36(1)(viii) of the Income-tax Act, 1961, as reproduced in paragraph 2 above and the definition of the term 'timing differences', as reproduced in paragraph 5 above.

13. The Committee notes that there are two essentialities for timing differences to arise:

(i) There should be difference between taxable income and accounting income originating in one period; and

(ii) The difference so originated should be capable of reversal in one or more subsequent periods.

The Committee notes that there is no condition of any limitation of the period for reversal of such differences, i.e., as per the definition of 'timing differences', the reversal of the difference can take place at any time in future.

14. The Committee notes from the Facts of the Case that the company has itself admitted in paragraph 6 above that creation of special reserve under section 36(1)(viii) creates difference between accounting income and taxable income in the period in which special reserve is created. The Committee also notes that this difference is *capable of reversal* in the period in which the special reserve is utilised or withdrawn for the purposes specified by the NHB, since in the year of utilisation or withdrawal, the amount of special reserve would be added to taxable income thus resulting into a higher taxable income than the accounting income of that period. Therefore, the Committee is of the view that the creation of special reserve results into timing differences as per AS 22.

15. The Committee also notes paragraph 14 of AS 22 which states as below:

> "14. This Statement requires recognition of deferred tax for *all* the timing differences. This is based on the principle that the financial statements for a period should recognise the tax effect, whether current or deferred, of all the transactions occurring in that period." (Emphasis supplied by the Committee.)

16. The Committee further notes paragraph 8 of Accounting Standards Interpretation (ASI) 6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Acccountants of India, which, inter alia, describes one of the principal conceptual bases of AS 22 as below:

> "8. There are two methods for recognition and measurement of tax effects of timing differences, viz., the "full provision method" and "partial provision method". Under the "full provision method", the deferred tax is recognised and measured in

respect of all timing differences (subject to consideration of prudence in case of deferred tax assets) without considering assumptions regarding future profitability, future capital expenditure etc. On the other hand, the 'partial provision method' excludes the tax effects of certain timing differences which will not reverse for some considerable period ahead. Thus, this method is based on many subjective judgements involving assumptions regarding future profitability, future capital expenditure etc. In other words, partial provision method is based on an assessment of what would be the position in future. Keeping in view the elements of subjectivity, the 'partial provision method' under which deferred tax is recognised on the basis of assessment as to what would be the expected position, has generally been discarded the world-over. AS 22 also does not consider the above assumptions and, therefore, is based on 'full provision method'."

17. From the above, the Committee notes that even if an enterprise expects that a difference between accounting and taxable income will not reverse and has not reversed in the past (partial provision approach), the difference should be recognised as timing difference if it is capable of reversal at any time in future (full provision approach). Thus, deferred tax is to be provided for *all* timing differences. Accordingly, the Committee is of the view that in the present case, the eventuality of utilisation/withdrawal of special reserve or the past experience in this regard is not of relevance. So long as the utilisation/withdrawal is *capable* of taking place, the creation of special reserve results into timing differences for which deferred tax should be provided.

18. With regard to the other arguments advanced by the querist in paragraphs 8 and 9 above, the Committee is of the view that an industry-practice, if it is not in accordance with an accounting standard, does not imply that the accounting treatment adopted by the industry is correct. Further, the opinion is based on the requirements of AS 22 with the specific objective that accounts give a true and fair view. There are various instances where the treatment of items of income and expenses is different for accounting purposes than that under the Income-tax Act because

the objectives of the two are different. The objectives of the Income-tax Act do not govern the accounting treatment of an item.

## D. Opinion

19. On the basis of the above, the Committee is of the opinion that the company is required to create deferred tax liability on the special reserve created and maintained under section 36(1)(viii) of the Income-tax Act, 1961 as on 31.03.2006, irrespective of the fact that withdrawal of the reserve may or may not happen and has not happened in the past since the company is capable to withdraw the reserve resulting into reversal of the difference between accounting income and taxable income (i.e., timing difference).

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***Query No. 19***

***Subject: Accounting for costs incurred for acquisition/ construction of shared manufacturing facilities due to divestment of a business unit.[1]***

## A. Facts of the Case

1. A company has three business units engaged in the business of manufacture and sale of paints, speciality chemicals and adhesives. The manufacturing facilities, viz., effluent treatment plant, electrical substations, roads, fire fighting facilities, weighbridge, canteen, etc., which are shared by all the three business units, are situated at a common site taken on lease by the company.

2. During the year, the company has divested its speciality chemical business (henceforth referred to as 'divested business') on a going concern basis for an agreed composite consideration. As per the terms of the sale agreement, a portion of the undivided

[1] Opinion finalised by the Committee on 9.8.2007.

land on which the manufacturing facilities of the divested business are situated, is being bifurcated for transfer to the purchaser. Certain shared facilities located on the portion of land so bifurcated, will also have to be transferred to the purchaser as a part of the aforesaid divestment. Due to the above divestment, the company will have to acquire/construct similar shared facilities at the site for its continuing businesses. Management estimates that such cost of acquisition/construction will be significant.

3. The querist has suggested two possible accounting treatments for the costs to be incurred for acquisition/construction of such new shared facilities:

(A) Cost to be incurred for acquisition/construction of the new shared facilities for use by the continuing businesses should be adjusted against profit on sale of the divested business.

(B) The sale of existing shared facilities should be recognised in the books of account as sale and acquisition/ construction of the new shared facilities should be recognised as fixed assets.

4. The querist has given the following arguments in favour of treatment 'A' as mentioned in paragraph 3 above:

- It would be an appropriate reflection of the substance of the transaction since the need for the new facilities has been triggered due to sale of the divested business and the consideration paid by the buyer for the divestment reflects the economic value of the facilities being transferred as a part of the divested business.

- It would reflect the true economic value of the transaction and is in line with the 'matching concept' which is a fundamental accounting concept, and will therefore, not be in diversion with Accounting Standards and Generally Accepted Accounting Principles (GAAP).

- The facility to be constructed will not result in any incremental revenue generation to the continuing businesses.

5. The querist has given the following arguments in favour of treatment 'B' as mentioned in paragraph 3 above:

- Sale of the existing shared facilities and acquisition/construction of new facilities should be considered as independent transactions. Consequently, fixed assets sold off should be adjusted against the block of fixed assets and new assets should be capitalised when acquired/constructed.

- The new acquired/constructed assets will have their own useful lives as against the existing assets that are almost fully depreciated. In accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, the cost of acquisition/construction of new assets should be capitalised.

- The costs to be incurred for acquisition/construction of the new shared facilities are associated with the continuing businesses of the company. These expenditures relate to future conduct of the company's business and are not expenditure associated with business divestment. Accordingly, such expenditures are to be recognised on the same basis as if they arose independently of the aforesaid divestment. Such accounting treatment is in line with paragraphs 80 and 81 of International Accounting Standard (IAS) 37, 'Provisions, Contingent Liabilities and Contingent Assets'.

**B. Query**

6. The querist has sought the opinion of the Expert Advisory Committee as to which of the above mentioned accounting treatments, is the most appropriate accounting treatment for costs to be incurred for construction/acquisition of shared manufacturing facilities due to divestment of speciality chemicals business unit that are to be used in future by the continuing business units of the company.

## C. Points considered by the Committee

7. The Committee restricts itself to the issue raised by the querist in paragraph 6 above and has not considered any other issue that may arise from the facts of the case.

8. The Committee notes that the company in question has disposed of its speciality chemical business on a going concern basis for an agreed composite consideration. The disposal of the business comprises, inter alia, disposal of certain fixed assets of the company. The Committee notes paragraphs 25 and 26 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which state as follows:

> ***"25. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.***
>
> ***26. Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement."***

9. The Committee is of the view that the above treatment on disposal of fixed assets equally applies to the disposal of a group of fixed assets. Accordingly, the items of fixed assets disposed off in the sale transaction of divestment of the business are eliminated on disposal and the gains or losses arising on disposal are recognised in the profit and loss statement. The Committee is of the view that the divestment of the business and the acquisition/ construction of the new facilities for continuing businesses are independent transactions as these are not part of any exchange transaction of divestment and acquisition of the facilities. Thus, the cost incurred for acquisition/construction of the new facilities for use by the continuing businesses should be recognised as fixed assets.

## D. Opinion

10. On the basis of the above, the Committee is of the opinion that the second option mentioned by the querist in paragraph 3, is

correct, i.e., the gain or loss on sale of the divested business unit should be recognised in the profit and loss account and the cost incurred on the new acquisition/construction of shared facilities should be recognised as fixed assets.

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***Query No. 20***

***Subject: Manner of disclosure of income in the profit and loss account.***[1]

**A. Facts of the Case**

1. A company was incorporated under the Companies Act, 1956 in May 1994 by the Reserve Bank of India (RBI). The company was established by the RBI with the objective of developing an active and efficient debt market. The company is registered as a non-banking finance company under section 45 IA of the Reserve Bank of India Act, 1934. After the company's formation, the RBI introduced the scheme of 'Primary Dealers' in the Government securities market. The company, along with the Discount and Finance House of India Ltd., now SBIDFHI Ltd., was one of the first companies to receive accreditation as a primary dealer in India.

2. The RBI held an equity stake of 50.18 per cent in the company with other public sector banks and financial institutions holding the remaining stake. As a part of its policy, the RBI divested its entire stake in the company in two stages – in the years 1997 and 2002.

3. The company is an active participant in the wholesale debt market along with banks and financial institutions. As a primary dealer in the government securities market, it is actively involved in underwriting and bidding at each auction of government securities, subscribing to the auctioned securities and selling the

[1] Opinion finalised by the Committee on 9.8.2007.

acquired securities in the wholesale debt market. The company also deals in corporate bonds, money market instruments like, commercial paper, certificates of deposit and also equity shares and equity derivatives.

4. The company deals in purchase and sale of securities. Securities include the following:

(i) Government securities

(ii) Financial Institutions' and other bonds

(iii) Equity shares

(iv) Units of mutual funds

(v) Treasury bills

(vi) Commercial papers

(vii) Certificates of deposit (CODs)

(viii) Pass through certificates (PTCs)

The querist has stated that all these securities bought are treated as stock-in-trade. The inventory thereof is disclosed as 'Securities held as Stock–in–trade' under the head 'Current Assets' in the balance sheet.

5. The querist has further stated that the basic sources of income are discount and interest/dividend income on securities and profit/loss on trading in securities. The income is disclosed in the profit and loss account as follows:

"Discount Income

Interest Income

Dividend Income

Trading Profit on Securities"

Further break-up of discount income and trading profit on securities is disclosed in the schedules to the profit and loss account as follows:

(a) Discount Income earned on Treasury bills/Commercial papers/CODs/PTCs

| | | |
|---|---|---|
| Sales | XXXXX | |
| Add: Stock on hand as at the end of the year | XXXXX | XXXXX |
| Less: (i) Purchases | XXXXX | |
| (ii) Stock on hand as at the beginning of the year | XXXXX | XXXXX |
| Discount earned on … | | XXXXX |

(b) Trading profit/loss on Government securities, Financial Institutions' & other bonds, equity shares and units of mutual funds:

| | | |
|---|---|---|
| Sales | XXXXX | |
| Add: Stock on hand as at the end of the year | XXXXX | XXXXX |
| Less : (i) Purchases | XXXXX | |
| (ii) Stock on hand as at the beginning of the year | XXXXX | XXXXX |
| Trading Profit/Loss on... | | XXXXX |

(The stock is net of provision for decline in value of securities)

6. According to the querist, the Reserve Bank of India, unlike for banks, has not issued any guidelines for disclosures in the financial statements of the NBFCs. The company under these circumstances draws its financial statements under the provisions of the Companies Act, 1956 and as per Schedule VI.

7. The Comptroller and Auditor General of India (C&AG) has objected to the aforesaid disclosure of income on the following counts:

Para 3 of Part II of Schedule VI to the Companies Act, 1956 requires a separate disclosure of certain items of income and expenditure including the amount of turnover and purchases in profit and loss account of the company. Para 3(i)(a) of Part II defines 'Turnover' as "The turnover, that is, the aggregate amount for which sales are effected by the company". Part II further requires that in case of trading company, the Profit and Loss Account should also disclose under separate heads the purchase made, opening and closing stock, giving break up of each class of goods traded in by the company and indicating the quantity thereof. In the opinion of the C&AG the correct method of disclosure would be to show the amount of sales and purchases separately in the Profit and Loss Account and provide further details in the schedules.

8. The company contends that the disclosures made in the financial statements satisfy all the requirements of the Companies Act, 1956 for the following reasons:

(a) Provisos to sub-sections (1) & (2) of section 211 of the Companies Act, 1956, which provides for the form and contents of balance sheet and profit and loss account, give exemption from the disclosure provisions to certain class of companies where the form of balance sheet has been specified in any other statute. The examples of such class of companies are banks, electricity generation companies, insurance companies, etc. Since the disclosures under Schedule VI are devised to cover manufacturing companies, trading companies (trading in manufactured goods) and service companies, the aforesaid exemption was given especially to the finance companies, i.e., banks and insurance companies. The regulator, the RBI, in the case of the NBFCs has not issued any format for the balance sheet and profit and loss account and hence, the company has followed the format as per Schedule VI. Hence, the disclosure requirements for manufacturing and trading companies should not be followed, as such disclosures will give a misleading picture with respect to the affairs of the company.

(b) Even otherwise, the disclosures contemplated in Schedule VI are to be made out as to clearly disclose the result of the working of the company during the period covered by the financial statements. To disclose the entire purchase and sale of securities made during the year would show an incorrect picture. In the case of manufacturing companies and trading companies dealing in goods, the disclosure of each class of goods is necessary as the top line gives a true picture and impact on the profitability. In case of a primary dealer, such a disclosure will bloat the top line and will not disclose the true affairs of the company.

(c) Further, the disclosure requirements of the trading company are not applicable to the company. The C&AG's contention that paragraph 3(ii)(b) of Part II of Schedule VI to the Companies Act, 1956 is applicable to the company is incorrect, as the company is not trading in any kind of goods. Sub-clauses (a), (c) and (d) of paragraph 3 are also not applicable as (a) is for manufacturing, (c) is for companies rendering or supplying services and (d) for composite activities mentioned in (a), (b) and (c). Naturally, the company falls within the purview of paragraph 3(ii)(e) relating to other companies. The clause requires disclosure of the gross income derived under different heads. The company is disclosing the gross income accordingly as referred under paragraph 5 above.

9. The C&AG has requested the company to seek an opinion from the Institute of Chartered Accountants of India on the aforesaid issue.

**B. Query**

10. Under the light of the aforesaid facts, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Whether the disclosure made by the querist of sales and purchases under the schedules of gross income is in line with the requirements of Schedule VI to the Companies Act, 1956.

(b) If the answer to the query under (a) above is in the negative, then whether the company has to disclose the quantities of securities bought and sold during the year as per the requirements of paragraph 3(ii) of Part II of Schedule VI to the Companies Act, 1956.

**C. Points considered by the Committee**

11. The Committee notes that the basic issues raised in the query relate to whether or not the sales and purchases of securities made by the company are covered under paragraph 3(ii) of Part II of Schedule VI to the Companies Act, 1956 and, accordingly, whether the company is required to disclose quantities of securities purchased and sold during the year in the profit and loss account or schedules of income, as the case may be. The Committee has, accordingly, answered only these issues and has not touched upon any other issue arising from the Facts of the Case, such as, transactions entered into for the purpose of speculation.

12. The Committee notes that section 211(2) of the Companies Act, 1956 states as follows:

> "211(2) Every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto:
>
> **Provided** that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company."

From the above, the Committee is of the view that since there is no specific form of profit and loss account specified for NBFCs, the company in the present case has to comply with the requirements of Part II of Schedule VI.

13. The Committee further notes paragraph 3(ii)(b) of Part II of Schedule VI to the Companies Act, 1956, which states as follows:

> "3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:
>
> …
>
> (ii) (b) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof."

14. The Committee is of the view that in the general commercial parlance, 'trading' means buying and selling of goods and since the company is actively involved in the sale and purchase of securities and it itself considers the securities as 'stock-in-trade', the company is a trading company.

15. The Committee further notes the definition of 'goods' as defined in section 2(7) of the Sale of Goods Act, 1930 which states as follows:

> "(7) "goods'' means every kind of moveable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale".

On the basis of the above, the Committee is of the view that since the securities are covered within the definition of the term 'goods', the requirements as to profit and loss account applicable to trading companies would also be applicable to the company.

## D. Opinion

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

(a) No, the disclosure made by the querist of sales and purchases under the schedules of gross income is not in line with the requirements of Schedule VI to the Companies Act, 1956.

