COMPENDIUM OF OPINIONS

Volume XXVIII

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

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(Volume XXVIII)

of the

Expert Advisory Committee

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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(This twenty eigth volume contains opinions finalised between February 2008 and January 2009. The opinions finalised upto September 1981 are contained in Volume I. The opinions finalised thereafter upto January 2008, are contained in Volumes II to XXVII.)

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Foreword

In recent years, owing to globalisation, the Indian economy has witnessed considerable changes across various sectors. Financial reporting sector is no exception to this phenomenon. Striking the opportunities available world wide, the business enterprises are entering into complex transactions, making the task of financial reporting intricate and challenging.

In such a scenario, accountants sometimes face dilemma in the preparation and presentation of financial statements. Here comes the role of the Expert Advisory Committee, which has been constituted by the Council of the Institute to address the difficulties faced by the members of the Institute while discharging their duties in the implementation/application of accounting and/or auditing principles and allied matters. Since its inception, the Committee has been playing a creditable role in providing advisory services to the members of the Institute and in the present times, it has become all the more significant.

I am glad to note that the Expert Advisory Committee has brought out this twenty-eighth volume of the Compendium of Opinions containing opinions finalised by the Committee during the period February 2008 to January 2009. I congratulate the entire team of Expert Advisory Committee for bringing out this volume and sincerely hope that the readers would find it of great relevance and use.

New Delhi
February 4, 2009

CA. Ved Jain
President

Preface

It is indeed a matter of great pleasure for me to introduce the twenty-eighth volume of the Compendium of Opinions, containing opinions finalised by the Expert Advisory Committee during the period February 2008 to January 2009. The opinions contained in this volume pertain to diverse subjects including applicability of Accounting Standards, exchange differences in respect of foreign currency borrowings, construction contracts, valuation of investments, fixed assets, inventories, recognition of provisions, machinery spares, revenue recognition, Government grants, deferred tax assets/liabilities, borrowing costs, etc.

I would like to point out that the opinions expressed by the Committee are based on the facts and circumstances of the query as supplied by the querist, the relevant laws and statutes and the applicable accounting/auditing principles prevailing on the date the Committee finalises the particular opinion. The date of finalisation of each opinion is indicated along with every opinion. The opinions, must therefore, be read in the light of any subsequent change/ amendments or other developments in the applicable accounting/ auditing Standards or relevant enactments that might affect the opinions.

I may bring to the kind attention of the readers that the Expert Advisory Committee entertains the queries only in accordance with the Advisory Service Rules prescribed by the Council of the Institute in this regard. These Rules are published in all the volumes of the Compendium of Opinions.

I place on record my sincere gratitude to my learned colleagues on the Expert Advisory Committee, namely, CA. K. P. Khandelwal, (Vice-Chairman), CA. Ved Kumar Jain (President), CA. Uttam P. Agarwal (Vice-President), CA. Sunil H. Talati, CA. Bhavna G. Doshi, CA. Atul C. Bheda, CA. Mahesh P. Sarda, CA. V.C. James, CA. Anuj Goyal, CA. Vinod Jain, CA. Amarjit Chopra, CA. S. Santhanakrishnan, Shri K.R. Maheshwari, CA. K. C. Parashar, CA. D. Venkata Jankinath, CA. Manish Gupta and CA. Subramanyam Reddy C. I would also like to thank Dr. Avinash Chander, Technical Director, CA. Anuradha Jain, Secretary, Expert Advisory Committee, and other officers of the Technical Directorate for their untiring efforts and invaluable support in finalising the opinions.

It is my firm belief that the opinions contained in this volume, like the opinions contained in the earlier volumes, will be of much efficacy to the accounting professionals.

New Delhi
February 4, 2009

CA. Vijay K. Gupta
Chairman
Expert Advisory Committee

Contents

Query No. 1

Subject: Accounting of foreign income on cash basis.[1]

A. Facts of the Case

1. A Government of India enterprise under the Ministry of Steel, is executing engineering and consultancy jobs and preparing various reports like feasibility report, project report, etc., for clients in India and abroad. According to the querist, the company is following accrual basis of accounting as per the Companies Act, 1956. Accordingly, revenue is recognised on accrual basis and as per the applicable accounting standards.

2. The querist has informed that long back, the company used to follow accrual basis of accounting in case of foreign consultancy jobs also, in line with domestic jobs. However, due to various reasons prevailing in the countries like Nigeria, Iran, Bangladesh, etc., where most of the clients were located, receipt of payment from the clients became uncertain. The querist has further informed that the company had to make provision for bad debts/write off the bad debts frequently as per the audit observations on the ground of uncertainty of realisation. However, constant follow up for realisation of the payment continued and in some cases, the company realised the payment after an abnormally long period. Recognition of income due to receipt of these payments used to create confusion as to whether these should be treated as current year's income or prior period income. According to the querist, though the amounts were insignificant but occurrence of such events was not insignificant. However, to avoid frequent provisioning of bad debts/write off in a particular period due to uncertainty and subsequently recognising it as income in future, the company started following the practice of recognition of foreign income on receipt basis.

3. The querist has informed that the company has also disclosed the basis of accounting in case of foreign consultancy jobs in the notes to the accounts. The company is following the same practice consistently every year. However, this is not specifically mentioned

[1] Opinion finalised by the Committee on 17.3.2008

in the accounting policy of the company for revenue recognition. The querist has mentioned that the company provides only consultancy services and is not involved in export of any plant or machinery whatsoever. Income from foreign services is also insignificant and low which is even less than 1% of the company's total turnover.

4. The querist has further clarified that in respect of foreign consultancy jobs, the company gets orders from various overseas clients with specific fees, terms of payment, etc. The company raises invoices from time to time as per the orders. Therefore, no uncertainty either with respect to the measurement of the payment that is to be received from the client or in respect of the creditworthiness of the client is envisaged at the time of receipt of order. However, due to various reasons, uncertainty arises at a later date.

B. Query

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

(a) Whether the company can continue the same practice, i.e., cash basis of accounting for foreign consultancy jobs or should it follow the accrual basis of accounting.

(b) Whether there is any deviation/violation of the Companies Act, 1956 or any Accounting Standard.

C. Points considered by the Committee

6. The Committee notes section 209(3) of the Companies Act, 1956, which states as follows:

"(3) For the purposes of sub-sections (1) and (2), proper books of account shall not be deemed to be kept with respect to the matters specified therein,–

(a) if there are not kept such books as are necessary to give a true and fair view of the state of affairs of the company or branch office, as the case may be, and to explain its transactions; and

(b) if such books are not kept on accrual basis and according to the double entry system of accounting."

7. The Committee also notes 'accrual' as one of the fundamental accounting assumptions for the preparation and presentation of financial statements as given in Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'. It notes its definition as per paragraph 10 of AS 1 as follows:

"*c. Accrual*

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. ..."

The Committee notes that the Guidance Note on Accrual Basis of Accounting, issued by the Institute of Chartered Accountants of India (ICAI), recognises that the accounting treatment contained in the Guidance Notes, Accounting Standards, etc., issued by the ICAI are primarily based on accrual accounting. Thus, adoption of accounting treatment recommended in these documents would ensure that an enterprise has followed accrual basis of accounting. Accordingly, the Committee is of the view that the company would be deemed to have followed accrual basis of accounting for revenue recognition if it follows the principles for recognition of revenue as laid down in Accounting Standard (AS) 9, 'Revenue Recognition'.

8. The Committee notes that AS 9 lays down the following three conditions for recognition of revenue:

(a) Performance of the act giving rise to revenue.

(b) Measurability of the revenue.

(c) Collectability of the revenue.

With respect to the effect of uncertainties on revenue recognition, the Committee notes paragraphs 9.1 to 9.3 of AS 9, which provide as follows:

"9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded."

9. The Committee notes on the basis of the information provided by the querist in paragraph 4 of the Facts of the Case that the uncertainty with regard to collectability of foreign income arises subsequent to the receipt of the order. The Committee is of the view that when the three conditions for recognition of revenue read with paragraphs 9.1 to 9.3 of AS 9 reproduced above are met in respect of the foreign consultancy jobs, the company should recognise revenue in its books of account. If uncertainty as to its collection arises subsequent to recognition of revenue, it would be appropriate to create a provision for bad and doubtful debts. However, if the collectability of revenue is not reasonably certain at the time of raising claim therefor, recognition of revenue should be postponed. In such cases, revenue should be recognised when it becomes reasonably certain that ultimate collection will be made. The assessment with respect to collectability should be made separately for each transaction.

10. The Committee notes that owing to reasons given by the querist in paragraph 2 above, i.e., frequent provisioning on account of frequent occurrences of uncertainty of collection and insignificance of the amounts involved, the company resorted to

cash basis of accounting in respect of the foreign income, i.e., in effect it departed from the provisions of AS 9 in respect of foreign income. The Committee notes that mere difficulties arising on account of frequent provisioning of bad debts/write-offs of such debts is not a sufficient reason to allow foreign income to be accounted for on cash basis and is contrary to the requirements of AS 9, the fundamental accounting assumption of accrual and section 209(3)(b) of the Companies Act, 1956.

11. In respect of the other reason of recognising foreign income on cash basis, viz., the insignificance of the amount of foreign income, the Committee notes from the Preface to the Statements of Accounting Standards, issued by the Institute of Chartered Accountants of India, which states, inter alia, that, "The Accounting Standards are intended to apply only to items which are material." The same principle has also been specifically stated in paragraph 3 of the Annexure A 'General Instructions' to the Companies (Accounting Standards) Rules, 2006, notified by the Central Government. Further, the Committee notes 'materiality' as one of the consideration for selection and application of accounting policies as defined in AS 1 and certain excerpts from paragraphs 3 and 5 of Standard on Auditing (SA) 320 (AAS 13), 'Audit Materiality', issued by the Institute of Chartered Accountants of India which are reproduced below:

> "*Materiality*
>
> Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."
>
> "3. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. …"
>
> "5. The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in

conformity with recognised accounting policies and practices. The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transactions…"

12. From the above, the Committee is of the view that though 'accrual' is one of the fundamental accounting assumptions, the materiality threshold is applicable to this accounting assumption also. If an information is not material, on the consideration of materiality as mentioned in the above paragraph, its accounting would not have any effect on the decisions of the users of the financial statements. Accordingly, it needs to be determined under the specific facts and circumstances of the company concerned as to whether the revenue from foreign consultancy jobs, either individually or in aggregate, can influence the decisions of the users of the financial statements. For this purpose, apart from the volume of transactions and quantum of turnover, other factors such as nature of the item, impact on profit/loss, etc., should also be considered. The assessment of what is material is a matter of professional judgement to be determined on each balance sheet date.

D. Opinion

13. On the basis of the above, the Committee is of the following opinion in respect of the issues raised in paragraph 5 above:

(a) The company should follow accrual basis and not the cash basis of accounting to account for income from foreign consultancy jobs unless the said income is not considered material as discussed in paragraphs 11 and 12 above.