(b) The company should disclose the quantities of securities bought and sold during the year as per the requirements of paragraph 3(ii)(b) of Part II of Schedule VI to the Companies Act, 1956.

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***Query No. 21***

***Subject: Accounting treatment in respect of amount withheld from a contractor in respect of customs duty.[1]***

**A. Facts of the Case**

1. A public sector undertaking registered under the Companies Act, 1956 is engaged in refining and marketing of petroleum products and is having its refineries at various locations. The company has entered into lump sum turn key (LSTK) agreement with a foreign contractor for installation of process plant.

2. The querist has stated that the job was awarded to the foreign contractor based on total lump sum price which was inclusive of customs duty. Total lump sum price was bifurcated into three main heads, viz., engineering, supply and construction. The supply part of lump sum price consists of imported and indigenous supply. The contractor furnished further break-up of lump sum prices including structure of taxes and duties, which was used for release of progressive payments.

3. The querist has further stated that the contractor paid customs duty on the price at which he had procured the materials. The

[1] Opinion finalised by the Committee on 9.8.2007.

procurement price of the material was less than the price indicated by the contractor in the break-up of lump sum prices. However, he claimed customs duty based on the CIF value as per the price break-up (which corresponded to their quoted CIF amounts). Thus, the total amount of customs duty as shown in the lump sum price break-up was in excess of the amount of actual customs duty paid by the contractor. However, as per the querist, notwithstanding the amounts shown in the price break-up under various heads, the total payments to the contractor for performance of this contract shall be limited to lump sum price mentioned in the contract. The balance of customs duty, as indicated in the relevant price schedule, after accounting for progressive payments, was to be released on submission of the proof of payment of customs duty.

4. Keeping in view the above contractual provisions and the fact that the actual CIF value of the supplies made by the contractor was much less as compared to the CIF values indicated in the contract, the customs duty element was reimbursed to the contractor based on the documents submitted for proof of payments and for the balance amount of customs duty, i.e., against which the documents were not submitted by the contractor, a liability has been provided but the amount was withheld for payment.

5. The contractor has refuted the stand of the company and contended that in a lump sum contract price, the stage-wise payment particulars are only indicative items for effecting progressive payments and that he is entitled to get the total price irrespective of variations against the indicated CIF prices as given in the contract and he is not required to submit any documents in support of their final claim. The contractor has invoked the arbitration proceedings over the withholding of the amount and the final outcome of the arbitration is still awaited. However, the amount withheld has been provided as liability and accordingly capitalised in the books as, in the view of the company, the amount is payable to the contractor and the dispute is only on the procedure, i.e., furnishing of documents before releasing the payment.

6. The accounting policy followed by the company in respect of contingent liabilities and claims is given below:

**"Contingent Liabilities –**

Show Cause Notices issued by various Government Authorities are not considered as obligation.

When the demand notices are raised against such show cause notices and are disputed by the Corporation, these are classified as disputed obligations.

The treatment in respect of disputed obligations, in each case above Rs. 5 lakh, is as under:

(i) A provision is recognised in respect of present obligations where the outflow of resources is probable;

(ii) All other cases are disclosed as contingent liabilities unless the possibility of outflow of resources is remote.

**Claims:**

Claims are accounted for:

(i) When there is certainty that the claims are realisable

(ii) Generally at cost".

7. The accounting treatment followed by the company is as follows:

The total lump sum amount payable to the foreign contractor including full amount of taxes and duties has been capitalised and the amount withheld for want of custom duty documents from the contractor is shown as liability in the books of account against which the contractor has invoked arbitration proceedings which are still pending.

**B. Query**

8. The opinion of the Expert Advisory Committee has been sought in relation to accounting treatment of the withheld amount payable to foreign contractor, pending final outcome of the arbitration proceedings, on the following issues:

(a) Whether the accounting treatment of capitalising plant at the total lump sum price (including taxes and duties) payable to the foreign contractor for lump sum turn key contract is in order by providing for liability for the amount withheld towards balance customs duty on account of non-submission of customs documents against which the contractor has invoked arbitration proceedings.

(b) In case the answer to the above query is in the negative, whether the amount withheld from the LSTK contractor, which is under arbitration, is to be treated as contingent liability.

(c) In case the same is to be treated as contingent liability, whether provision can be made and capitalised since in the view of management, the outflow of resources in this case is probable.

## C. Points considered by the Committee

9. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 8 above and has not touched upon any other issue arising from the Facts of the Case, such as, accounting policy of the company in respect of show cause notices issued by the Government authorities.

10. The Committee notes that Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute of Chartered Accountants of India, defines the terms 'provision', 'liability', 'contingent liability' and 'present obligation' as follows:

> ***"A <u>provision</u> is a liability which can be measured only by using a substantial degree of estimation."***
>
> ***"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."***
>
> ***"A <u>contingent liability</u> is:***
>
> ***(a) a possible obligation that arises from past events and the existence of which will be confirmed***

***only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or***

***(b) a present obligation that arises from past events but is not recognised because:***

***(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or***

***(ii) a reliable estimate of the amount of the obligation cannot be made."***

***"<u>Present obligation</u> - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."***

11. The Committee further notes paragraphs 14, 15 and 22 of AS 29, which state as follows:

***"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.***

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for

example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68)."

"22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68)."

12. The Committee notes from paragraph 5 of the Facts of the Case that as far as the company is concerned, the amount of customs duty claimed by the supplier has been recognised as a liability as the amount is payable to the contractor and the dispute is only on the procedure, i.e., furnishing of documents evidencing payment of customs duty before releasing the payment. The Committee also notes from the Facts of the Case that the supplier cannot present such documents, as evidence of payment of customs duty, since the duty has not been paid at all. In the view of the Committee, since such documents cannot be presented, it cannot be considered as a procedural matter. If the argument of the company is to be accepted that the company has to release only the actual customs duty paid, there is no liability of the company in this regard. The Committee, however, also notes that the supplier

has contended that irrespective of the actual payment of customs duty, it is the total amount of contracted price which is payable by the company under the terms of the lump sum turn key contract. Keeping in view the fact that the matter is pending before arbitration, the Committee is of the view that the company will have to make an assessment about the probability of the outcome of the arbitration proceedings. In case the company is of the view that it is probable that the arbitration award will require the company to pay the full contracted amount irrespective of the actual payment of customs duty, the company should make a provision. Otherwise, the same should be disclosed as a contingent liability as per the requirements of AS 29. In case the company considers that based on its assessment it is necessary to create a provision, it is appropriate to capitalise the amount of the provision for customs duty as a part of the cost of the plant.

## D. Opinion

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

(a) The accounting treatment of capitalising plant at total lump sum price (including taxes and duties) payable to the foreign contractor for lump sum turn key contract is in order if provision for liability for the amount withheld towards balance customs duty, which is pending before arbitration, is made in accordance with the requirements of AS 29.

(b) In case the company does not consider appropriate to create a provision under the requirements of AS 29, the amount of balance customs duty in dispute should be disclosed as a contingent liability.

(c) In case the amount of disputed balance of customs duty is to be disclosed as contingent liability as required under AS 29, a provision cannot be made and capitalised. If the management considers that the outflow of resources is probable and other recognition criteria as specified in paragraph 14 of AS 29 are met, it would not be appropriate to disclose the amount as a contingent liability.

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***Query No. 22***

***Subject: Treatment of compensatory afforestation charges paid to Forest Department.[1]***

## A. Facts of the Case

1. 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 through its transmission network. With the growing investment in power sector, it also undertakes construction of new transmission system linked with the generating units as well as system strengthening schemes of the existing networks. A transmission system consists of transmission lines, sub-stations for transmitting the power and switchyards at generating units.

2. The querist has stated that the transmission line sometimes passes through forest area for which approval of Ministry of Environment and Forest (MOEF), Government of India, under Forest (Conservation) Act, 1980, is mandatory. As per the stipulations of the Forest (Conservation) Act, compensatory afforestation on equivalent non-forest land or on degraded forest land (twice the forest area diverted/used) is a pre-condition for all diversion of forest land for non-forest purpose. While granting approval, MOEF letter stipulates that tree cutting shall be restricted to tower footing and 3-7 meter corridors below each conductor depending upon the type and line voltage. Accordingly, towers are erected at varying distance and stringing of conductor is made among the various towers. Trees are uprooted at places where the towers are erected which occupy a space of approx. 400 sq. meters and in corridors of 3 to 7 m in the entire stretch of line. In rest of the stretch, trees are lopped/trimmed or sometimes cut to maintain desired electric clearance. However, approval is obtained for use of forest area based on complete right of way (ROW). One such case of construction of transmission line is referred by the querist for the opinion of the Expert Advisory Committee. In the approval letter dated 10th January, 2003 it has been agreed that

[1] Opinion finalised by the Committee on 13.11.2007.

63.960 hectare of forest land shall be diverted on 30 years lease subject to fulfillment of the following conditions:

(i) The user agency shall transfer the cost of compensatory afforestation and its maintenance over double the degraded forest land, i.e., 127.92 ha. to the State Forest Department.

(ii) The right of width is allowed to 23 meters and the clearance between conductor and trees to 5.5 meters.

(iii) The user agency shall prepare a plan for plantation of small size tree species below the transmission line for a period of five years and transfer the cost to the State Forest Department.

(iv) The user agency shall ensure the minimum felling and the maximum height of the towers in the forest area.

The financial implication of the above conditions is Rs. 49.06 lakh as required to be paid by the company to the Forest Department, communicated vide letter dated 13th February, 2003.

3. The querist has further stated that the company is required to pay lease premium of Rs.1.38 crore for transfer of land on lease for a period of 30 years for construction of the above project. Apart from this, 10% of lease premium, i.e., Rs. 13.78 lakh is required to be paid annually as lease rent over a period of 30 years.

4. The querist has also stated that the Hon'ble Supreme Court has ordered that the projects be charged net present value of benefits from a forest, including, oxygen production, biodiversity, carbon absorption and flood and drought control. This is over and above the current system of compensatory afforestation, paying for cutting the trees and getting new ones planted. A sum of Rs. 5.88 crore has been paid by the company @ Rs. 9.20 lakh per hectare for 63.96 hectare of forest land as required vide letter dated 19/11/2003.

5. As per the querist, after the compliance of above conditions, the land is diverted to the company for a period of 30 years. Such

lease gives right to use the land for the specific purpose and contains various conditions restricting the usage of land, such as:

(i) Legal status of land shall remain unchanged.

(ii) No damage is to be caused to forest property and wildlife by employees of the company or its contractors.

(iii) The company shall have right to use the land within the lease period for the specific project only.

There are many other conditions, which restrict the use of land so that minimal loss to forest and wildlife is caused and the same are given in the letter dated 15th June, 2004.

6. The querist has stated that the company treats the expenditure stated above as incidental expenditure during construction, directly attributable to construction of transmission line and accordingly, such payments are capitalised as part of the cost of the transmission line. The lease rent stated above, paid after commissioning of the line is charged to revenue. According to the querist, the above accounting treatment is based on the following:

(i) Paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, states, inter alia, that the cost of an item of fixed asset comprises its purchase price and any directly attributable cost of bringing the asset to its working condition for its intended use. The cost of site preparation is an item of directly attributable cost.

(ii) Paragraph 9.3 of AS 10, inter alia, provides that the administration and other general overhead expenses are usually excluded from the cost of fixed assets. 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 fixed asset.

7. The Comptroller and Auditor General of India (C&AG), while conducting the audit of the company for the financial year 2004-

05, pointed out that the expenditure incurred by the company as compensatory afforestation charges (i.e., payments referred to in paragraphs 2 and 4 above only) resulting in the plantation of trees by the Forest Department would be the property of the Forest Department and is not represented by any tangible asset of the company and, therefore, inclusion of such expenditure under capital cost of transmission line is not correct. The C&AG is of the opinion that such amount is required to be accumulated under a separate account head indicating its nature until the commencement of commercial operation of the transmission system and should be written-off/amortised as per the company's accounting policy which states that "*Capital expenditure on assets not owned by the company* is amortised over a period of four years from the year in which the first line/substation of the project comes into commercial operation and thereafter, from the year in which the relevant assets are completed and become available for use" (emphasis supplied by the querist).

8. In addition to above, the Government auditor has also made a reference to query no. 1.32 of Compendium of Opinions, Volume-1X. The query relates to treatment of capital expenditure on land not belonging to the company and not represented by tangible assets, e.g., building-up and maintenance of roads, bridges, culverts, etc., on land not belonging to the company. The querist has stated that in respect of this query, the Expert Advisory Committee (EAC) has opined that, expenditure incurred on creation of various facilities not belonging to the company though of capital nature should be disclosed separately and accumulated in a separate account until the commencement of commercial operations of the project. Thereafter, it should be written-off to the profit and loss account as recommended in the Guidance Note on Treatment of Expenditure during Construction Period[2], i.e., over the approximate period of its utility or over a relatively brief period not exceeding five years, whichever is less.

9. The company, in its reply, has stated that the compensatory afforestation charges paid to forest authorities are for getting

[2] The Guidance Note has since been withdrawn pursuant to the decision of the Council at its 280th meeting held on August 7-9, 2008.

clearance for construction of transmission line in the forest area. Since the expenditure is directly attributable and is a necessary expense for the construction of transmission line in the forest area, the expenditure necessarily should be included in the cost of transmission line only. The accounting treatment is based on paragraphs 9.1 and 9.3 of AS 10. The accounting policy referred to by the C&AG has been framed to account for building-up and maintenance of approach roads, expenditure on community development, bridges and culverts, etc. on land not belonging to the company. Such expenses facilitate the project or are taken up as welfare measure and are not a pre-condition imposed for taking up construction work. The auditor was also informed that the querist of query no. 1.32, published in the Compendium of Opinions, Volume-IX, had again referred the matter to the EAC stating that the general policy (as opined in volume-IX) may not be applicable in all cases and circumstances and in particular, it may not be applicable to the hydro-electric projects. The EAC considered the query and gave inter alia the opinion which is reproduced below:

> *Query*: Creation of assets on alternative land in lieu of the land given by the government: The company sometimes gets land free from the state government/forest department. In lieu of the free land provided for the duration of the project, the company has to get the afforestation done on alternative land of the government/forest department. [Point (1)(e) of the query no. 1.3 of Volume XII of Compendium of Opinions]
>
> *Opinion*: The expenditure incurred on alternative land, as a precondition for obtaining the relevant piece of land, should be considered as a part of cost of acquisition of land. Accordingly, this expenditure should be capitalised as cost of land and shown as part of the cost of land in the balance sheet.

10. On the basis of this opinion, as per the querist, the company strengthened its stand by indicating that the case is analogous as referred above except that in our case, the land has been diverted on lease basis for the specific purpose of passing through of transmission line over the forest area. Even after diversion of land, trees are required to be grown on the diverted land upto a specific

height and the same remains the property of the Forest Department. The land also remains the property of the Forest Department since no other use is permissible. Thus, the querist is only obtaining the right to use the designated forest land for the purpose of right of way for erection of towers and stringing. This afforestation and payment of NPV is in lieu of the loss of vegetation/damages of existing trees and resultant environmental/ecological impact due to construction of transmission line in the forest area. Hence, in the view of the querist, the expenditure should be booked to the cost of relevant assets, i.e., transmission tower.

**B. Query**

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

(i) Whether the company's policy of capitalising the various expenditure on account of compensatory afforestation stated above for obtaining approval for construction of transmission line in the forest area as cost of transmission line is correct or not.

(ii) If not, the correct accounting treatment.

**C. Points considered by the Committee**

12. The Committee notes that the querist has raised the issue in respect of expenditure relating to compensatory afforestation only. Therefore, the Committee has examined only that issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting for lease premium, etc.

13. The Committee notes from the Facts of the Case that the company in question has obtained the right to use the forest land from the Government for the purpose of erecting towers and laying down transmission line on the said land. The Committee further notes that this right to use of the land has been obtained for a period of 30 years by way of a lease agreement by paying an upfront lease premium and an annual lease rental.

14. The Committee is of the view that the right to use of the forest land is an intangible asset keeping in view the following definitions

of the terms 'asset' and 'intangible asset' as defined in Accounting Standard (AS) 26, 'Intangible Assets', issued by the Institute of Chartered Accountants of India:

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

15. The Committee notes from the Facts of the Case that the right to use of forest land, gives the company, the right to lay transmission lines which facilitates transmission of power, thus, carries future economic benefits. It also gives the right to the company to obtain future economic benefits flowing from the underlying asset and also restricts the access of others to those benefits. The enterprise has, thus, control over the asset. Accordingly, the right to use of forest land meets the definition of an asset. Further, since this right is an identifiable, non-monetary asset, without physical substance and is held for use in the production and supply of transmission of power, it is of the nature of an intangible asset.

16. The Committee notes from the above that in fact there are two assets which the company in question has, namely, the transmission line and the intangible asset of right to use the forest land. The issue is whether the following payments made by the company should be capitalised as a part of the cost of the transmission line or as a part of the cost of the intangible asset of right to use the forest land:

(i) The cost of compensatory afforestation and its maintenance paid to the Forest Department.

(ii) The cost of plantation of small size tree species below transmission line for a period of five years.

(iii) A sum of Rs. 5.88 crore as net present value of benefits from forest, including, oxygen production, biodiversity, carbon absorption and flood and drought control.

17. The Committee is of the view that the expenditure referred to in paragraph 16 above cannot be considered as the expenditure incurred on the site preparation for transmission line. The Committee is of the view that the site preparation cost in relation to transmission line would be of the nature of felling of trees or of foundation laying down costs of towers, etc. The Committee is further of the view that the expenditure referred to in paragraph 16 above has been incurred for diverting the use of forest land for non-forest purposes and, therefore, the costs are related to right to use the land. Accordingly, these should be capitalised with the cost of right to use the forest land. The Committee is of the view that this view is also supported by the opinion on query no. 1.3 contained in Volume XII of the Compendium of Opinions referred to in paragraph 9 above. The Committee notes that the opinion on query no. 1.32 contained in Volume IX of the Compendium of Opinions referred in paragraphs 8 and 9 above, is not relevant in the present case.

## D. Opinion

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

(i) No, the company's policy of capitalising the various expenditure on account of compensatory afforestation stated in paragraph 16 above for obtaining approval for construction of transmission line in the forest area as cost of transmission line is not correct.

(ii) The company should capitalise the above-said expenditure for obtaining right to use of forest land as a separate intangible asset.

**_Query No. 23_**

**_Subject: Treatment of time related fixed payroll cost for estimating the cost of completion of a contract.[1]_**

## A. Facts of the Case

1. A company which is a Government of India enterprise under the Ministry of Steel, is an engineering, consultancy and contracting organisation, offering a full range of services required for setting up of projects from concept to commissioning including turnkey execution. The company is a multi-disciplinary company having a network of offices spread all over the country experienced in handling consultancy assignments and Engineering, Procurement, Construction and Commissioning (EPC) projects. As per the querist, the company has played a significant role in the development and the expansion of Indian industry. The company is an ISO: 9001: 2000 company and it is registered with international financial institutions, like, World Bank, Asian Development Bank, African Development Bank and has technological tie-ups with world leaders.

2. In the course of execution of turnkey projects, all jobs pertaining to manufacturing and supply of plant and machinery are off-loaded to various manufacturers since the company has no manufacturing or assembly unit. Similarly, all site related activities, like, civil works, erection, commissioning, etc., are also done by various contractors. The company's personnel provide engineering services (if required) and supervision only.

3. According to the querist, while executing turnkey projects, the company is following the provisions of Accounting Standard (AS) 7, 'Construction Contracts'. The querist has further stated that as per their understanding of AS 7, contract cost should comprise costs that relate directly to the specific contract and costs that can be allocated and / or specifically chargeable to any specific contract. Costs which cannot be attributed to a contract activity or which cannot be allocated to a contract and costs for which reimbursement is not specified in the contract, are excluded from the costs of a construction contract.

[1] Opinion finalised by the Committee on 13.11.2007.

4. As per the querist, in case of the company, all direct costs and costs attributable and allocated to a contract are considered while estimating the cost to complete the project. Direct manpower costs for manufacturing, civil works, erection, etc., for completion of the project are included in the respective packages which are ordered to various vendors. All other costs pertaining to the project are judiciously considered while estimating the cost to complete the project. However, the company does not consider payroll cost of its own employees for estimation of the cost to complete the project. Salaries, wages and other benefits of the employees are time related fixed cost and have no relevance or relationship with any project. It is payable to employees even if an employee remains idle and no additional amount is payable to anybody even if he works beyond working hours or during holidays. Also, the payroll cost is not reimbursed by the clients. In view of the above, the company considers that its own payroll cost is not a direct cost and is a non-allocable cost, which may not be included in estimation of cost to complete the project. Instead, the company charges pay roll cost directly to the profit and loss account. The querist has informed that this practice is being followed by the company over the years and the same is also disclosed in the company's Notes to Accounts.

**B. Query**

5. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the practice of the exclusion of time related fixed payroll cost while estimating the cost to complete a contract results in a deviation from AS 7.

**C. Points considered by the Committee**

6. The Committee notes paragraphs 15, 17, 18 and 19 of AS 7 which state as follows:

***"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."***

"17. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance;

(b) costs of design and technical assistance that is not directly related to a specific contract; and

(c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs."

"18. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in 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."

From the paragraphs of AS 7 reproduced above, the Committee is of the view that the payroll cost of the employees of the company should be included in the contract costs if these can be attributed to contract activity in general and can be allocated to specific contracts.

7. The Committee notes that the querist has stated in paragraph 4 of the Facts of the Case that the company considers that its own payroll cost is not a direct cost and is a non-allocable cost and has no relevance or relationship with any project. However, the Committee also notes that in paragraph 2 of the Facts of the Case, the querist has stated that the company's personnel provide engineering services, if required and supervision to the turnkey projects. The Committee is of the view that the services rendered by such employees forms part of the various activities necessary to execute and complete the contracts undertaken by the company. Thus, the payroll cost of such employees is part of the cost that is necessary to incur to complete the contracts of the company. Accordingly, the Committee is of the view that the payroll cost of such employees is attributable to the contract activity and should form part of the contract cost, as allocated to various contracts on the basis of a systematic and rational method, such as, time spent on the various contracts. The Committee further notes that the querist has not elaborated upon the nature of jobs performed by other employees of the company. Therefore, the Committee is unable to comment upon the inclusion/non-inclusion of the payroll cost of other employees in the contract costs. However, the Committee is of the view that payroll cost of all those employees whose activities are attributable to the contract activity should be allocated on a systematic and rational basis to various contracts. However, according to paragraphs 18 and 19 of AS 7, which are reproduced above, general administration costs should not be included in the contract cost.

## D. Opinion

8. On the basis of the above, the Committee is of the opinion that the payroll cost of the employees rendering services that are necessary to complete the contract are costs that are attributable to the contract activity in general and should be included in the

cost to complete a contract allocated on a systematic and rational basis, such as, the time spent on the various contracts. The payroll cost of other employees rendering general administrative services should, however, be charged directly to the profit and loss account.

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***Query No. 24***

***Subject: Treatment of expenditure incurred on abandoned projects and discontinued survey and investigation schemes.[1]***

## A. Facts of the Case

1. A company was incorporated in 1976 as a wholly owned Government of India enterprise under the administrative control of Ministry of Power to plan, promote, investigate, survey, design, construct, generate, operate and maintain hydro and thermal power stations and to explore and utilise the power potential of north-east in particular. The company is presently running three hydro-projects and two thermal projects in north-eastern states and catering to the demand of north-eastern states only.

2. The stages involved from conception to execution of power projects are as follows:

(a) Survey and investigations for preparation of pre-feasibility report.

(b) Survey and investigations for preparation of detailed project report.

(c) Arrangement of various clearances and investment approval from Public Investment Board and Cabinet Committee on Economic Affairs.

[1] Opinion finalised by the Committee on 13.11.2007.

3. At the initial stage, the company has to incur expenditure on survey and investigation for collection of topographical, hydrological, geological and meteorological data besides pursuing various clearances like forest clearance, environmental clearance, etc. This expenditure, other than those expenditures which are of capital nature, is booked as incidental expenditure during construction and shown under capital work-in-progress. This incidental expenditure incurred during construction forms part of the project cost approved by the Government of India and specifically attributable to construction of projects which on completion of the project is apportioned to ultimate assets on pro-rata basis in compliance with paragraph 9.3 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India.

4. The querist has pointed out that it is the standard industry practice to prepare shelves of project reports out of which economically viable projects are taken for execution. The schemes which are not found economically viable are discontinued or abandoned. The expenditure on such schemes is written-off over a period of time.

5. According to the querist, as per the standard industry practice and accepted accounting principles, expenditure incurred over a period of time and recognised as asset is written-off over a period in the event of abandonment or unsuccessful construction. Accordingly, the company has framed its accounting policy approved by its Board of Directors to write off the incidental expenditure incurred on abandoned projects and expenditure incurred on discontinued survey and investigation schemes over a period of five accounting years.

**B. Query**

6. The opinion of the Expert Advisory Committee has been sought by the querist as to whether the accounting policy followed by the company is in compliance with the existing Accounting Standards and standard accounting principles.

## C. Points considered by the Committee

7. The Committee notes that the query primarily involves two issues. The first issue is whether it is appropriate to treat the expenditure specified in paragraph 3 above as an asset by carrying it as capital work-in-progress. The second issue is whether the accounting policy followed by the company to write-off such capital work-in-progress on abandoned projects, discontinued survey and investigation schemes over a period of 5 accounting years, is appropriate.

8. The Committee is of the view that before treating such expenditure as capital work-in-progress, i.e., a fixed asset, in accordance with provisions of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', as indicated by the querist in paragraph 3 above, such expenditure should meet the definition of an asset as given in the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India. Accordingly, the Committee notes the definition of an asset as per the Framework which provides as 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."

9. On the basis of the above definition, the Committee is of the view that future economic benefits from the project could be expected only when the company reaches a conclusion that the project is economically viable and the company decides to continue the project. Accordingly, the Committee is of the view that before the project reaches the economic viability stage, no asset is created.

10. The Committee notes that since no asset can be created till the project reaches the economic viability stage, the question of writing-off such expenditure on abandoned projects, discontinued surveys and investigation schemes over a period of 5 accounting years, does not arise. Therefore, the expenditure incurred before reaching the aforesaid stage should be written-off as and when incurred.

## D. Opinion

11. On the basis of the above, the opinion of the Expert Advisory Committee on the issue raised in paragraph 6 above is that the accounting policy followed by the company is not in compliance with the existing Accounting Standards and standard accounting principles.

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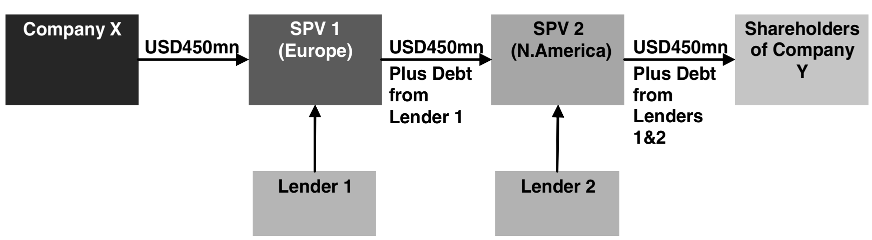
***Query No. 25***

***Subject: Accounting for derivative contracts intended to hedge investment in a subsidiary.*[1]**

## A. Facts of the Case

1. Company X ("X"), an Indian Company acquired an overseas Company Y ("Y") in Canada. The acquisition was to be funded by contribution by Company X by way of an equity contribution of USD 450 mn to a Special Purpose Vehicle – Netherlands incorporated company ("SPV 1") and the balance money was by loans drawn by this SPV and others specifically created for this purpose. The payment structure was as follows:




[1] Opinion finalised by the Committee on 13.11.2007.

2. SPV 1 issued equity shares denominated in Euro to X. SPV 2 issued equity denominated in USD to SPV 1.

3. X had put in the bid for company Y during last week of January '07 and Y communicated to X on 20th February, '07 that they have been chosen as the preferred bidder. The transaction had to be paid for and consummated by 15th May, '07. To protect against currency fluctuations, X entered into some forward contracts and option contracts during last week of March '07 and early April '07 for USD 380 mn out of the total USD 450 mn exposure. Since the exact payment dates were not known at that stage but the expectation was that the deal would be closed not later than 31st May and ideally around 15th May. Hence, X entered into derivatives maturing around the expected payment date ranging from end April to May 15th.

4. Significant portion of the derivative contracts was in the form of Zero Cost Collar options, i.e., these derivatives provide the holder a right to buy Dollars. However, instead of paying premium the holder writes a compensating sell option. In the present case, X has entered into leveraged options, i.e., where the pay off on the written sell option is higher than the bought call option. X has also entered into other variants of options.

5. The details of the derivative instruments and the activity therein are as set out in the Annexure.

6. The actual payments were made as follows:

| | | |
|---|---|---|
| 16-Apr-07 | USD 70 mn | USD 50 mn purchased from market |
| | | USD 20 mn from early delivery from Tranche 5 |
| 8-May-07 | USD 380 mn | USD 340 mn was used by taking delivery against the derivative contracts on 8th May as set out in table given in the Annexure. |
| | | USD 40 mn was purchased from market |

7. X has accounted for the losses incurred on various dates on cancellation of the leveraged portion of the options and roll-forward of the option contracts amounting to approximately Rs. 67 crore as expense in the profit and loss account of the relevant period.

8. The net impact of settlement of the forward contracts on May 8, 2007 was not material.

**B. Query**

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

(i) Whether the losses incurred (refer paragraph 7 above) on the derivatives contracted for hedging the cash outflow for equity investments can be considered as a direct cost of acquisition and accordingly, added to the cost of investments or would the losses have to be taken to the profit and loss account.

(ii) Whether the combination of call and put options can be considered as a forward exchange or another financial instrument that is in substance a forward exchange contract as in paragraph 36 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', and thus, be accounted for as forward contracts. In the absence of any specific guidance for accounting for option contracts what would be the primary source of technical guidance for its accounting/disclosures including the option contracts entered for hedging the forecast transaction.

(iii) If it is agreed that these transactions are not covered by existing Indian Accounting Standards, then whether reference can be made to International Accounting Standard (IAS) 39, 'Financial Instruments: Recognition and Measurement', only for these transactions, i.e., not adopt IAS 39 in its entirety, including potential for claiming hedge accounting under IAS 39.

## C. Points considered by the Committee

10. The Committee notes that the company in question had entered into certain options and forward contracts to cover the foreign currency risk to purchase an investment in future. In other words, the aforesaid derivative contracts were entered into in expectation of purchase of an investment in future.

11. The Committee notes that paragraph 36 of AS 11 provides 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."***

12. The Committee also notes that the above paragraph of AS 11 does not apply to forward exchange contracts to cover a future transaction. In this context, the Committee notes that the Institute of Chartered Accountants of India had issued, in January 2006, an Announcement titled as 'Accounting for exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment[2] or a highly probable forecast transaction[3]'. The said Announcement is reproduced below:

> "1. The Institute of Chartered Accountants of India (ICAI) issued an Announcement, on 'Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in

[2] A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

[3] A forecast transaction is an uncommitted but anticipated future transaction.

Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction (see 'The Chartered Accountant', July 2004 (pp. 110)). As per the Announcement, AS 11 (revised 2003) is not applicable to the exchange differences arising on forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction. It is stated in the Announcement that the hedge accounting, in its entirety, including hedge of a firm commitment or a highly probable forecast transaction, is proposed to be dealt with in the Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation.

2. It may be noted that as per the above Announcement, AS 11 (revised 2003) is not applicable to the exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction. Accordingly, the premium or discount in respect of such contracts continues to be governed by AS 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates.

3. It has been noted that in the absence of any authoritative pronouncement of the Institute on the subject, different enterprises are accounting for exchange differences arising on such contracts in different ways which is affecting the comparability of financial statements. Keeping this in view, the matter has been reconsidered and the Institute is of the view that pending the issuance of the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation, exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction should be recognised in the statement of profit and loss in the reporting period in which the exchange rate changes. Any profit or loss arising on renewal or cancellation of such contracts should be recognised as income or expense for the period."

13. The Committee notes that the above Announcement had been deferred by subsequent Announcements made by the ICAI in February 2006, June 2006 and July 2007.

14. With regard to whether the losses on derivatives should have been added to the cost of investments, the Committee also notes paragraph 28 of Accounting Standard (AS) 13, 'Accounting for Investments', which requires as follows:

> ***"28. The cost of an investment should include acquisition charges such as brokerage, fees and duties."***

15. The Committee is of the view that the requirement of the above paragraph of AS 13 covers charges on acquisition and, accordingly, it does not include losses on derivative contracts as a part of cost of investments.

16. The Committee is of the view that the nature of options contracts or the combination thereof as per the facts of the case is different from the forward contacts or their combination and accordingly, the options contracts or their combination cannot be considered as a forward exchange contract or another financial instrument that is in substance a forward exchange contract for the purposes of paragraph 36 of AS 11 and the Announcements mentioned in paragraphs 12 and 13 above. The Committee is, therefore, of the view that insofar as option contracts are concerned, since there was no pronouncement of the ICAI, the company could have adopted any rational treatment. Thus, recognising losses on the options contracts was in order, keeping in view the principle of prudence. Insofar as forward contracts were concerned, although the Announcement reproduced in paragraph 12 above had been deferred, the said Announcement formed the only authoritative source of accounting for a forward transaction of a highly probable forecast transaction. Thus, in case the concerned transaction met the definition of the highly probable forecast transaction, recognition of the loss thereon in the profit and loss account was in order.