(b) Recognition of income from foreign consultancy jobs on cash basis, in the case under consideration, is contrary to the requirements of the Companies Act, 1956, AS 1 and AS 9, unless the said income is not considered material as discussed in paragraphs 11 and 12 above.

Query No. 2

***Subject: Valuation of fixed assets from incomplete records.*[1]**

A. Facts of the Case

1. A State Government company in which the State Government is holding 99.99% shares is engaged in mining and selling of rock phosphate, gypsum, limestone and lignite and its mines are located at different places in the State. The company also has wind power mills installed in one of the districts of the State.

2. In the year 2002-03, vide gazette notification dated 19.12.2003 issued by the Department of Company Affairs (now known as the Ministry of Corporate Affairs), Government of India, the company and XYZ Ltd., another State Government mining corporation, were amalgamated under section 396 of the Companies Act, 1956 with effect from 20.02.2003. Accordingly, the annual accounts of both the companies were consolidated from 1.4.2001 and common accounting policies were adopted for the year 2002-03 and onwards.

3. As per the querist, prior to amalgamation, the company was following written down value (WDV) method for charging depreciation on its fixed assets whereas XYZ Ltd. was charging depreciation on straight line method (SLM). After amalgamation, a common policy of charging depreciation on WDV method, was adopted by the amalgamated company and accordingly, impact on the profits of the amalgamated company due to change in accounting policy, was to be shown in the accounts of the amalgamated company by recalculating depreciation retrospectively on the assets of XYZ Ltd. as per WDV method in compliance with the provisions of Accounting Standard (AS) 6, 'Depreciation Accounting'.

4. The querist has further stated that the depreciation on WDV method could not, however, be calculated as the gross purchase prices (opening balances) of most of the assets of XYZ Ltd. were not available. As per the querist, there were a number of small units of XYZ Ltd. in which fixed assets were purchased from time to time, but complete records of such assets indicating purchase

[1] Opinion finalised by the Committee on 17.3.2008

value of individual asset, depreciation charged on each asset, location, etc., were not maintained by such small units and records of only gross block of assets were being maintained.

5. The querist has also stated that since the original cost of individual assets of XYZ Ltd. was not available, the company could not calculate and charge depreciation on WDV method for such assets retrospectively and to that extent, the provisions of AS 6 could not be complied with and is also not possible to do so. Since then, the statutory auditors are qualifying the balance sheet of the company stating that on account of amalgamation of XYZ Ltd. with the company, the effect of change of accounting policy of charging depreciation from SLM to WDV is not given retrospectively for the assets of XYZ Ltd. as per the requirements of AS 6. The querist has also mentioned that the value of the assets of XYZ Ltd. is very negligible compared to the assets of the company.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to what action should be taken by the company to comply with the provisions of AS 6.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to the determination of gross purchase price of individual assets of XYZ Ltd., for the purposes of calculating depreciation thereon as per the WDV method. 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, accounting for amalgamation, etc.

8. The Committee notes that AS 6 does not exempt recalculating depreciation from retrospective effect on account of difficulty in the estimation of original cost/gross purchase price of various assets. The Committee further notes that the querist has stated in paragraph 3 above that XYZ Ltd. was following straight line method of depreciation before amalgamation. In the view of the Committee, if the gross block of assets is known (as mentioned by the querist in paragraph 4 above) and straight line method is being followed, the amount of depreciation for individual assets can be determined

based on the yearly amount of depreciation and the life of the asset. Accordingly, in such circumstances, the original cost of a fixed asset can be determined by adding in the balance of fixed asset as on the date of change in the method of depreciation, the total depreciation charged as per the annual accounts for the number of years of operation of the asset and making adjustments for the assets purchased or sold during a year. However, as stated by the querist in paragraph 4 above, in case of small units, where complete records of such assets are not available, and it is not possible to determine the depreciation for individual assets due to any reason, the management should make an appropriate assessment keeping in view the facts and circumstances of the case, to determine the purchase price of individual fixed asset and to determine depreciation in accordance with WDV method. In this regard, factors, such as, book values of similar fixed assets in the books of the company/similar companies in the industry, of the same specifications as to brand, year of make, year of purchase, model, capacity, method(s) employed for the use of the asset, etc. may be taken into account.

9. As regards the contention of the querist that the value of the assets of XYZ Ltd. is 'very negligible', it is not clear as to which value is being contemplated here – the balances as appearing in the books of XYZ Ltd. at the date of amalgamation or the estimated gross purchase price. Moreover, the Committee notes that the term 'very negligible' is nowhere used in the pronouncements of the Institute of Chartered Accountants of India. The term used in various pronouncements is "material". With regard to the materiality aspect, the Committee notes that paragraph 4.3 of the Preface to the Statements of Accounting Standards, issued by Institute of Chartered Accountants of India, states, inter alia, that "The Accounting Standards are intended to apply only to items which are material". The Committee further notes that paragraph 17(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', explains 'materiality' as below:

> *"c. Materiality*
>
> Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."

10. The Committee also notes that paragraph 3 of Standard on Auditing (SA) 320 (AAS 13), 'Audit Materiality', issued by the Institute of Chartered Accountants of India, explains, inter alia, that, "Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful". It further states, inter alia, in paragraphs 4 and 5, respectively that "the assessment of what is material is a matter of professional judgement" and "the concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices".