17. It may be noted that the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement', corresponding to IAS 39. AS 30 becomes recommendatory in respect of accounting

periods beginning 1st April, 2009 and mandatory from 1st April, 2011. In view of the fact that options contracts are not forward exchange contracts or another financial instrument that is in substance a forward exchange contract as envisaged in paragraph 36 of AS 11, the company can follow AS 30 with regard to hedge accounting provisions in case the combination(s) of options taken by the company constitute(s) a hedging instrument(s), after having satisfied all the requirements related to hedge accounting, e.g., those related to hedge effectiveness, documentation, etc.

**D. Opinion**

18. On the basis of the above, the opinion of the Committee on the issues raised by the querist in paragraph 9 are as below:

(i) Losses incurred on the derivative contracts for hedging the cash outflow for equity investments cannot be considered as a direct cost of acquisition thereof and accordingly, should not have been added to the cost of investments. The treatment followed by the company to recognise these losses in the profit and loss account was in order.

(ii) Combination of call and put options cannot be considered as a forward exchange or another financial instrument that is in substance a forward exchange contract as envisaged in paragraph 36 of AS 11. For authoritative source of technical guidance for options contracts please see (iii) below.

(iii) In view of the fact that options contracts are not forward exchange contracts or another financial instrument that is in substance a forward exchange contract as envisaged in paragraph 36 of AS 11, the company can follow AS 30, corresponding to IAS 39, with regard to hedge accounting provisions in case the combination(s) of options taken by the company constitute(s) a hedging instrument(s) after having satisfied all the requirements related to hedge accounting, e.g., those related to hedge effectiveness, documentation, etc.

| Tranches | Type of derivative | Maturity date | Particulars | | How utilised c |
|---|---|---|---|---|---|
| Tranche 1 | Option contract | 30-Apr-07 | Buy Call USD 65 Mio at 44.15 and Sell USD 130 Mio Put at 43.51. | | The excess cancelled on Rs. 17.63 Crore |
| | Option contract | 30-Apr-07 | Buy Call USD 5 Mio at 44.15 , Sell Call USD 5 Mio at 45.00, Sell Put USD 5 Mio at 43.34 | | The excess cancelled on **resulting loss** above. |
| | | | | | The balance to deals (65+5) US <u>May 31</u> at 41.30 Crores |
| Tranche 2 | Option contract | 4-May-07 | Buy Call USD 20 Mio at 44.15, Sell Call USD 20 Mio at 45.00, Sell Put USD 20 Mio | | The bought ca at 41.3015 with |
| Tranche 3 | Option contract | 7-May-07 | Buy Call USD 25 Mio at 44.15 and Sell USD 50 Mio Put at 43.55. | | The excess so (50-40)) was ca 7.88 Crores |
| | Option contract | 7-May-07 | Buy Call USD 40 Mio at 44.038, Sell Call USD 30 Mio at 45.00, Sell Put USD 50 Mio at 43.36 | | The balance b (25+40+25) <u>was</u> with loss of Rs |
| | 'Option contract | 7-May-07 | Buy Call USD 25 Mio at 43.94, Sell Call USD 25 Mio at 44.54, Sell Put USD 25 Mio at 43.52 | | |
| Tranche 4 | Option contract | 10-May-07 | Buy Call USD 10 Mio at 44.09,Sell Call USD 10 Mio at 44.50, Sell Put USD 10 Mio at 43.59. | | The whole co on 8th May at |
| Tranche 5 | Forward Contracts | 15-May-07 | USD 65 Mio at 43.7917 | | |
| | Forward Contracts | 15-May-07 | USD 115 mio @43.955 | | Took early d extent of USD |

Annexure

## Query No. 26

## Subject: Accounting treatment of insurance/capital spares.[1]

## A. Facts of the Case

1. A public sector company registered under the Companies Act, 1956, is engaged in the construction and operation of Hydro Electric Power Projects. While procuring plant and machinery for power stations, capital spares/insurance spares are also procured or sometimes procured afterwards separately. As per the querist, all such spares are capitalised in line with the accounting policy of the company, which had been framed keeping in view Accounting Standard (AS) 2, 'Valuation of Inventories', Accounting Standard (AS) 10, 'Accounting for Fixed Assets', Accounting Standards Interpretation (ASI) 2, 'Accounting for Machinery Spares' read with an earlier opinion on the subject, 'Accounting treatment of insurance spares' given by the Expert Advisory Committee of the Institute of Chartered Accountants of India (published in Compendium of Opinions, Volume XXI, Query No. 40). The said accounting policy of the company is given below:

(a) Machinery spares procured along with the plant and machinery or subsequently and whose use is expected to be irregular are capitalised separately, if cost of such spares is known and depreciated fully over the residual useful life of the related plant and machinery. If cost of such spares is not known particularly when procured along with the mother plant, these are capitalised and depreciated along with the mother plant.

(b) The written down value (WDV) of the spares is charged to revenue in the year in which such spares are consumed. Similarly, the value of such spares, procured and consumed in a particular year is charged to revenue in that year itself.

(c) When the useful life of the related fixed asset expires and the asset is retired from active use, such spares

[1] Opinion finalised by the Committee on 13.11.2007.

are valued at net book value or net realisable value whichever is lower. However, in case the retired asset is not replaced, WDV of related spares less disposable value is written off.

(d) Other spares are treated as 'stores and spares' forming part of the inventory and expensed when issued.

2. The querist has informed that during the audit of accounts of the company for the year 2006-07, the government auditor has raised an observation regarding accounting policy mentioned in paragraph 1(b) above whereby, the company is charging WDV of machinery spares to revenue in the year of consumption of spares. The contention of the auditor is that the said accounting policy is not in conformity with ASI 2 as charging of WDV of such spares to revenue on consumption of such spares has resulted in overstatement of consumption of spares, and understatement of depreciation and net block of machinery spares and profit before tax. The querist has provided the observation of the auditor which is reproduced below:

> "…based on the above policy, unit charged machinery spares costing Rs.__ crore to revenue accounts-'Consumption of spares' instead of allocating the cost of such spares over the remaining useful life of the assets as required under Accounting Standards Interpretation (ASI) 2 on Accounting Standards 2 and 10. This has resulted in overstatement of Consumption of Spares by Rs.___ crore, understatement of Depreciation by Rs.___ crore and understatement of Net Block and Profit before tax by Rs.___ crore."

3. The querist has further referred to the company's reply to the aforesaid observation, which is reproduced below:

> "The Accounting Policy of the company is based on AS 2, Accounting Standards Interpretation (ASI) 2 on Accounting Standards 2 and 10 and opinion of the Expert Advisory Committee of the ICAI on query No. 40 as available at page No.196 to 202 of Compendium of Opinions, Volume XXI. A careful reading of ASI 2 and that of the opinion referred to above would reveal that both are recommending the same

accounting treatment. Opinion is however exhaustive and goes on to further explain as under:

> 'When the capital spare/insurance spare is actually used, i.e., it replaces the worn out spare in the fixed asset, the written down value of the capital spare, on the date it is put to use, should be immediately expensed. *This is because the replacement of the spare does not increase the future benefits from the existing asset beyond its previously assessed standard of performance...'* (emphasis supplied by the querist).

In this connection attention is also invited to the following portions of the operating part of the opinion as contained in paragraph 18:

'(a) Insurance spares should be capitalised on purchase as explained above and should be depreciated on a systematic basis over the useful life of the related fixed asset. When an insurance spare is used as a replacement of the existing part in the fixed assets, the written down value of the spare should be charged to revenue. *This meets the requirement of paragraph 23 of AS 10, i.e., it is not added to the book value of the fixed asset because it does not increase the future benefits from the existing asset beyond its previously assessed standard of performance.* (Emphasis supplied by the querist.)

(d) An item of capital/insurance spares should be charged to revenue, if the year of purchase and consumption is the same.'

It would be noted from the above that the opinion not only recognises the principles laid down in ASI 2 but it goes to recognise the underlying principles contained in paragraph 23 of AS 10 which are of paramount importance.

In view of the above, the accounting policy as well as the accounting treatment is as per laid down accounting principles and it is requested that the provisional comment may please be dropped."

4. The querist has informed that the provisional comment was dropped by the auditor on the assurance that the matter shall be referred to Expert Advisory Committee of the Institute of Chartered Accountants of India for further opinion in the matter.

**B. Query**

5. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the aforesaid policy of the company complies with the provisions of AS 2, AS 10 and ASI 2 read with the referred opinion of the Expert Advisory Committee.

**C. Points considered by the Committee**

6. The Committee notes that the basic issue raised by the querist relates to the expensing of the written down value of the capital/ insurance spare when it replaces an existing part in the fixed asset. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as the appropriateness of other accounting policies.

7. The Committee having perused Accounting Standards Interpretation (ASI) 2, 'Accounting for Machinery Spares', notes paragraph 4 of ASI 2, which states as below:

> "4. Machinery spares of the nature of capital spares/ insurance spares should be capitalised separately at the time of their purchase whether procured at the time of purchase of the fixed asset concerned or subsequently. The total cost of such capital spares/insurance spares should be allocated on a systematic basis over a period not exceeding the useful life of the principal item, i.e., the fixed asset to which they relate."

8. The Committee also notes paragraphs 8.2 and 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which state as below:

> "8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of

fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item."

***"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."***

9. From the above stated paragraphs and the Facts of the Case, the Committee notes that AS 10 and ASI 2, do not specifically deal with the situation where the capital/insurance spares are actually issued/used pursuant to a breakdown or failure of the fixed asset to which they relate. The Committee is of the view that the intended purpose behind the procurement of capital/insurance spares is to ensure uninterrupted flow of production/operations in the event of breakdown of the related fixed asset on account of defective parts, etc. Uptil the time of such breakdown which requires replacement of an old defective or scrapped part, the capital/insurance spares having been capitalised on their purchase will be depreciated by systematically allocating their total cost over a period equal or shorter to the useful life of the related fixed asset. This is in accordance with the requirements of ASI 2 and AS 10.

10. The Committee also notes that once the breakdown, etc., occurs and the capital/insurance spares are used, i.e., replace the defective part, they become an integral part of the related fixed asset. In effect, the capital/insurance spares cease to have their own identity when they replace the existing part in the fixed asset. Further, the Committee notes that as the capital/insurance spares replace the defective parts of the principal fixed asset, the fixed asset continues to maintain its same level of performance. Thus, the replacement of a part by the capital/insurance spare does not amount to an increase of the future benefits from the asset beyond its previously assessed standard of performance. Also, the written down value of the part that is replaced continues to be a part of the total written down value of the fixed asset. Hence, the Committee is of the view that in accordance with paragraph 23 of AS 10 which is reproduced above, the written down value of the

spares should be charged to the profit and loss account when it replaces the existing part in the fixed asset.

**D. Opinion**

11. On the basis of the above, the Committee is of the opinion that the accounting policy followed by the company with respect to expensing the written down value of the insurance/capital spare when it replaces an existing part of the fixed asset, is in accordance with AS 2, AS 10 and ASI 2.

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***Query No. 27***

***Subject: Provision of liability for unused sick leave under AS 15 (revised 2005).[1]***

**A. Facts of the Case**

1. A bank, incorporated under an Act of Parliament, has the main business of providing banking and financial services to its customers/account holders. As on 31.03.2007, the bank had over 9500 branches spread over entire India and a staff strength of 1.85 lakh employees.

2. The bank has been accounting for retirement benefits provided to its employees in the financial statements in accordance with its principal accounting policy as stated hereunder:

> ***"Retirement Benefits***
>
> Contributions payable to the Bank's Provident Fund Trust in terms of its Provident Fund Scheme are charged to profit and loss account on accrual basis.

[1] Opinion finalised by the Committee on 13.11.2007.

Liability for gratuity, pension and leave encashment (which are defined benefits) is determined on the basis of actuarial valuations carried out at the year end and the incremental liability is provided for by charging to the profit and loss account."

3. The querist has stated that the Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005), issued by the Institute of Chartered Accountants of India (ICAI), comes into effect in respect of accounting periods commencing on or after 7th December, 2006. Accordingly, the bank would value and disclose the employee benefits provided to its employees in accordance with AS 15 (revised 2005).

4. The bank employees are entitled to sick leave as per the following terms:

"An officer shall be eligible for 30 days of sick leave for each completed year of service subject to a maximum of 18 months during the entire service. Such leave can be accumulated upto 540 days during the entire service and may be availed of only on production of medical certificate by a medical practitioner acceptable to the bank or, at the bank's discretion, nominated by it at its cost. In respect of the period of sick leave, an officer shall be eligible to receive one half of the full emoluments. In the first year of service, an employee will be granted sick leave on pro-rata basis. Where an officer has put in a service of 24 years, he shall be eligible to additional sick leave at the rate of one month for each year of service in excess of 24 years subject to a maximum of 3 months of additional sick leave."

5. The querist has drawn attention of the Committee to paragraphs 13, 14 and 15 of AS 15 and Issue 5 of the 'ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)' issued by the Accounting Standards Board of ICAI. Paragraph 15 of AS 15 has been reproduced by the querist as below:

"15. The method specified in the previous paragraph measures the obligation at the amount of the additional payments that are expected to arise solely from the fact that the benefit accumulates*. In many cases, an enterprise may not need to make detailed computations to estimate that there is no material obligation for unused compensated absences.* For example, a leave obligation is likely to be material only if there is a formal or informal understanding that unused leave may be taken as paid vacation." (Emphasis supplied by the querist.)

6. The querist has further drawn attention of the Committee to the following paragraphs of FASB Statement No. 43, *Accounting for Compensated Absences,* issued by the Financial Accounting Standards Board, USA:

"6. An employer shall accrue a liability for employees' compensation for future absences if *all* of the following conditions are met:

a. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,

b. The obligation relates to rights that vest or accumulate,

c. Payment of the compensation is probable, and

d. The amount can be reasonably estimated.

If an employer meets conditions (a), (b), and (c) and does not accrue a liability because condition (d) is not met, that fact shall be disclosed."

*"7. Notwithstanding the conditions specified in paragraph 6, an employer is not required to accrue a liability for nonvesting accumulating rights to receive sick pay benefits (that is, compensation for an employee's absence due to illness) for the reasons stated in paragraph 15."* (Emphasis supplied by the querist.)

The querist has also drawn the attention of the Committee to the Summary of Consideration of Comments on Exposure Draft of FASB Statement No. 43 which states in paragraph 15 as below:

> "15. Notwithstanding the Board's conclusion that accrual of a liability for the probable payment of accumulated unused sick days is appropriate under the liability definition in the elements Exposure Draft, the Board was influenced by respondents' comments that the amounts involved generally would not be large enough to justify the cost of computing the probable payments for nonvesting accumulating sick pay benefits. The Board concluded that accrual should not be required for an obligation related to employees' accumulating rights to receive compensation for future absences that are contingent on the absences being caused by an employee's future illness because, in the Board's judgment, the lower degree of reliability of estimates of future sick pay and the cost of making and evaluating those estimates do not justify a requirement for such accrual. Furthermore, the Board believes that the probable payments for accumulating sick pay benefits rarely would be material unless they vest or are otherwise normally paid without an illness-related absence (as discussed in the following paragraph), in which cases the benefits would not be dependent on an employee's future illness and the criteria of paragraph 6 would apply. On the other hand, this Statement does not prohibit an employer from accruing a liability for such nonvesting accumulating sick pay benefits, providing the criteria of paragraph 6 are met."

7. As per the querist, the sick leave is a non-vesting compensated absence which could be carried forward and could be used in future period if the current period's entitlement has not been fully availed. However, the bank does not incur any extra expenditure when the employee avails of carried forward sick leave at a future date beyond the salary and allowances payable to the employee for the period of his absence.

8. The querist has stated that as per Issue 5 of ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005), where the rules of an enterprise allow such leave to be carried forward up to the time of retirement, a liability should be recorded for the cost of the entitlement which should be estimated having regard to the probability of the employee availing the sick leave in future periods. According to the querist, the bank does not have the

database for earlier years pertaining to the sick leave availed by the employees. Collection of such information for all the 1.85 lakh employees of the bank working in 9500+ branches spread over entire India, is costly and time consuming exercise. Accordingly, the costs involved in making and evaluating these estimates would not justify the requirement of providing for the cost of accumulating sick leave.

9. As per the querist, the liability is to be computed taking into consideration the probability of the employee falling sick. This involves estimation and is contingent on the happening of a future event (employee falling sick). It is a probable liability where reliable estimates cannot be made. Accordingly, it should only be disclosed as a contingent liability and should be recognised as an expense when it is actually incurred.

10. As stated in paragraph 4 above, the employees are eligible for 30 days of half pay sick leave for each year of completed service upto a maximum of 18 months/540 days of sick leave. The employees who have completed 24 years of service, are eligible to sick leave at the rate of 1 month for each year of service in excess of 24 years subject to a maximum of 3 months of additional sick leave. Accordingly, the employees could be divided into two groups, one for whom sick leave continues to fall due/accrue and the other group for whom sick leave has ceased to accrue.

11. The querist has reproduced the definition of the term 'Short-term employee benefits', as per AS 15 (revised 2005) as under:

> ***"<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."***

However, according to the querist, as per Issue 3 of the ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005), "Whilst it is necessary to consider the earned leave which "***falls due***", the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether 'short-term' or 'long-term'. The value of short-term benefits should be determined without discounting and if the benefit is determined as long-term, it would be recognised and measured as "Other long-term benefits" in accordance with paragraph 129 of the Standard." According to the Guidance both the 'fallen due' as well as 'expected to occur' criterions have to be considered to determine whether the benefit is a short-term or long-term benefit. As per the querist, in the case of the bank, as the employees have not fully availed sick leave and have accumulated the same, the same appears to be the case of Long-Term Employee Benefit. However, AS 15 (revised 2005) defines 'Other long-term employee benefits' as ***"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*",** but the employees in the case of the bank are entitled to 'sick leave' immediately after rendering proportionate period of service.

12. Further, as per the ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005), Issue 5, where the rules of an enterprise allow such leave to be carried forward up to the time of retirement, a *liability should be recorded for the cost of the entitlement* which should be estimated having regard to the probability of the employee availing the sick leave in future periods (emphasis supplied by the querist). According to the querist, the guidance considers the question of sick leave allowed to be carried forward up to the time of retirement in the light of paragraphs 14 and 15 contained in AS 15 which pertain to 'short-term employee benefits'. Further the guidance requires the liability to be recorded for the cost of entitlement and not on a discounted basis. Therefore, the same could also be treated as a short-term employee benefit.

## B. Query

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

(i) Whether in view of paragraphs 7, 8 and 9 above, the bank is obliged to recognise any liability towards the 'unused sick leave'.

(ii) If yes, whether the bank is required to recognise the same as 'short-term employee benefit' or 'long-term employee benefit' especially after considering the facts stated in paragraphs 10, 11 and 12 above.

## C. Points considered by the Committee

14. The Committee, while answering this query, has restricted itself to the issues raised in paragraph 13 above and has not touched upon any other issue arising from the Facts of the Case, such as, the liability on account of provident fund scheme, gratuity, pension and leave entitlement/encashment other than sick leave.

15. The Committee notes the definition of the term 'short-term employee benefits' as contained in AS 15 (revised 2005) which is reproduced below:

> ***"<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."***

16. The Committee also notes that paragraph 8 of AS 15 (revised 2005) provides as below:

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

17. On the basis of the above, the Committee is of the view that short-term employee benefits include only those compensated absences which accrue to the employees and are expected to be availed (or encashed, as the case may be) within twelve months after the end of the period in which the employees render the related service. Thus, those compensated absences which can be

and are also expected to be carried forward for any further period cannot be termed as 'short-term employee benefits'. In this context, the Committee also notes the definition of the term 'Other long-term employee benefits' as contained in AS 15 (revised 2005) which is reproduced below:

> ***"<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."***

18. The Committee is of the view that where it is expected that the employees will avail the whole of the benefit accruing to them on account of sick leave within the twelve months after the end of the period in which the employees render the related service, the same would fall within the category of 'short-term employee benefits'. However, the Committee notes from the Facts of the Case that the sick leave entitlement of the employees of the bank can be carried forward for more than twelve months after the end of the period in which employees render the related service. Further, the querist has stated in paragraph 11 of the Facts of the Case that the employees have not fully availed the sick leave and have accumulated the same. Therefore, the Committee is of the view that the benefit on account of sick leave does not fall within the category of 'short-term employee benefits'. Rather, the entire benefit on account of sick leave should be treated as 'other long-term employee benefits'.

19. With respect to the recognition and measurement of other long-term employee benefits, the Committee notes that AS 15 (revised 2005) provides that the same should be measured on actuarial basis using the Projected Unit Credit Method. The Standard contains detailed requirements in this regard in paragraphs 129 and 130.

20. The Committee notes that paragraphs 13, 14 and 15 of AS 15 (revised 2005) to which attention has been drawn by the querist, relate to short-term compensated absences. Thus, before these paragraphs become applicable, the benefit has to fall in the category of 'short-term employee benefit', which is not the case in respect

of the bank as stated in paragraph 18 above. The Committee also notes that the bank would incur extra expenditure when the employee avails of carried forward sick leave at a future date, in the form of the salary and allowances paid for the period he remains on leave even though no equivalent services are rendered for that period by the employee. The Committee further notes that the Accounting Standards formulated by the Accounting Standards Board of the Institute of Chartered Accountants of India are based on the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board. Accordingly, the accounting treatments contained in the Accounting Standards prescribed by any other body are not applicable.

**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 13 above:

(i) The bank is obliged to recognise liability towards the unused sick leave.

(ii) The bank is required to recognise the liability towards unused sick leave as 'other long-term employee benefits'.

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***Query No. 28***

***Subject: Accounting treatment for wind mill project set up to produce power for captive consumption.***[1]

**A. Facts of the Case**

1. A public sector undertaking is engaged primarily in the extraction and sale of manganese ore from its mines in two States.

[1] Opinion finalised by the Committee on 30.1.2008.

It also produces and sells ferro manganese, a value added product at one of its mines in one of the States by using a small quantity of its manganese ore production as principal raw material.

2. The company has recently ventured into generation of electricity by installation of wind turbine generators in one of the States. The company has entered into an agreement with another company (which installed and commissioned the generators) for operating the wind turbine generators by paying operations and maintenance charges.

3. The existing regulations framed by the State Government permitted the company to opt for any one of the following:

(a) Direct sale of electricity to X State (Western Region) Electricity Distribution Company Ltd., at the rates decided by the regulatory authority.

(b) Use of the power units generated at the Wind Mills Project (WMP) for the company's own activities at any other location in State X by transmitting the power generated to grid through the X State (Western Region) Electricity Distribution Company Ltd., and drawing 98% of the units generated from the X State (Eastern Region) Electricity Distribution Company Ltd., for its specified consuming units. In this case, the company enters into an agreement with various arms of the X State Government, viz., (i) X State (Western Region) Electricity Distribution Company Ltd. (where power is generated), (ii) X State Power Transmission Company Ltd. (through which power is transmitted) and (iii) X State (Eastern Region) Electricity Distribution Company Ltd., (where actual consumption is made).

4. As the company is in a position to get more benefit by way of reduction in electricity bills of consuming units as compared with direct sale of electricity, the company has opted for (b) above. The company has identified one of its manganese mines and ferro manganese plant as its specified consuming unit. By virtue of the agreement with the above distribution/transmission arms of the electricity companies (hereafter referred to as 'XEDCL'), gross

consumption by manganese mine and ferro manganese plant is reduced by actual power generated at the WMP *less* 2% towards wheeling charges/transmission and distribution losses. Thus, the company gets electricity bills of specified consuming units for net amount payable to XEDCL.

5. Further, if the actual consumption at the consuming units is less than the units generated at the WMP, the reduction in power units is restricted to actual consumption at the consuming units. The additional units generated, termed as "inadvertent flow", are compensated at a specified fixed rate per unit by the distribution company.

6. The querist has stated that although the revenue generated from the project is not substantial in relation to the total turnover of the company, the investment in the project is more than 10% of its gross block of assets. In view of this and the fact that the risks and rewards of the new venture are different from that of the existing business, the company considers the WMP as a separate reportable segment.

7. The querist has stated that the company considers the following accounting treatment and presentation to be appropriate and in line with the accounting standards:

(i) Since the ultimate consumers are units of the company itself, the transaction shall not be termed as 'sale of electricity'.

Consumption of products of one of the units by other units, commonly referred to as 'captive consumption', is generally charged to other units as the cost of production of the producing unit. However, in this case, the revenue generated from the project shall be disclosed separately under the heading 'other income' in the profit and loss account for the following reasons–

(a) The reduction allowed in electricity bills by XEDCL towards units generated at WMP, which otherwise would have been charged to consuming units at normal power tariff rates, represents gain realised 'in cash' as distinguished from a mere book adjustment.

(b) Power generated by the company goes into the grid and loses its identity there itself (as distinguished from a case where the same commodity is transported to another location).

(c) Power generating/consuming company, power receiving company and power distributing company are three different legal entities involved in the transaction and a third party (XEDCL) is quantifying the value of electricity generation.

In view of the above, the net reduction in electricity charges of the two divisions, i.e., ferro manganese plant and manganese mine, equal to the value of credit given by XEDCL in its monthly bills, shall be treated as revenue generated from the project. Further, in the event of generation at WMP exceeding the consumption at consuming units, amount credited by XEDCL in electricity bills shall also be treated as revenue generated from the project and shall also be treated as 'other income'.

The querist has furnished a statement containing extracts from the electricity bill for November 2006 for the perusal of the Committee to explain the methodology. As against the gross bill of Rs. 39,14,579, the company is required to pay only Rs. 26,85,455 thus resulting in reduction of Rs. 12,29,124 towards power generation at WMP. This sum of Rs. 12,29,124 shall be treated as revenue generated from the project.

Separate accounting of 2% wheeling charges on expenditure side, by grossing up revenue, is not considered necessary because the reduction is made by XEDCL at generation point and accounting on expenditure side will pose difficulty in allocation of the charges to consuming units.

(ii) Operations and maintenance charges are payable after a specified period at agreed rate per machine on annual basis. Besides this, administrative expenses like rates and taxes, inspection fees, etc., are to be borne by the company right from the first year of operation. All the above expenses shall be disclosed separately in the profit and loss account as expenditure of wind mills division.

(iii) Depreciation on WMP assets shall be indicated separately below the fixed assets schedule in line with the practice followed by the company in respect of manufacturing units.

(iv) Ferro manganese plant and mine will not be charged with actual cost of generation of electricity at WMP because (a) these units continue to consume the same quantity of power (b) the credit given by the XEDCL in electricity bills of these units towards electricity generation at WMP represents gain realised in cash, (c) power generating/consuming company, power receiving company and power distributing company are three different legal entities involved in the transaction and a third legal entity (XEDCL) is quantifying the value of electricity generated and (d) profit centre concept does not permit such an adjustment.

In view of the above, the company shall also value stock of manganese ore and ferro manganese by considering gross cost of power at these power consuming units without deduction of credit given by XEDCL in electricity bills.

(v) Net profit from operating wind mills, after deducting operational/ administrative expenses and depreciation, shall be disclosed in segment reporting and memorandum profit and loss account separately.

**B. Query**

8. In view of the above, the querist has sought the opinion of the Expert Advisory Committee specifically on the issue of the treatment of reduction in electricity bills on account of credit given by XEDCL in electricity bills towards generation of electricity at wind mills division.

## C. Points considered by the Committee

9. The Committee notes from paragraph 8 above that the querist has raised the issue only with respect to the treatment of reduction in electricity bills on account of credit given by XEDCL in the electricity bill towards generation and supply of electricity by the company through its wind mill division. The Committee has, therefore, considered only this issue and has not considered or touched upon any other issue arising from the Facts of the Case, such as, segment reporting for wind mill division, treatment of various expenses of the wind mill division, disclosure of depreciation on the assets of the wind mill division, etc.

10. The Committee notes from the Facts of the Case that the company is not selling the power generated at its wind mill division. Rather, the company is using the power generated at the wind mill division for the company's own activities at another location. For this purpose, the company is transmitting the power generated through a distribution company. The extracts from the agreement with the distribution company furnished by the querist also indicate that the power is being transmitted by the company to the distribution company for its self-use only. For this purpose, wheeling charges in the form of 2% of the energy fed into the system by the company, are paid to the distribution company. Thus, the company is drawing only 98% of the energy fed into the system for its self-use at a different location. The energy drawn above this limit is charged to the company separately. In case, a lesser quantity of energy is drawn by the company, the company is compensated for the excess units generated at specified rates. The Committee notes that the distribution company in the electricity bill sent to the company shows charges for the full energy drawn by the company and then gives a credit for 98% of the energy that was actually fed into the system by the company itself. The Committee is of the view that this is only a manner of disclosure in the electricity bill. It does not amount to sale and purchase of energy to and from the distribution company. Thus, the Committee is of the view that the energy drawn by the company for its self-use is only an inter-divisional transfer from the wind mill division to its consuming divisions, though at a different location.

11. The Committee notes that the querist has argued in paragraph 7 above that the net reduction in electricity charges of the consuming divisions equivalent to the 98% of the energy fed into the system by the company by its wind mill division, should be treated as revenue generated by the wind mill division. In this context, the Committee notes the definition of the term 'revenue' as per Accounting Standard (AS) 9, 'Revenue Recognition', which is reproduced below:

> "4.1 *Revenue* is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

The Committee is of the view that as per the definition of the term 'revenue' as reproduced above, inter-division transfers do not constitute revenue. The Committee further notes that as per an Announcement issued by the Institute of Chartered Accountants of India in the year 2005, titled 'Treatment of Inter-divisional Transfers', transfers within an enterprise cannot be considered as fulfilling the definition of the term 'revenue'.

12. The Committee also notes that the reduction in the electricity bills of the consuming units does not constitute 'income' for the company. In this context, the Committee notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term 'income' as "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". The Committee is of the view that selling to itself does not result in enhancement of assets and, therefore, the reduced electricity bills do not fit into the definition of the term 'income' as above.

Accordingly, it is not appropriate to present the same as 'other income'.

13. The Committee is of the view that the expenditure incurred by the wind mill division together with the electricity charges paid by the consuming divisions to the distribution company for excess electricity drawn, would represent the cost on account of electricity charges of the consuming divisions. Thus, no separate accounting entries need be passed for the saving in cost towards electricity charges. However, it may be noted that to the extent of the 'inadvertent flow' of electricity to the XEDCL (referred in paragraph 5 above), the compsensation received towards the same would be treated as sale of electricity and appropriately disclosed in the profit and loss account.

## D. Opinion

14. On the basis of the above, the Committee is of the opinion that the accounting treatment suggested by the querist for the reduction in the electricity bills on account of credit given by the distribution company in electricity bills towards generation and supply of electricity by the wind mill division, is incorrect. The correct treatment would be as given in paragraph 13 above.

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***Query No. 29***

***Subject: Basis of valuation of year-end unused import licenses.***[1]

## A. Facts of the Case

1. A company has a turnover of Rs. 179 crore and is not listed on a stock exchange. The company is engaged in the business of manufacture and sale of conveyor belts. Two types of conveyor

[1] Opinion finalised by the Committee on 30.1.2008.

belts are manufactured by the company, viz., steel and textile. The company exports around 20 percent of its output of textile belts to various countries. In respect of such exports, the company receives export incentives that entitle the company to duty-free import of input materials to replenish such materials that had been used for manufacture of the exported belts. In fact, the export benefit generally used by the company is in the form of Advance Licenses, where the company is entitled to first, import duty free and export later. But in the present case, the company is exporting first and utilising those licenses afterwards. Textile (Industrial Fabric) is one such input material, on which customs duty is around 16%.

2. The querist has informed that sufficient quantities of textiles fulfilling the quality requirements are not readily available in the international market and hence, the company had to purchase a large quantity of its textiles requirements from the domestic market. The domestic prices of such textiles (‘Domestic Price’) are generally higher than the landed cost of imported textiles on which customs duty has been paid (‘Duty Paid Landed Cost’) and, obviously, the duty free import price is further lower.

3. The company has also entered into an arrangement with a domestic textile supplier. Under the terms of the arrangement, the company transfers its import entitlements of textile to the supplier and receives equivalent quantities of textile at a price (‘Deemed Export Price’) that is lower than the landed cost of duty free imported textiles (‘Duty Free Landed Cost’).

4. The period-end unused licenses in hand represent the entitlement to replenish inputs used in the manufacture of exported belts through duty free import of such inputs or purchase of such inputs from the domestic market on deemed export basis. This benefit is given to exporters under the existing Export-Import (EXIM) policy since duty free inputs (either by way of imports or purchase from domestic market on deemed export basis) are to be used for manufacture of finished goods that are to be exported. This export benefit, which the company has earned fully during the year of export, is accounted for in the year itself but physically those licenses may be used in the subsequent years.