11. From the above, the Committee is of the view that threshold of materiality is applicable to all items of financial statements. If an information is not material, on the consideration of materiality as mentioned in the paragraphs above, its accounting would not have any effect on the decisions of the users of the financial statements. Accordingly, it needs to be determined under the specific facts and circumstances of the company concerned as to whether the value of fixed assets of XYZ Ltd., if not determined as per the revised method of depreciation, can influence the decisions of the users of the financial statements. For this purpose, various factors, such as the revised estimated value of such assets of XYZ Ltd. as compared to the value of the fixed assets of the company as on the date of amalgamation, nature of the items, impact on profit/ loss etc., should be considered.

12. On the basis of the above, the Committee is of the view that if keeping into consideration the factors mentioned in the aforesaid paragraphs, the aggregate revised estimated value of the fixed assets of XYZ Ltd. is not material, i.e., their disclosure at unrevised value would not influence the decisions of the users of the financial statements, these could be disclosed at the unrevised value.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the company should provide for the depreciation as per the

revised method of depreciation, i.e., WDV method by determining the gross purchase prices of the various assets of XYZ Ltd. by adding back the total depreciation provided on SLM basis to the balance of fixed assets on the date of amalgamation or on some other basis as discussed in paragraph 8 above. However, if the value is not material, the assets of XYZ Ltd. could be shown at unrevised value as mentioned in paragraphs 11 and 12 above.

Query No. 3

Subject: Provision for repair work-in-progress.[1]

A. Facts of the Case

1. A public sector undertaking under the Ministry of Shipping, Road Transport and Highways, was incorporated on 29th March, 1976 under the Companies Act, 1956. The main objective of the company is to provide integrated dredging services to all major and minor ports, Indian Navy, fishing harbors and other maritime organisations.

2. The dredging activities are carried out by ocean going dredgers, self-propelled or dumb dredgers. As compared to any other ocean going vessel, the dredger has got a much greater amount of machinery installed. The trailer dredgers have almost twice the amount of machinery fitted as compared to ocean going ships of the same size. Most of the time, the dredgers operate in various types of soils and sandy waters which affects the outer surface of hull plates as well as the internal plates of the hopper, which in turn, results in wear and tear of hull and other soil touching parts/equipments. These dredgers would normally be working 24 hours a day continuously for a period of about 3 weeks when the machinery will be stopped for undertaking preventive maintenance.

[1] Opinion finalised by the Committee on 17.3.2008

Such continuous usage of the machinery in the shallow and sandy waters of the port causes heavy wear and tear necessitating periodic repairs in a drydock and also the consumption of spares and stores.

3. Keeping the above facts in view, the company undertakes major dry dock repairs of its dredgers on a requirement basis and to meet conditions imposed by classification society and periodical survey requirements. Every effort is made to dry dock the dredgers to keep them in a good condition to undertake the project works. The expenditure towards dry dock repairs of dredgers is expensed in the year of incurrence.

4. The company, being a listed company, has to publish its quarterly unaudited results and get the same reviewed by the company's auditors as per clause 41 of the Listing Agreement with Stock Exchanges.

5. The method being followed by the company for interim reporting in respect of expenditure on dry dock repairs (usually on each occasion repair cost ranges between Rs. 7 to 8 crore per dredger) is as follows:

- ➢ The actual dry dock repair expenditure in respect of dredgers dry docked and the repairs fully completed during the period (up to the end of the relevant quarter) is expensed in full in the particular quarter.

- ➢ If the repairs of a dredger spill over to the next quarter or beyond, the expenditure is accounted for on the basis of the percentage of work done as certified by the Technical Department of the company.

6. During the Limited Review, statutory auditors of the company expressed their view that if the dry dock repair of a particular dredger spills over to more than a quarter/ year, then the full expenditure is to be considered in the quarter/ year in which the dry dock repairs are fully completed.

7. According to the querist, there is also a different view that if the dry dock repair expenditure spills over to more than a quarter/

year, then the full expenditure is to be considered in the quarter/ year in which the dry dock repair actually commenced.

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the following issues in respect of dry dock repair expenditure spilling over to the next quarter/year to meet the requirement of interim reporting as also at the end of the year, i.e., 31st March:

(i) Whether dry dock repair expenditure should be provided based on the percentage of work completed as per the certifications of the Technical Department of the company applied on the estimated dry dock repair cost (as the actual cost will be known only after completion of repair and scrutiny of the repair bill).

(ii) Whether full dry dock repair expenditure should be provided in the quarter/year in which the dry dock is fully completed, i.e., after knowing the actual liability towards dry dock repair expenditure.

(iii) Whether full dry dock expenditure should be provided in the quarter/year in which the dry dock repair commenced based on the estimated dry dock repair cost.

(iv) Whether any other alternative method should be followed to provide expenditure in line with the accepted standard practices.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to recognition and measurement of dry dock repair expenditure to be accounted for interim reporting as also to be accounted for at the end of the year in case the repair expenditure spills over to next quarter/year. 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.

10. The Committee notes sub-section (3) section 209 of the Companies Act, 1956, which is reproduced below:

"(3) For the purposes of sub-sections (1) and (2), proper books of account shall not be deemed to be kept with respect to the matters specified therein, –

(a) …

(b) if such books are not kept on accrual basis and according to the double entry system of accounting."

11. The Committee further notes that 'accrual' is one of the fundamental accounting assumptions underlying the preparation and presentation of financial statements as per Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'. The term 'accrual' has been defined in the Standard as below:

"Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this Standard)."

12. The Committee also notes paragraph 1.09 of the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India, which is reproduced below:

" 1.09 Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable."

13. From the above, the Committee is of the view that in respect of dry dock repairs which are in progress on the balance sheet date, the company has an accrued liability. There is a present obligation but only in respect of the extent of work done as at the balance sheet date. This will result in a payment in future (after adjustments such as advance payment, if any). The amount of such an obligation should be recognised in the financial statements,

if a reliable estimate of the same can be made. The amount recognised should be the best estimate of the expenditure required to settle the accrued liability at the balance sheet.

14. The Committee notes the following paragraphs from Accounting Standard (AS) 25, 'Interim Financial Reporting':

> "2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator."
>
> ***"27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.***
>
> 28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements."

"32. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed."

"38. Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year."

15. The Committee notes that at present, the Listing Agreement with Stock Exchanges as per clause 41 specifically requires the quarterly and year to date results to be prepared in accordance with the recognition and measurement principles laid down in AS 25.

16. From the above, the Committee notes that the principles for recognition and measurement of the dry dock repair expenditure which is in progress at the balance sheet date as stated in paragraph 13 above are equally applicable to such expenditure for the purposes of interim reporting under clause 41 of the Listing Agreement with Stock Exchanges. Accordingly, the Committee is of the view that dry dock repair expenditure should be recognised by the company in a particular interim period (quarter in the case of the company) only to the extent of work done during that period, provided a reliable estimate can be made. The reliable estimate depends on particular circumstances. There can be a variety of methods for assessing the work completed, such as, a survey of work performed, completion of a physical proportion of the work performed, etc. The method which reliably measures the work performed should be used. Apart from an appropriate measurement of work, cost estimation should also be reliable. Only if the certificate of the Technical Department of the company meets these parameters resulting in a reliable estimate, it can be the basis for

recognition of the expenditure, otherwise an appropriate method of estimation is to be devised, which may include an estimation given by the party performing the repair work and a survey by an outside agency. The amount recognised should be the best estimate of the expenditure required to settle the accrued liability at the interim reporting date. Further, the Committee is of the view that dry dock repair expenditure incurred in the current interim period spilling over to the next period cannot be deferred to future for interim reporting purposes. Similarly, dry dock repair expenditure that continues to be incurred in future cannot be estimated and accounted for in the period of commencement of the repair work. Recognition of dry dock repair expenditure to the extent of work done in a particular interim period ensures that measurement for interim reporting purposes is made on an year-to-date basis. This principle is equally applicable for annual reporting also.

D. Opinion

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

(i) Dry dock repair expenditure should be recognised to the extent of work done during a period provided a reliable estimate can be made. This principle is applicable both for annual reporting as well as for interim reporting under clause 41 of the Listing Agreement with Stock Exchanges. The reliable estimate depends on particular circumstances. The certificate of the Technical Department of the company or any other appropriate method of estimation is acceptable, only if it is a reliable estimate as explained in paragraph 16 above. The amount recognised should be the best estimate of the expenditure required to settle the accrued liability at the reporting date.

(ii) Providing for full dry dock expenditure in the quarter/year in which the dry dock repair is fully completed, i.e., after knowing the actual liability towards dry dock repair expenditure, is not correct.

(iii) Providing for full dry dock expenditure in the quarter/ year in which the dry dock repair commenced based on the estimated dry dock repair cost is not correct.

(iv) Other than (i) above, there is no other alternative method so far as timing and quantum of the expenditure to be recognised in a period is concerned. As regards the method of estimation of work performed and cost, as stated in paragraph 16 above, it depends on the particular circumstances.

Query No. 4

Subject: Accounting treatment of crude oil inventory pending passing of the title.[1]

A. Facts of the Case

1. A public limited company, which is a 100% subsidiary of a government company (hereinafter referred as the 'company'), is in the business of overseas exploration and production of oil and gas and other hydrocarbon related activities outside India. Usually, the legal regimes applicable in most of the countries provide that the ownership of mineral resources (hydrocarbons) is with the governments. Accordingly, the host governments grant the rights to explore, develop and produce hydrocarbons in certain specified geographical areas within their territories (hereinafter referred to as 'Rights') to the companies on some equitable consideration under various regimes. The activities of the company thus include securing such Rights and then to explore, develop and produce hydrocarbons. Such Rights are secured either on a 100% basis, wherein the company or its affiliates themselves take the entire risks and rewards of such Rights or in consortium with other

[1] Opinion finalised by the Committee on 17.3.2008

participants, such consortia usually being unincorporated joint ventures wherein the joint venture participants share the risks and rewards in certain agreed proportions. Such Rights are granted by the host governments in accordance with the applicable legal and fiscal regime in the host country which are incorporated into binding contractual arrangements entered into with the host governments.

2. One such regime is Production Sharing Agreement (hereinafter referred to as 'PSA'), under which the host government, which has the ownership rights over the hydrocarbons, grants to a company or consortium (usually called contractor) the Rights subject to certain obligations/payments by the contractor including sharing the hydrocarbons, if produced with the government or its nominated agency as per the principles detailed in the PSA.

3. The company is a participant in one such PSA along with other companies (hereinafter referred to as 'Consortium'), with the government of a foreign country (hereinafter referred to as 'State') in respect of certain geographical area specified in the PSA (hereinafter referred to as the 'Area'). Under the PSA, the State granted the exclusive Rights to the Consortium to conduct hydrocarbon operations in the Area subject to the terms and conditions of the PSA.