5. Year-end unutilised import entitlements are recognised by the company at a value equivalent to the difference between the Domestic Price and the Deemed Export Price on such quantitative entitlements. Management believes that this is appropriate, since most of the company's textile requirements have to be procured from the domestic market (equivalent quantities not being readily available in the international market currently), and hence, the aforesaid difference between Domestic Price and Deemed Export Price is the amount of benefit that is ultimately derived from the import entitlements.

6. For ease of understanding, the querist has given the following example:

| | | |
|---|---|---|
| Year-end duty free import entitlements | : | 100 kgs |
| Domestic Price | : | Rs.155 per kg |
| Duty Paid Landed Cost | : | Rs.150 per kg |
| Duty Free Landed Cost | : | Rs.129 per kg |
| Deemed Export Price-Landed | : | Rs.125 per kg |

According to the querist, at the year-end, the management intends to value the unutilised import entitlements at Rs. 3,000, i.e., 100 @ Rs. 30 per kg (Rs. 155 - Rs. 125).

7. According to the querist, the management is of the view that the above valuation policy is appropriate on the following grounds:

(i) Since the required quantities of textiles of specific quality are not available from the international market readily fulfilling the other commercial terms, the company procured such textiles from the domestic market at Rs. 155/kg. However, the company will ultimately purchase such materials from the domestic supplier at Rs. 125/kg (Deemed Export Price). Textiles will be first procured from the domestic market at Rs. 155/kg and used in the manufacture of textile belts. Once the belt is exported, the company receives an entitlement to replenish the quantity of textiles used in the belt at a price of Rs. 125/

kg. Hence, the difference should be recognised as the value of unutilised benefit.

(ii) The export products' costing is done on the basis of the duty free import or Deemed Export Price, whichever is lower on the assumption that the licenses will be utilised for bringing those textiles for manufacturing finished products. *It may be noted here that Advance Licenses under Duty Exemption Entitlement Certificate (DEEC) scheme are not saleable or transferable to any other party like Duty Entitlement Pass Book (DEPB) scheme or Duty Free Replishment (DFR) scheme.* (Emphasis supplied by the querist.)

(iii) If there are DEPB Licenses (which are readily saleable in the market at face value) in hand, then, the value of those licenses are recognised in the accounts on the basis of their face value, whereas, it is known that the DEPB value represents not only the customs duty but the differences of Domestic and Import prices on an average basis.

(iv) If such unutilised benefits are to be valued at Rs. 21/kg (Rs. 150 – Rs. 129) (as suggested by the auditors), then it will result in an additional benefit of Rs. 9/kg (Rs. 30 – Rs. 21) in the following year. However, such benefit is arising from the export activities and hence, should be recognised in the year in which the belts are exported. The unutilised value of the licenses are kept in "Receivable Account" at the year-end and in the subsequent years when those particular licenses are utilised for bringing the textile (concerned material). Textile costs are taken in the profit and loss account by loading the actual purchase cost with the proportionate amount of this benefit and simultaneously the Receivable Account gets neutralised with the proportionate loading amount.

8. The statutory auditors are of the view that the year-end unutilised import entitlements are to be recognised in the financial statements at a value equivalent to the customs duty benefit to which the company is entitled to on import of textiles in future. The

rate of customs duty to be considered for this purpose should be based on the best estimate of the management regarding the benefit to be derived in future from such entitlements. Based on review of utilisation in the past and review of current orders in hand, there is no concern that the company may not be able to fully utilise such entitlements. Accordingly, as per the auditors, it is appropriate to value year-end unutilised import entitlements at Rs. 2,100, i.e., 100 kgs @ Rs. 21 per kg (Rs. 150 – Rs. 129).

9. According to the querist, the auditors do not agree with the views expressed by the management in paragraph 7 above on the following grounds:

(i) The difference of Rs. 5 per kg between the Domestic Price and the Duty Paid Landed Cost is not arising from exports made by the company but from market conditions existing at the time of purchase. Availability of sufficient quantities of imported textiles is determined by market conditions, and in case such sufficient quantities are available, a user will generally prefer to import textiles since Duty Paid Landed Cost is cheaper than Domestic Price. Consequently, this difference should not be considered for valuation of year-end unutilised export licenses.

(ii) Difference of Rs. 4 per kg between the Duty Free Landed Cost and Deemed Export Price considered by the management for valuation of unutilised licenses at the year-end is not only dependent on transfer of duty free import entitlements to the domestic supplier but also on the price to be negotiated with such supplier for purchases in future and, as such, should not be considered for valuation of year-end unutilised import entitlements. Also, the price negotiated for purchases in future will be guided by market conditions that will exist on the date of such purchases. Consequently, at the year-end, the auditors are unable to form an opinion that there are no significant uncertainties regarding ultimate collectability of the aforesaid difference. In accordance with Accounting Standard (AS) 9, 'Revenue Recognition', issued by the

Institute of Chartered Accountants of India, the aforesaid benefit should not be recognised till such significant uncertainties exist.

(iii) From the above example, it is expected that the company will be able to realise the customs duty benefit of Rs. 21 per kg of imported textiles and hence, year-end unutilised import entitlements should be valued at that rate. *DEEC licenses that are not used for direct imports by the company are generally transferred to a domestic textile supplier for consideration. The consideration receivable for such transfer may exceed the benefit that the company would have derived by importing the textiles itself. However, as explained in point (ii) above, such excess is contingent upon future price negotiations with the domestic supplier.* Also, the treatment of unutilised import entitlements that are intended to be transferred *to a domestic textile supplier* for purchase of textiles at Deemed Export Price should be similar to the treatment when these are intended to be utilised for direct imports by the company. Hence, year-end unutilised import entitlements should be valued at Rs. 21 per kg, being the benefit that is expected to be realised from direct imports by the company. (Emphasis supplied by the querist.)

**B. Query**

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

(i) Whether the basis of valuation of year-end unused export licenses intended to be used for subsequent domestic purchase on deemed export price, adopted by the company is correct.

(ii) Whether the basis of valuation suggested by the statutory auditors is correct.

(iii) If answers to (i) & (ii) above are in the negative, what should be the correct basis of valuation of the year-end unused export licenses.

## C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to valuation of year-end unutilised export licenses on hand. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, the timing of recognition of export benefit, presentation of unutilised licenses in the balance sheet, accounting for DEPB scheme, etc. The Committee has not examined the matter as to whether the company can transfer the benefit under import license to the supplier from whom the company is purchasing the relevant input, since it is an interpretational issue and the Committee is prohibited from giving opinions on such issues. The opinion given hereafter is based on the presumption that such a transfer can be made under the EXIM policy.

12. The Committee notes that in view of the non-availability of sufficient quantity of textiles of specific quality in the international market readily, the company procures them from the domestic market on 'deemed export' basis. By transferring the import entitlement to the domestic supplier, the company is able to purchase the textile item at a cheaper price, i.e., 'deemed export price'. This deemed export price, according to the querist, is lower than, not only the domestic price, but also the duty paid landed cost as well as duty free landed cost.

13. The Committee notes paragraph 4.1 of AS 9, which defines the term 'Revenue' as follows:

> *"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."

The Committee is of the view that the benefit in the form of getting a cheaper price from the domestic supplier as a result of foregoing the right to make direct imports duty free with consequent acquisition of that right by the domestic supplier is not meeting the above definition of revenue. A saving, whether in the form of duty free import or in the form of domestic purchase at a cheaper price, is a reduction in the cost of inventory and is not revenue.

14. The Committee also notes the following paragraphs of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, in respect of the definition of the term 'Asset' and its recognition criteria:

> "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." [Paragraph 49 (a)]
>
> "An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably." [Paragraph 88]

The Committee is of the view that though import entitlements may meet the above cited definition of an asset, it does not meet the recognition criteria cited above. The Committee notes that purchase price is a matter of negotiation between the supplier and the buyer. The mere fact that an intended transfer of an existing duty free import entitlement to the domestic supplier may result in reduction in the purchase price is not a sufficient ground for ascribing a value to that entitlement and recognising the same as an asset. This is because, ultimately, price obtained depends, among other things, on the negotiating power of the parties and the demand-supply position. Further, the Committee does not agree with the querist's contention that once the belt is exported, the company receives an entitlement to replenish the quantity of textiles used in the belt at a specific price (Rs. 125/kg for the example given by the querist). Sometimes, a portion of the benefit, i.e., the customs duty element may be retained by the domestic supplier also. For this reason and for reasons stated above, the Committee does not agree with the statutory auditors' views that customs duty element should be separately isolated and accounted for as revenue. Thus, the value of the entitlement may fluctuate considerably, since it would depend upon many uncertain factors such as demand for imported goods, change in prices of domestic goods, rate of custom duty prevailing at the relevant point of time, etc. Further, the cost of the advance license is not reliably ascertainable.

15. The Committee notes that the examples of intangible assets given in paragraph 7 of Accounting Standard (AS) 26, 'Intangible Assets', include, among other things, licenses and import quotas. The Committee also notes the following paragraphs from AS 26:

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

As already mentioned in paragraph 14 above, the cost of the advance license is not reliably ascertainable. Therefore, the Committee is of the view that the import entitlements represented by the advance licenses cannot be recognised as intangible assets in the balance sheet.

16. The Committee also notes the following paragraphs from Accounting Standard (AS) 2, 'Valuation of Inventories':

> ***"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.***
>
> 7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to

the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase."

17. From the above, the Committee notes that the costs of purchase includes, inter alia, purchase price. Separate accounting of possible reduction in purchase price (or even actual reduction in purchase price of items yet to be procured) as income and subsequently neutralising the same by loading in the purchase price is not permitted under AS 2.

18. Thus, the Committee is of the view that for the unutilsed export licenses on hand, which are to be subsequently used for domestic purchase at deemed export price, no value should be ascribed. The actual purchase price will form part of costs of purchase.

**D. Opinion**

19. On the basis of the above and subject to the presumption stated in paragraph 11 above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

(i) The basis of valuation of year-end unused export licenses intended to be used for subsequent domestic purchase at deemed export price, adopted by the company is not correct.

(ii) The basis of valuation suggested by the statutory auditors is also not correct.

(iii) No value should be ascribed to the licenses mentioned in (i) above.

## Query No. 30

***Subject:*** ***(i) Reimbursement of hometown settlement expenses on retirement,***

***(ii) Post retirement medical facilities, and***

***(iii) Employee Family Benefit Scheme.***[1]

### A. Facts of the Case

1. A company which is a Government of India enterprise under the Ministry of Steel, is an engineering, consultancy and contracting organisation, offering a full range of services required for setting up of projects from concept to commissioning including turnkey execution. The company is a multi-disciplinary company having a network of offices spread all over the country experienced in handling consultancy assignments and Engineering, Procurement, Construction and Commissioning (EPC) projects. As per the querist, the company has played a significant role in the development and expansion of Indian industry. The company is an ISO: 9001: 2000 company and it is registered with international financial institutions like World Bank, Asian Development Bank, African Development Bank and has technological tie-ups with the world leaders.

2. The company had been consistently following Accounting Standard (AS) 15, 'Accounting for Retirement Benefits in the Financial Statements of Employers' (issued 1995), up to the financial year 2006-07. In addition to the normal retirement benefits like provident fund, pension, gratuity, leave encashment, etc., the company provides some additional benefits which, as per the querist, are purely discretionary in nature, like the following:

**(i) Hometown settlement on separation from the services of the company**

As per the prevailing practices/rules of the company, employees are entitled to reimbursement of hometown settlement expenses on separation from the services of the company. Further, as per the rules of the company,

[1] Opinion finalised by the Committee on 30.1.2008.

an employee is allowed to change his place of hometown once in the service period. The company has its offices and project sites at different places in the country and any employee may be posted at any office at any time during his service period. Depending upon the place of posting at the time of separation, the declared hometown of the employee, number of dependants of employee and mode of travel (i.e., by train, air, etc.), the extent of the employer's liability varies from case to case.

**(ii) Post-retirement medical facilities**

As per the prevailing practices/rules of the company, employees are entitled to get post-retirement medical facilities as per their choice. The employees may opt either to avail medical facilities at the company's hospital or to get a fixed amount per annum (presently Rs. 2400/- per family) for this purpose. They are free to change their option also. Depending upon the place of settlement of the employee after separation and the option preferred by the employee, the extent of the employer's liability varies from case to case.

**(iii) Employee Family Benefit Scheme**

Employee Family Benefit Scheme is a voluntary scheme. On separation of an employee from the service of the company on account of death or permanent total disablement, his nominee/the employee, as the case may be, on depositing with the company the entire amount of provident fund and gratuity of the employee, would be entitled to monthly payments equivalent to the last drawn basic pay plus dearness allowance in respect of non-executive employees and 1.15 times of only basic pay in respect of executive employees as per the Scheme. Such monthly payments shall continue till the normal date of superannuation of the employee. The employee/nominee shall deposit in lumpsum, the amounts of provident fund and gratuity with the company, after the same are settled by the employer, as per rules. In some cases, the employees may have effected temporary/permanent withdrawals from the provident fund or may like to retain part of such funds to meet their family commitments. In such cases, the monthly payment admissible will be reduced in the same proportion which the shortfall in the provident fund accumulation at the time of death of the employee bears to the total of the gratuity and notional provident fund which would have accrued, had the withdrawal not been made. The notional provident fund would consist of the employee's own contribution over the period of his service, interest accrued thereon and the employer's matching contribution with interest accrued thereon, but will not include any voluntary contributions made by the employee and the interest accrued thereon. The notional provident fund would be worked out as if there had not been any temporary/permanent withdrawal over the period of his service. On the normal date of superannuation of the employee, the monthly payments under this Scheme would cease and the amount deposited with the company under this Scheme would be refunded to the depositor or his/her nominee, as the case may be. Under the Scheme, no interest on the provident fund and gratuity deposits will be admissible for the period of deposit. The benefit under the Scheme will be admissible from the date of separation of the employee. The payment to the employee/nominee shall, however, start from the date of deposit of the amount.

If the employee/nominee desires to permanently withdraw the provident fund and gratuity amount deposited with the company under the Scheme at any point of time, he/she will be allowed to do so. In such cases, the employee/nominee would cease to receive the benefit under the Scheme from the date of withdrawal.

As per the querist, the company's Employee Family Benefit Scheme is an employee welfare scheme and not a retirement benefit scheme.

3. The querist has informed that as per his understanding, AS 15 applies to those retirement benefits which are either in the

nature of defined contribution scheme or in the nature of defined benefit scheme. AS 15 does not apply to those retirement benefits for which the employer's obligation cannot be reasonably estimated.

4. According to the querist, the company is following AS 15 and all benefits under defined contribution schemes like provident fund, pension, etc., and under defined benefit schemes like gratuity and leave encashment, are strictly complied with as per the guidelines of AS 15. The benefits like settlement of retired employees to their hometown, post-retirement medical facilities and Employee Family Benefit Scheme are discretionary on the part of the management and undergo changes from time to time. They can be withdrawn/modified/curtailed at any time. As per the querist, these benefits cannot be strictly classified either into defined contribution scheme or defined benefit scheme and the employer's obligation cannot be reasonably estimated. In view of this, expenses on account of these facilities are accounted for on actual basis. This policy is being followed by the company consistently over the years and is also disclosed in the Notes to Accounts.

5. The querist has also informed that Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005), is under implementation in the company from the financial year 2007-08 and all the schemes described above will be addressed properly and the necessary accounting treatment would be followed in compliance with AS 15 (revised 2005).

**B. Query**

6. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the accounting treatment followed by the company for the following retirement benefits amounts to a deviation from AS 15 (issued 1995):

(i) Reimbursement of hometown settlement expenses on retirement,

(ii) Post-retirement medical facilities, and

(iii) Employee Family Benefit Scheme.

## C. Points considered by the Committee

7. The Committee notes that the query relates to accounting for the three schemes (specified in paragraph 6 above) provided by the company to its employees in addition to provident fund, pension, etc. In respect of Employee Family Benefit Scheme, the Committee also notes that the querist is of the view that such a scheme is a welfare scheme and not a retirement benefit scheme. The Committee disagrees with the querist and in this regard notes the following definition of 'retirement benefit schemes' given in AS 15 (issued 1995):

> "*Retirement benefit schemes* are arrangements to provide provident fund, superannuation or pension, gratuity, or other benefits to employees on leaving service or retiring or, after an employee's death, to his or her dependants."

8. From the Facts of the Case, the Committee notes that the benefits under the said Scheme are provided on the permanent disability of the employee, which in effect are 'benefits to employees on leaving service', or are provided in the event of the death of the employee while in service to his dependants. As the said Scheme is within the meaning of the above stated definition, the Committee opines that Employee Family Benefit Scheme is a retirement benefit scheme.