4. The Area is offshore. The Consortium has drilled production wells from nearby onshore location and also from an offshore platform to produce oil and gas from the Area. Produced hydrocarbons are brought to Onshore Processing Facility (OPF) through a pipeline, processed in the OPF and then transported through another pipeline to the storage tanks. Storage tanks have stirring and heating facility which can be used to heat and/or to stir the crude oil. After heating on a need basis in storage tanks, the crude oil passes through a metering system and is then transported through an undersea pipeline to Single Point Mooring facility (SPM) where it is loaded into the tankers (ships) for transporting to the export destination.

5. The querist has informed that Article 19.2 of the PSA provides that the title to hydrocarbons to which the Consortium is entitled to, shall, unless an earlier separation point is agreed upon between the State and the Consortium, pass to the Consortium at the

Delivery Point (DP). Article 1.23 of the PSA defines DP to mean with respect to each type, grade or stream of hydrocarbons made available for delivery to customers as part of hydrocarbon operations, the outlet flange of the final stage of processing and treatment facilities included in hydrocarbon operations used to render that type, grade or stream of hydrocarbons suitable for sale to customers, whether such facilities are located in offshore or onshore areas. The querist has confirmed that no earlier separation point has been agreed to between the State and Consortium under Article 19.2.

6. Given the fact that the crude oil is rendered suitable for sale in the storage tanks, the DP under the PSA shall be the outlet flange of the storage tanks. As per Article 19.2 of the PSA, read with the Article 1.23, the title to the crude oil to which the Consortium is entitled to, shall pass to the Consortium only at the outlet flange of the storage tanks, i.e., to the extent crude oil lies downstream of the storage tanks, while the title to the crude oil produced from the strata but situated upstream of the storage tanks remains with the State, although the crude oil is no longer in its natural habitat in strata.

7. Since the title to the crude oil lying upstream of the storage tanks remained with the State, the company did not recognise the crude oil lying in (i) the pipelines from the wells to OPF; (ii) OPF; (iii) the pipeline from OPF to the storage tanks; and (iv) the storage tanks, as its inventory in its accounts for the financial year 2006-07. The company also disclosed the following in the notes to the accounts for the relevant PSA:

> "The closing stock of crude oil till the Delivery Point has not been considered in view of the contractual arrangement that it remains the property of the State until the Delivery Point."

8. The above treatment did not attract any adverse comment/ observations either from the statutory auditors or from the C&AG also during its review under section 619(3)(b) of the Companies Act, 1956.

9. A doubt has now been raised on the appropriateness of the aforesaid accounting treatment of the crude oil inventory lying

upstream of the storage tanks on the basis of 'substance over form'. It has been stated that although the title to hydrocarbons to which the Consortium is entitled to, passes from the State to the Consortium at the outlet flange of the storage tanks under the contractual arrangement, i.e., PSA, for all economic purposes, the Consortium is assured of receiving its share of crude oil lying upstream of DP. Thus, in substance, the crude oil produced from the strata but lying upstream of the outlet flange of the storage tanks as on the balance sheet date, belongs to the Consortium, although the title is yet to pass from the State to the Consortium.

B. Query

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

(i) Whether the accounting treatment carried out by the company in not recognising the crude oil inventory lying upstream of the Delivery Point is appropriate.

(ii) Whether such inventory needs to be valued and recorded by the company in its accounts with suitable disclosure regarding the lack of title thereto applying the principle of 'substance over form'.

(iii) Whether there is any other appropriate accounting treatment/disclosure for such inventory.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to recognition of crude oil inventory lying upstream of the delivery point ('DP'). Therefore, the Committee has not touched upon any other issue that may be contained in the Facts of the Case, such as, treatment of production cost related to unrecognised inventory in accounts.

12. From the annual report of the company for the year 2006-07, the Committee notes that the company follows the policy of valuing crude oil (including concentrate) at the lower of cost and net realisable value. Though Accounting Standard (AS) 2, 'Valuation of Inventories', is applicable to such inventories, that Standard

does not deal with the timing of recognition of inventories in the financial statements. The Committee also notes that while Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', deals, *inter alia*, with accounting by the venturer of any income from the sale or use of its share of output of a joint venture, that Standard also does not deal with the timing of recognition of the same in the financial statements. Accordingly, the company should account for its share of crude oil inventory in the joint venture in accordance with generally accepted accounting principles.

13. The Committee also notes that as per Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), one of the major considerations governing the selection and application of accounting policies is 'substance over form'. The Committee notes that as per paragraph 17(b) of AS 1, "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".

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:

> "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)]
>
> "Many assets,… are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; …Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. ..." [Paragraph 56]
>
> "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]

15. From the above, the Committee is of the view that the company should recognise its share of inventory of crude oil lying upstream of the delivery point pending the passing of the title to the Consortium, if all of the following three conditions are met:

(i) The company and other participants of the Consortium have control over their share of inventory and their respective shares are clearly ascertainable;

(ii) It is probable that future economic benefits associated with the company's share of inventory will flow to it; and

(iii) The cost of the company's share of inventory can be measured reliably.