9. The Committee further notes paragraph 2 of AS 15 which states as below:

> "2. Retirement benefits usually consist of:
>
> (a) Provident fund
>
> (b) Superannuation/pension
>
> (c) Gratuity
>
> (d) Leave encashment benefit on retirement
>
> (e) Post-retirement health and welfare schemes
>
> (f) Other retirement benefits.

> This Statement applies to retirement benefits in the form of provident fund, superannuation/pension and gratuity provided by an employer to employees, whether in pursuance of requirements of any law or otherwise. It also applies to retirement benefits in the form of leave encashment benefit, health and welfare schemes and other retirement benefits, if the predominant characteristics of these benefits are the same as those of provident fund, superannuation/pension or gratuity benefit, i.e. if such a retirement benefit is in the nature of either a defined contribution scheme or a defined benefit scheme as described in this Statement. This Statement does not apply to those retirement benefits for which the employer's obligation cannot be reasonably estimated, e.g., ad hoc ex-gratia payments made to employees on retirement."

10. From the above, the Committee notes that AS 15 also applies to those retirement benefits other than provident fund, pension, gratuity, etc., provided that such benefits possess the characteristics of a defined contribution scheme or a defined benefit scheme. However, in the present case, the querist is of the view that the additional retirement benefit schemes provided by the company are neither of the nature of a defined contribution scheme nor of the nature of a defined benefit scheme. In this context, the Committee notes the definitions of 'defined contribution schemes' and 'defined benefit schemes' as per AS 15 given as under:

> *"Defined contribution schemes* are retirement benefit schemes under which amounts to be paid as retirement benefits are determined by contributions to a fund together with earnings thereon."
>
> *"Defined benefit schemes* are retirement benefit schemes under which amounts to be paid as retirement benefits are determinable usually by reference to employee's earnings and/or years of service."

11. The Committee notes that the definition of 'defined benefit schemes' states that the retirement benefits are 'usually' determinable by reference to the employee's earnings and/or years of service. The Committee is of the view that the use of the word

'usually' in the definition, suggests that a scheme can be defined in some other manner also.

12. In view of the above, and the Facts of the Case, the Committee is of the view that reimbursement of hometown settlement expenses on retirement, post retirement medical facilities, and Employee Family Benefit Scheme are defined benefit schemes as in each of the three schemes the company assumes the obligation to provide agreed benefits to the employees as follows:

(i) In respect of hometown settlement retirement benefit, the agreed benefit is the reimbursement of the expenses incurred by the retiring employee on settlement to his/her hometown.

(ii) In case of post-retirement medical facilities, the retiring employees enjoy the benefit of medical facilities either by way of availing the same at the company's hospital or by way of a fixed yearly amount. In this case, though the benefit depends on the option exercised by the employee, the basic agreed upon benefit is the provision of medical facilities upon retirement. Thus, in this sense, the benefit is defined.

(iii) With regard to the Employee Family Benefit Scheme, the benefit is defined in terms of what the employee/nominee is entitled to receive every month till the date of the deemed retirement of the employee and on the date of the deemed retirement. In this case, the amount of the benefit to be received every month is based on employee's earnings.

13. The Committee further notes paragraphs 10 and 12 of AS 15 which state the following with regard to defined benefit schemes:

> "10. Defined benefit schemes, especially those that promise benefits related to remuneration at or near retirement, present significant difficulties in the determination of periodic charge to the statement of profit and loss. The extent of an employer's obligation under such schemes is usually uncertain and requires estimation. In estimating the obligation, assumptions

may need to be made regarding future conditions and events which are largely outside the employer's control."

"12. The cost of retirement benefits to an employer results from receiving services from the employees who are entitled to receive such benefits. Consequently, the cost of retirement benefits is accounted for in the period during which these services are rendered. Accounting for retirement benefit cost only when employees retire or receive benefit payments (i.e., as per pay-as-you-go method) does not achieve the objective of allocation of those costs to the periods in which the services were rendered."

14. From paragraph 10 of AS 15 reproduced above and the Facts of the Case, the Committee notes that difficulties may arise in the estimation of the amount of the additional retirement benefit schemes provided by the company which are in the nature of defined benefit schemes. The Committee further notes that in accordance with the requirements of AS 15, the company's obligation exists towards providing the employees benefits in exchange for the services rendered by them during the tenure of their service and even though in the present case the retirement benefit schemes are discretionary by the management which are subject to changes/modifications, the company is required to provide these benefits. Accordingly, as per paragraph 12 of AS 15, the amount of the benefits should be allocated on a reasonable basis, during the tenure of the service and should not be accounted for on actual basis. Thus, the Committee is of the view that mere difficulty in the estimation of the amount of retirement benefits does not relieve the company from its responsibility of making provision for such benefits, and as these benefits accrue to the employees as a result of the services provided over their tenure, the cost of such benefits to the company should also be spread over their tenure on a reasonable basis by using actuarial methods.

15. The Committee further notes that as per paragraph 4.3 of the 'Preface to the Statements of Accounting Standards', accounting standards are intended to apply only to material items. Accordingly, the Committee is of the view that in case the amounts involved are not material, the requirements of AS 15 would not be applicable.

Hence, in such a scenario, the company may account for the additional retirement benefits in question differently, provided the method followed is reasonable having regard to the facts and circumstances of the case and is followed consistently.

## D. Opinion

16. Based on the above, the Committee is of the opinion that the accounting treatment followed by the company in respect of the retirement benefit schemes stated in paragraph 6 above, is not in accordance with the requirements of AS 15. These schemes are defined benefit schemes and should be accounted for as per paragraph 15 above, unless the amounts involved are not material.

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***Query No. 31***

***Subject: Accounting for purchase and sale of mobile handsets by a subsidiary of a telecommunication service-provider company, in the separate financial statements of the subsidiary and in the consolidated financial statements.[1]***

## A. Facts of the Case

1. Company B is engaged in the business of providing infrastructure and marketing services for the telecommunication industry. Company B is a 100% subsidiary of Company A, which is a listed public company engaged in the business of providing telecommunication services in India under a telecom license.

2. The 'wireless' business segment contributes about 75% towards the total revenue of Company A on a consolidated basis. Company A provides wireless telephony services by using Code Division Multiple Access (CDMA) technology. The services are

[1] Opinion finalised by the Committee on 30.1.2008.

provided through wireless telephone handsets, which are dedicated to the network of the telecom service provider (as against Global System for Mobile Communications (GSM) handsets which can be used on any GSM network by changing the Subscriber Identity Module (SIM) Card provided by the telecom operator). As per the marketing arrangements between Company A and Company B, all telephone subscribers are provided with the mobile connectivity through Company A's network (pursuant to holding a telecom license) and the wireless handsets are provided by Company B.

3. Company B procures handsets from third party vendors and sells them to third party distributors/dealers and retailers. All these transactions are on a principal to principal basis. Company B sells these handsets to the distributors/dealers and retailers at a significant discount on the Maximum Retail Price (MRP). The Company gets a Value Added Tax (VAT) credit on purchase and pays VAT on sale of the handsets. The prices are reviewed on a monthly basis. The historical data shows that these prices have always been significantly lower than the cost at which Company B acquired handsets from third party vendors.

4. The querist has informed that in the stand-alone financial statements of Company B, the sale of handsets is netted off against the purchase cost and the excess of purchase cost over sale proceeds is included in the 'Sales and Distribution Expenses', which are disclosed on a net basis in the profit and loss account. In the consolidated financial statements of Company A, from the Group's point of view, the following note appears in the notes to the consolidated financial statements:

> "One of the main businesses of the Group is operating Mobile Telecom Network. The Group is not engaged in the business of trading in handsets required for accessing the Mobile Telecom Network and consequently, purchases and sales of handsets are not reflected as a trading activity. However, the Group is required to provide such handsets to its customers as a part of the marketing activity related to the Mobile Telecom Network. The Group, therefore, provides such handsets after purchasing them, the provision normally, being at a discount to the acquisition price. The net loss on the provision of

handsets, including subsidies/commission given to distributors and dealers, amounting to Rs. XXX is included as a part of Selling Expenses".

Further, the querist has mentioned that this view is based on the argument that from the Group's point of view, the purchase and sale of handsets (at a conscious loss) is purely from the point of view of acquiring a customer on the network. Hence, the excess of purchase cost of handsets over the amount recovered from the subscriber should be disclosed as selling and marketing cost in the stand-alone profit and loss account of Company B and in the consolidated profit and loss account. This view is based on the substance of the transaction.

5. The querist has mentioned that there is a contrary view according to which the sale and purchase of handsets should be disclosed on a gross basis in the stand-alone profit and loss account of Company B and consequently, in the consolidated profit and loss account of the Group. This view is based on the following:

(i) Accounting Standard (AS) 9, 'Revenue Recognition', clearly 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. Sale of handsets clearly falls within this definition.

(ii) Not showing purchases and sale of handsets separately would also not be in consonance with the requirements of Part II of Schedule VI to the Companies Act, 1956. The sale of handsets is a sale as per law. This sale is a part of the operating activities of the Group without which the telephony service cannot be provided.

(iii) Sale of handset at a loss to customers is a part of a bundled contract, where such a sale is made at a loss in anticipation of the profit that the company will earn based on future usage by the customer.

(iv) A specific value/benefit is delivered to the company's customer and is not a general expense incurred towards promotion of the company's products.

(v) These are considered as sale and purchase from the perspective of sales tax/VAT laws. The company should not take a different view in determining the nature of the transaction for accounting in its books.

(vi) The handset is an essential element in provision of telecom services by the Group and it would therefore not be appropriate to view the provision of the same to the customers as just a marketing activity. Further, it can also be argued that the handsets sold by the Group are unique to its network and in substance the Group looks at the total recoveries from a customer and not at the break-up of these recoveries between those for handsets and those for services. Purchase and sale of handsets is thus an essential part of the operating activities of the Group.

(vii) Net reporting of revenue is an exception rather than a rule and therefore, may not be resorted to unless there is a clear support for the same. Such support does not seem to be available for offsetting sales to customers against purchases from suppliers of handsets.

6. The querist has provided the following views that support the disclosure of handset expenses as a marketing expense:

(i) AS 9 and Schedule VI require disclosure of gross revenue. They do not require disclosure of partial recoupment of "cost" as revenue. In substance, the company is required to provide at its cost, handsets to its customers as there is no independent market where customers can acquire handsets. Therefore, it would be necessary to provide the handsets to customers before the company can sell airtime. The company would have to incur the capital "cost" of handset, permit use and recover the handset from the customer getting out of the network. In fact, the company follows this route on sale of fixed line telecom services. But given the volume of mobile customers, it is practically impossible to keep track of handsets. The company therefore gives away the handset, safe in the knowledge that the customer cannot do anything else with the handset as it can only be used on the company's network. The company is able to recoup a part of the cost of the handset from the customers. It is clearly not a "sale" price. It is impossible to conceive that as a consistent long term policy a business is carried on, on the basis that the "sale price" is lower than "cost". The recovery from the customer is not "sale price", it is recoupment of cost. The unrecouped cost is correctly written off as a marketing expense.

(ii) Disclosure of sale price as part of trading business will result in incorrect information to the reader of the financial statements. It will imply that the company is in the business of "trading" in handsets whereas the company is not engaged in such a business unlike manufacturers and dealers of handsets (mostly GSM handsets of general use). Schedule VI refers to the turnover of goods "dealt in" by the company. Handsets are not such goods.

(iii) The bundled service concept does not apply in case of the company as it does not insist that the customer who buys the handsets (and therefore is the recipient of a subsidy) should have a long term contract with the company. The customer is free to stop paying for the network services at any time. The company may not recover the balance of the marketing loss. The company thus gives an upfront subsidy to attract a customer. The company is able to reduce the upfront subsidy from an amount equal to the entire cost of the handset (it would have to give the handset free if it wants to sell airtime) to a lesser amount as customers are willing to reimburse (pay for) a part of the cost incurred by the company. The customers have no interest in buying handsets as they (the handsets) have no other use except on the company's network. What the customer pays is not really the price of the handset. It is a product which has no other use to him.

(iv) Handsets are capital equipment. A part of the capital cost is recovered from the customer. The balance of the cost is written off as a marketing expense as the company has given up the ownership of the asset. This is the essence of the accounting treatment adopted by the company. To reflect this as a trading activity would be contrary to the truth.

(v) The law relating to VAT is based on different concepts and cannot be used to determine accounting principles.

(vi) It is true that net reporting of revenue is an exception. But an item which is not revenue cannot be reported as revenue. Gross reporting of recoupment of capital cost as revenue would be incorrect accounting. The company's method of accounting does not report net revenue. It reports "expense" or "loss" and correctly reports the net expense or loss suffered by the company. The error is in approaching an expense item as a revenue item. As an expense item, it is correct and normal to report net expense, net of recoveries. That is the method followed. It is not an exception. It is normal accounting.

**B. Query**

7. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the current accounting policy for disclosure of net loss on the supply of handsets to airtime customers as marketing expenses in the profit and loss account is appropriate or should purchase and sale of handsets be disclosed separately as constituting trading turnover of products dealt in by Company B.

**C. Points considered by the Committee**

8. At the outset, the Committee wishes to clarify that the opinion sought by the querist relates to the accounting policy for the

disclosure of mobile handset expenses to be adopted in the preparation and presentation of the stand-alone financial statements of Company B and the consolidated financial statements of the Group. The Committee also wishes to state that the opinion given hereinafter is based on the extant generally accepted accounting principles in India.

*Stand-alone Financial Statements of Company B*

9. The Committee notes the definition of the term 'revenue' as per Accounting Standard (AS) 9, 'Revenue Recognition', which is reproduced below:

> "4.1 *Revenue* is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

10. The Committee notes that insofar as Company B is concerned, under its arrangements with the company A, it is engaged in the business of purchase and sale of mobile handsets, even though at a loss. For Company B, it is an ordinary activity. Hence, gross inflows from the sale proceeds of Company B is 'revenue arising in the course of ordinary activities' as per the definition of 'revenue' in AS 9 which is reproduced above.

11. The Committee notes that selling and distribution expenses are costs incurred to sell (e.g. advertising) and distribute (e.g., freight-out) goods. Excess of purchase price over sale proceeds of handsets is not in the nature of selling and distribution expenses for Company B; instead, sale of handsets represents revenue to Company B as per AS 9.

12. The Committee notes the argument given in paragraph 6(i) for disclosing excess of purchase price of handsets over the sale proceeds as selling and distribution expenses. As per the argument,

it is contended that the sale price of the handset, which is at discount, amounts to partial recoupment (recovery) of cost and not revenue. The Committee is of the view that sale of handsets even though it is at a discount represents revenue as the same represents 'charges made to customers for goods supplied'. Therefore, any amount recovered from the customers for sale of goods even at a lower amount is revenue. Further, it can be argued that revenue in all cases is recoupment of costs, with or without a return.

13. The Committee also notes the requirements of Part II of Schedule VI to the Companies Act, 1956, with regard to disclosure of revenue (turnover) as follows:

> "3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:
>
> (i)(a) The turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately…"

14. The Committee notes that the querist has contended that one reason for the current accounting policy being pursued is that the handsets do not represent the 'goods dealt with by the company' as contemplated in the above requirements of Schedule VI. The Committee disagrees with this reasoning given by the querist and is of the view that as far as Company B is concerned, it purchases and sells handsets, which amounts to handsets being the goods dealt with by the company.

*Consolidated Financial Statements*

15. The Committee notes that Accounting Standard (AS) 21, 'Consolidated Financial Statements', requires in paragraph 13, inter alia, as follows:

> ***"13. In preparing consolidated financial statements, the***

> ***financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses".***

Thus, once the separate financial statements of Company B recognise the purchase and sale of mobile handsets on a gross basis as discussed in the above paragraphs, the consolidated financial statements would be prepared merely by adding the purchases of Company B with the purchases of Company A and the sales of Company B with the sales of Company A, resulting in recognition of purchase and sale of handsets in the consolidated financial statements.

## D. Opinion

16. On the basis of the above, in respect of the issue raised in paragraph 7, the Committee is of the opinion that the accounting policy of netting off the proceeds from the sale of handsets against their purchase price and disclosing the excess of the purchase price over the sale proceeds as selling and distribution expenses is incorrect. The correct accounting policy is to disclose purchase and sale of handsets separately in the stand-alone profit and loss account of Company B and in the consolidated profit and loss account.

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***Query No. 32***

***Subject: Capitalisation/decapitalisation of exchange loss/ gain.[1]***

## A. Facts of the Case

1. A public sector company is owned by the Government of India coming under the administrative control of the Ministry of

[1] Opinion finalised by the Committee on 30.1.2008.

Coal. The company is engaged in the business of production of lignite and generation of power. The present capacity of the mine is 24 million tonnes per annum and 2490 MW of thermal power generation. The company is in the phase of expansion from 24 million tonnes to 30.6 million tonnes of lignite and from 2490 MW to 3240 MW of power generation.

2. The company has entered into an agreement for a foreign currency loan, in respect of its expansion projects requirements for 50 million Euros under the External Commercial Borrowing route with XYZ Bank, Singapore. During the year 2006-07, the company has drawn 34.58 million Euros in two trenches on various dates. The loan balance has been reinstated with the exchange rate prevailing on 31st March, 2007. As on 31st March, 2007 there was a reduction in the exchange rate for Euro, thereby the liability of the loan has been reduced by Rs. 2.76 crore. The credit effect has been given in the profit and loss account under the head 'other income' and the same has been transferred to the expenditure during construction as an abatement since the projects for which the loan has been drawn are in the construction stage.

3. The querist has informed that the entries made in the company's books of account in this regard are as follows:

| | Dr. | Cr. |
|---|---|---|
| Foreign Currency Loan Account | xxxx | |
| Other Income - Exchange Rate Variation (P&L A/c)<br>(Income accounted for on account of exchange rate variation on foreign currency loan) | | xxxx |
| Expenditure Transferred to Capital Account (P&L A/c) | xxxx | |
| Capital Work-in-Progress<br>(Foreign Exchange rate variations abated to Capital Work-in-Progress during the period of construction) | | xxxx |

4. The querist has stated that as per the pre-revised Accounting Standard (AS) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates' (1994), the foreign exchange rate variation of the nature described above has been identified with the respective assets to which the loan pertains and capitalised or abated as the case may be. Further, according to the querist, this treatment is in line with Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. The querist has referred to paragraph 9.3 of AS 10, issued by the Institute of Chartered Accountants of India, which states as follows:

> "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".

5. The querist has drawn the attention of the Committee to paragraph 5.1 of the Guidance Note on Treatment of Expenditure During Construction Period[2] issued by the Institute of Chartered Accountants of India, which states as follows:

> **"5. Indirect Expenditure Incidental and Related to Construction**
>
> 5.1 … expenditure is that, for a running concern, it would be of a revenue nature. However, because the expenditure is incurred during the construction period and because during that period, the expenditure is indirectly related to construction and is incidental thereto, it should be capitalised as part of the construction cost."

The querist has stated that it may be noted that all revenue expenditures, such as, salary and wages of the employees engaged in the construction, depreciation of the machinery used in the

[2] The Guidance Note has since been withdrawn pursuant to the decision of the Council at its 280th meeting held on August 7-9, 2008.

construction, interest on the loan taken for the project, stores & spares and other administrative expenditure incurred during the period of construction is being capitalised. Likewise any income, such as, interest on short term investment of the fund raised for the project, test and trial run revenue and other miscellaneous receipts are abated to the capital cost of the project.

6. The querist has stated that as per paragraph 13 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' (revised 2003), ***"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. ...".*** Hence, the exchange rate variance is an item of income or expenditure as the case may be. Since this has been incurred during the period of construction, this should be either added or abated to the capital cost as the case may be.

7. The querist has further informed that the joint statutory auditors of the company in their audit report have commented upon the non-compliance of AS 11 stating that the non-recognition of the exchange fluctuation on foreign currency loan in the profit and loss account as per revised AS 11, has resulted in the understatement of current year's profit by Rs. 2.76 crore and the understatement of capital work-in-progress by the same amount. The auditors' observation is based on the premise that AS 11 specifically states that foreign exchange rate variations should be recognised as income or as expenses in the period in which they arise and it is not concerned with capitalisation of the same during the construction period as in the case of borrowing cost as per Accounting Standard (AS) 16, 'Borrowing Costs', where the interest during the construction period is capitalised. The querist contends that the considered view of the company is that expenditure or income attributable to capital projects still in the construction stage should be added or abated to capital cost as incidental expenditure during construction. AS 11 should not be read in isolation and instead it should be read with AS 10 as well as with the Guidance Note on Treatment of Expenditure During Construction Period.

## B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the exchange rate variations on the foreign currency loan taken/foreign currency liability incurred for the project, during the period of construction should be capitalised or abated, as the case may be, as incidental expenditure during construction.

## C. Points considered by the Committee

9. The Committee wishes to state at the outset that the opinion given hereinafter is on the facts of the query as stated above.

10. The Committee notes paragraph 9.3 of AS 10 as reproduced by the querist in paragraph 4 above and paragraph 21 of AS 10, which states that *"**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**".* The Committee notes that in the context of interest, AS 16 lays down the principles with regard to which borrowing costs should be considered as attributable to the construction activity[3]. With regard to the issue raised by the querist, the Committee notes that paragraph 4(e) of AS 16 considers that the exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs, are regarded as the borrowing costs for the purpose of that Standard.

11. In the context of the issue raised by the querist, the Committee also notes from paragraph 6 of AS 11 (revised 2003), that exchange differences arising under paragraph 4(e) of AS 16 are excluded from AS 11 (revised 2003).

12. The Committee notes that paragraph 4(e) of AS 16, as notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, provides that borrowing costs include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest

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[3] The Committee notes that the portion of paragraph 20 of AS 10 related to capitalisation of borrowing costs was withdrawn on AS 16 coming into force.

costs. The Committee further notes that the 'Explanation' to the said paragraph provides as below:

> "Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings costs to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, The Effects of Changes in Foreign Exchange Rates. For this purpose, the interest rate for the local currency borrowings is 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."

Thus, the Committee notes that exchange loss on foreign currency borrowings is capitalised to the extent described above.

13. With respect to the foreign exchange gain arising on the foreign currency borrowings, the Committee is of the view that the same should be reduced from the cost of the fixed asset to the extent the exchange loss has been capitalised as per the provisions of paragraph 4(e) of AS 16. Any excess exchange gain should be accounted for as income for the year in which the same arises. Since borrowing costs can be capitalised only with respect to a qualifying asset as per AS 16, the Committee is further of the view that the decapitalisation can be done only during the period of construction of the asset, i.e., only with respect to a qualifying asset as per AS 16.

**D. Opinion**

14. On the basis of the above, the Committee is of the opinion that foreign exchange loss on the foreign currency loan can be capitalised only to the extent as envisaged under paragraph 4(e) of AS 16. Any excess exchange loss should be expensed in the

profit and loss account. The exchange gain with respect to a qualifying asset under AS 16 can be adjusted to the cost of the fixed asset only to the extent exchange loss was capitalised under paragraph 4(e) of AS 16. The exchange gain in excess of such adjustment should be treated as income in the profit and loss account of the year in which the same arises.

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***Query No. 33***

***Subject: Accounting for the effects of changes in foreign exchange rates as per AS 11.***[1]

## A. Facts of the Case

1. A listed government company is carrying on a business of operating ships. The company does not have any subsidiary company.

2. The company formed a joint venture company Z in March 2006 along with other five joint venture partners. As per the querist, Z is a jointly controlled entity as described in Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', issued by the Institute of Chartered Accountants of India. Z is incorporated at Malta. The company holds 26% stake in company Z which has been shown as investment. The company has also advanced US $ 22 million to Z. Out of this advance, US $ 7 million was a temporary finance arrangement for Z and the same was realised by the company on 22.04.2007. The balance US $ 15 million advanced to Z is in the nature of shareholder's loan to be repaid by Z. Accordingly, the same has been shown by the company under the head 'Amount Advanced to Joint Venture Companies'.

3. Z will construct and own one LNG tanker and the same will be chartered under a long term 'Time Charter Agreement 25 years'

[1] Opinion finlaised by the Committee on 30.1.2008.

upon delivery of the tanker in September 2009. The balance advance of US $ 15 million will be realised by the company over the period of operations of Z. The querist has separately informed that the loan is in the nature of shareholder's contribution towards project cost for which there is no separate repayment schedule. Repayment of loan is dependent on the net surplus cash flow generated by the joint venture company from operation of ship owned by it. The querist has also informed that the company has not hedged the risks in respect of the foreign currency loans advanced to the joint venture company, through any hedging instruments. The company has a large number of foreign currency receipts and payments and the amount of foreign currency payments are more than foreign currency receipts in a year. Therefore, as per the querist, it cannot be said that there is any natural hedge. Meanwhile, the company is earning interest on the amount advanced at the bank rate or LIBOR + 80 bps, whichever is higher, on the amount advanced.

4. The exchange differences on the amount advanced to Z were being debited by the company to the profit and loss account till financial year 2006-07. The company has also been accounting for interest received/receivable on the advances as income in its books of account.

5. Apart from Z, the company has two other joint venture companies X and Y incorporated at Malta. X and Y were formed before 01.04.2004. The company has advanced shareholder's loan to these companies on terms similar to the advance to Z. These advances were made before 01.04.2004.

6. The exchange differences on the amounts advanced to X and Y were also being debited to the statement of profit and loss by the company till 31st March, 2004, i.e., till the financial year 2003-04. The company had also been accounting for interest received/receivable on the advances as income in its books of account in those years.

## B. Query

7. The querist has sought the opinion of the Expert Advisory Committee on the following issues in respect of accounting by the company,

*Regarding Z:*

(a) What should be the accounting treatment of the exchange differences arising on the advance of US $ 22 million to Z?

(b) Whether this exchange difference can be recognised in the statement of profit and loss.

(c) Whether it should be taken to foreign currency translation reserve as per paragraphs 15 and 16 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', (revised 2003).

(d) In case of the company, there is a foreign currency loss on the amount advanced to Z. Currently, there is no balance in the foreign currency translation reserve. In case, it is opined to transfer the exchange differences on amount advanced to Z to foreign currency translation reserve, the foreign currency translation reserve account will have a debit balance. Whether this reserve can have a debit balance. If so, how should it be disclosed in the balance sheet?

(e) Whether the treatment will be different for exchange differences on US $ 15 million and US $ 7 million as per paragraph 16 of AS 11 (revised 2003) which distinguishes between long-term receivables or loans and trade receivables or trade payables (temporary finance arrangements vis-à-vis long-term loan arrangements).

(f) Whether paragraph 24 of AS 11 (revised 2003) is applicable to the company which deals with translating the financial statements of non-integral foreign operations for its incorporation in the reporting enterprise's financial statements.

(g) If the answer to (c) above is in the affirmative, what could be the accounting treatment from 01.04.2007 in the light of the fact that the company has treated such exchange differences as revenue and charged to the statement of profit and loss in the earlier years.

*Regarding X and Y:*

(h) What should be the accounting treatment for exchange differences arising on the advance given prior to 01.04.2004 as per Accounting Standard (AS) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates' (revised 1994) and after 01-04-2004, as per AS 11, 'The Effects of Changes in Foreign Exchange Rates' (revised 2003)?

(i) Whether this exchange difference can be recognised in the statement of profit and loss.

(j) Whether it should be recognised in foreign currency translation reserve as per paragraphs 15 and 16 of AS 11 (revised 2003).

(k) Whether paragraph 24 of AS 11 (revised 2003) is applicable to the company.

**C. Points considered by the Committee**

8. The Committee wishes to state that it has considered only the issues raised in paragraph 7 of the query. Accordingly, it has not considered the question as to whether the joint ventures in question should be considered as jointly controlled entities within the meaning of AS 27 since that issue has not been raised. The Committee's opinion is based on the presumption that the said joint ventures are jointly controlled entities within the meaning of AS 27.

*Regarding Z*

9. The Committee notes that in order to determine the accounting treatment of exchange differences arising on the amount advanced to the joint venture, three issues need to be addressed. First: Whether the loan advanced is monetary or non-monetary item. Second: Whether the operations of the joint venture are integral or non-integral to the operations of the company. Third: If operations of the joint venture are non-integral to the operations of the company, whether the amount advanced, in substance, forms part of the company's net investment in the joint venture.

10. The Committee notes the definition of the term 'monetary items' given in Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' (revised 2003), which provides as below:

> ***"Monetary items** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money."*

11. On the basis of the above, the Committee is of the view that loan advanced to the joint venture is a monetary item because amount to be received is fixed.

12. In order to determine whether the operations of the joint venture are integral or non-integral to the operations of the company, the Committee notes the following definitions, and paragraphs 18 to 20 of AS 11 (revised 2003):

> ***"Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise."***
>
> ***"Non-integral foreign operation is a foreign operation that is not an integral foreign operation."***
>
> "18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.
>
> 19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign

currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

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

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

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

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

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

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

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

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

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

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

13. The Committee notes from the Facts of the Case that the querist has not supplied information relevant for the above paragraphs of AS 11 to decide whether the joint venture in question is an integral or a non-integral foreign operation. The Committee is, therefore, of the view that the querist/company should apply the criteria specified in the above paragraphs to decide whether the joint venture is integral or non-integral.

14. The Committee notes paragraphs 13, 15, and 16 of AS 11 (revised 2003), dealing with recognition of exchange differences which are reproduced below:

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

**"Net Investment in a Non-integral Foreign Operation**

***15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in***

> ***the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.***
>
> 16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables."

15. In case the operations of the joint ventures are non-integral, the Committee is of the view that before determining accounting treatment of exchange differences, there is a need to determine whether the loan advanced to the joint venture, in substance, forms part of the company's net investment in the joint venture. The Committee notes from the Facts of the Case that the amounts are advanced as shareholder's loan and though there is no separate repayment schedule, the loan is repaid over the period of operations of joint venture(s) out of the surplus cash flow generated from the operations. Accordingly, it can be said that the repayment of loans is planned and is foreseeable. Thus, such loans are not of the nature of net investment in the joint venture. Temporary advances in any case are not of the nature of net investment in the joint venture. Therefore, the Committee is of the view that though shareholder's loan of US $ 15 million is long-term, but since its settlement is foreseeable, in substance, it does not form part of the company's net investment in joint venture. The Committee is, thus, of the view that the loan advanced is not covered by the treatment prescribed in paragraph 15 of AS 11. Accordingly, exchange differences arising on the loan advanced should be recognised as income or as expense as per paragraph 13 of AS 11.

*Regarding X and Y:*

16. With regard to the loans advanced before 1-4-2004, the Committee notes the applicability paragraph of AS 11 (revised 2003), reproduced below:

> "Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates (revised 2003), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable."

17. On the basis of the above, the Committee is of the view that advances given to joint ventures should be considered as 'transactions' for the purpose of application of AS 11 (revised 2003). Accordingly, if loan was advanced before AS 11 (revised 2003) coming into effect, i.e., before 1-4-2004, provisions of AS 11 (revised 1994) would apply to the exchange differences arising on such advances.

18. For advances given prior to 1-4-2004, the Committee notes paragraph 9 of Accounting Standard (AS) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates' (revised 1994), which is reproduced below:

> ***"9. Exchange differences arising on foreign currency transactions should be recognised as income or as expense in the period in which they arise, except as stated in paragraphs 10 and 11 below."***

19. On the basis of the above, the Committee is of the view that all exchange differences arising before 1-4-2004 should be recognised as income or as expense in the period in which that exchange differences had arisen.

**D. Opinion**

20. On the basis of the above, the Committee is of the following opinion in respect of the issues raised by the querist in paragraph 7 above:

Regarding Z

(a) The exchange differences on the advance of US $ 22 million to Z should be recognised as income or as expense in the statement of profit and loss.

(b) This exchange difference has to be recoVariation gnised in the statement of profit and loss.

(c) No.

(d) As mentioned in (a) above, since exchange differences should not be transferred to foreign currency translation reserve, the question of debit balance in foreign currency translation reserve does not arise.

(e) Treatment of exchange differences arising on both temporary and long-term advances should be the same, because long-term advance, in substance, does not form part of the company's net investment in joint venture.

(f) Paragraph 24 applies for the translation of financial statements if the operations of the joint venture are non-integral to the operations of the company.

(g) Answer to (c) above is in the negative.

Regarding X and Y

(h) All exchange differences arising on advances given prior to 1-4-2004, should be recognised as income or expense in the statement of profit and loss as per AS 11 (revised 1994).

(i) These have to be recognised in the statement of profit and loss.

(j) As mentioned in (h) above, all exchange differences should be recognised as income or expense in the statement of profit and loss. Therefore, nothing will be transferred to foreign currency translation reserve.

(k) No, since AS 11 (revised 2003) is not applicable.

## ADVISORY SERVICE RULES OF THE EXPERT ADVISORY COMMITTEE

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. 25,000/- 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. 10,000/- 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. While sending the hard copies of the query is necessary, a copy of the query can also be sent on a floppy or through E-mail at eac@icai.org

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', Indraprastha Marg, New Delhi-110 002.