16. The Committee is of the view that condition (i) above will be met if the company and other participants of the Consortium have the power to obtain the future economic benefits flowing from the underlying resource and can also restrict others from access to those benefits. This will be the case when the participants of the Consortium have assumed their share of significant risks and rewards of ownership in the inventory, which need not necessarily coincide with the transfer of legal title from the State to the Consortium. Risks could include risk of loss due to evaporation, spillage, fire, price fluctuation, etc., while rewards could include entitlement to lift the agreed share of the inventory. In this regard, the Committee notes paragraph 6.1 of Accounting Standard (AS) 9, 'Revenue Recognition', notified under the 'Rules', which is reproduced below:

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

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

The Committee is of the view that the abovementioned principle recognises the primacy of substance over form which should also be applied in recognition of acquisition of inventory. Whether significant risks and rewards of ownership in the inventory have been transferred is a question of fact to be determined on the basis of prevailing circumstances including the terms of the Production Sharing Agreement. What is important is actual assumption of risks and rewards of ownership and not possible future assumption of risks and rewards of ownership. It is stated (in paragraph 9 above) that for all economic purposes, the Consortium is assured of receiving its share of crude oil lying upstream of DP. This refers to possible future assumption of significant risks and rewards of ownership. The company should assess the point of time when the significant risks and rewards of ownership in the inventory pass on to the participants of the Consortium *de hors* the future receipt of its share of inventory and the consequent transfer of legal title.

17. The Committee is further of the view that in case the company's share of inventory of crude oil is recognised on satisfaction of all the three conditions stated in paragraph 15 read with paragraph 16 above, pending transfer of legal title, a suitable disclosure of the fact should be made in the accounts.

D. Opinion

18. 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 carried out by the company in not recognising the crude oil inventory lying upstream of the delivery point would be correct, only if any one or more of the three conditions stated in paragraph 15 read with paragraph 16 above is (are) not met.

(ii) Such inventory should be valued and recorded by the company in its accounts with suitable disclosure, only if all the three conditions stated in paragraph 15 read with paragraph 16 above are met.

(iii) There is no other appropriate accounting treatment/ disclosure for such inventory.

Query No. 5

Subject: Applicability of Accounting Standards to schemes of mutual funds[1].

A. Facts of the Case

1. Mutual funds in India are required to comply with the Securities and Exchange Board of India (SEBI) (Mutual Funds) Regulations, 1996 (hereinafter referred to as 'Regulations') as amended from time to time. These Regulations specify the operational/procedural policies, accounting policies and standards and other guidelines to be followed by the mutual funds. In addition to the above Regulations, SEBI also issues various circulars and guidelines from time to time governing the operations and various other aspects of a mutual fund.

2. The significant Regulations, as per the querist, are as under:

(i) Regulation 50 casts responsibility on the Asset Management Company (AMC) to maintain the accounts of the mutual fund.

(ii) Regulation 50(3) of the Regulations specifies that the AMC shall follow Ninth Schedule of the Regulations so as to provide appropriate details, scheme-wise.

[1] Opinion finalised by the Committee on 30.4.2008

(iii) Ninth Schedule to the Regulations deals with the accounting policies and standards to be followed for providing the above information including the preparation of financial statements. These mainly comprise policies relating to investments, dividend, interest income, income equalisation, commission, etc. This Schedule is silent on areas, such as, related party disclosures, cash flow disclosures, segmental reporting, etc.

(iv) Apart from the above, Regulations 54 and 56(2) of the Regulations deal with the following:

- Accounting policies and standards including policies in respect of valuation and revenue recognition
- Form and contents of Auditor's Report
- Matters to be included in the Auditor's Report
- Other disclosures to be given in the notes to accounts including historical data

These regulations are also silent on areas, such as, related party disclosures, cash flow disclosures and segmental reporting, etc.

3. The querist has stated that an issue arises whether the mutual funds are required to comply with the Accounting Standards issued by Institute of Chartered Accountants of India (ICAI), while preparing the financial statements for the various schemes of the mutual fund. In particular, whether a mutual fund has to comply with the following standards:

(i) Accounting Standard (AS) 3, 'Cash Flow Statements'

(ii) Accounting Standard (AS) 17, 'Segment Reporting'

(iii) Accounting Standard (AS) 18, 'Related Party Disclosures'

4. The querist has given the following arguments which seem to indicate that compliance with Accounting Standards (including AS 3, AS 17 and AS 18) is required in preparing the financial statements of a mutual fund scheme:

(i) The Preface to the Statements of Accounting Standards, issued by the ICAI states the following:

> "3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature."

From the above, according to the querist, *it seems that since mutual funds (or mutual fund schemes) engage in commercial activities, Accounting Standards are applicable to them.* (Emphasis supplied by the querist.)

(ii) Paragraph 4.2 of the Preface to the Statements of Accounting Standards, inter alia, states that Accounting Standards "do not override the local regulations". This, according to the querist, implies that if a particular Accounting Standard is found to be not in conformity with law (SEBI Regulations in this case), the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law. *Thus, the SEBI Regulations will have an overriding effect if an*

Accounting Standard is not in conformity with them. However, the areas on which the Regulations are silent, the Accounting Standards still apply. Where the law lays down additional requirements compared to those provided by the Standards, these should also be complied with. (Emphasis supplied by the querist.)

(iii) The fact that there is no general exemption to mutual funds from the applicability of accounting standards is supported by the fact that Accounting Standard (AS) 13, 'Accounting for Investments', specifically excludes mutual funds from its application. *This implies that other standards apply to mutual funds in the absence of any specific exemption.* (Emphasis supplied by the querist.)

(iv) The Ninth Schedule to the Regulations requires an auditor to give his opinion as to whether the balance sheet and the revenue account give a true and fair view. Auditing and Assurance Standard (AAS) 28[2], 'The Auditor's Report on Financial Statements', issued by the ICAI, inter alia, provides that **"the opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements."** *This is the reason that the auditor of a mutual fund scheme also states that the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India.* Based on the above, the framework for the preparation and presentation of financial statements of the mutual funds would include Accounting Standards issued by the ICAI apart from the SEBI Regulations. Thus, even if the SEBI Regulations are silent regarding compliance with Accounting Standards

[2] Auditing and Assurance Standard (AAS) 28 has since been renamed, renumbered and categorised as Standard on Auditing (SA) 700, 'The Auditor's Report on Financial Statements'.

issued by the ICAI, the auditor would need to consider them to conclude the opinion on the financial statements. (Emphasis supplied by the querist.)

5. As far as Accounting Standards 3, 17 and 18 are concerned, these are mandatorily applicable only to the Level I enterprises which include the following:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

The querist has stated that an issue that will arise in applying the above classification in the present case is whether it is the mutual fund that should be considered as the 'enterprise' or whether each scheme of a mutual fund should be so considered. As per the querist, the term 'enterprise' should be interpreted as referring to the reporting entity which in the present case is a mutual fund scheme and not the mutual fund as a whole.

Thus, if a mutual fund scheme falls in Level I, the three standards (AS 3, AS 17 and AS 18) are applicable to it even if the SEBI Regulations relating to financial statements of mutual funds do not contain any stipulation for compliance with Accounting Standards. (Emphasis supplied by the querist.)

6. As against the above, the querist has also given the following arguments indicating that Accounting Standards issued by the ICAI (including AS 3, AS 17 and AS 18) are not applicable to mutual funds and mutual fund schemes.

(i) The Preface to the Statements of Accounting Standards states that in case there is a conflict between the requirement of local regulations and those required by an Accounting Standard, the local regulations shall prevail over the Accounting Standard. In the instant case, as per the SEBI Regulations, AMC is responsible to follow those accounting standards and policies as specified in the Ninth Schedule. It does not lay a responsibility on AMC to ensure compliance with the applicable Accounting Standards issued by the ICAI. Further, the Regulations do not specifically require compliance with Accounting Standards issued by the ICAI. Thus, a mutual fund is governed by a specific regulatory framework which lays down the accounting policies and standards to be followed, and disclosures to be made in the financial statements. According to the querist, the regulatory framework considers these requirements to be self-contained as is evident from the fact that there is no reference to Accounting Standards in the Ninth Schedule. As the Ninth Schedule does not recognise Accounting Standards, a mutual fund is justified in not following them.

(ii) As per the Regulations, the statutory auditors are required to verify and report whether the financial statements have been prepared in accordance with the accounting policies and standards as specified in the Ninth Schedule. Thus, the audit report format which is provided by the Regulations, also does not require a mention on the compliance with Accounting Standards issued by the ICAI.

(iii) The Companies Act, 1956, had to be specifically amended to incorporate provisions regarding compliance with Accounting Standards, implying thereby that prior to the aforesaid amendment, a company was not obliged to follow the Accounting Standards.

(iv) A quick survey of the published annual reports of mutual funds indicates that some mutual funds in India are not making disclosures, such as, cash flows, segmental, related parties, etc., while some other mutual funds are giving these disclosures.

B. Query

7. Keeping in view the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether it is mandatory for a mutual fund to comply with the Accounting Standards issued by the ICAI generally, and AS 3, AS 17 and AS 18 in particular, in preparing the financial statements of various schemes operated by it.

(ii) If the answer to the above question is in the affirmative, what is the duty of the auditor if the financial statements of a mutual fund scheme do not comply with one or more of the Accounting Standards, e.g., if disclosures required under AS 3, AS 17 and/or AS 18 are not made in the financial statements?

C. Points considered by the Committee

8. The Committee notes paragraphs 3.3 and 4.1 of the Preface to the Statements of Accounting Standards. Paragraph 3.3 is reproduced in paragraph 4 above and paragraph 4.1 is reproduced below:

"4.1 Efforts will be made to issue Accounting Standards which are in conformity with the provisions of the applicable laws,

> customs, usages and business environment in India. However, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law."

9. On the basis of paragraph 3.3 of the Preface, the Committee notes that the Accounting Standards are applicable to an enterprise if it is engaged in commercial, industrial or business activities. The Committee notes that the activities of a mutual fund or mutual fund schemes are commercial in nature. Therefore, they are required to comply with the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI). Keeping in view paragraph 4.1 of the Preface, and the Ninth Schedule and Regulations 54 and 56(2) of the SEBI (Mutual Funds) Regulations, 1996, which prescribe the accounting policies and standards to be followed by the mutual funds for preparation of accounts, the Committee is of the view that in case of any contradiction between the Accounting Standards issued by the ICAI and the Regulations, the Regulations will prevail. However, in respect of the aspects on which the Regulations are silent, the Committee is of the view that the Accounting Standards issued by the ICAI would be applicable.

10. The Committee notes paragraph 6.1 of the Preface to the Statements of Accounting Standards which provides as below:

> "6.1 The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation."

11. From the above, the Committee is of the view that even though it is not mentioned in the Regulations that the auditor should examine whether the Accounting Standards issued by the ICAI

have been complied with or not, if the auditor finds any deviation from the Accounting Standards issued by the ICAI, except for those requirements of Accounting Standards for which accounting policies or standards have been prescribed by the Regulations, the audior should make adequate disclosures, in the audit report in accordance with Standard on Auditing (SA) 700, 'The Auditor's Report on Financial Statements', issued by the ICAI.

12. For determining whether a mutual fund scheme or a mutual fund as a whole should be considered as an enterprise for the applicability of AS 3, AS 17 and AS 18 which are mandatory for enterprises falling in Level I, the Committee notes paragraphs 3.3 and 3.4 of the Preface to the Statements of Accounting Standards, Regulation 54 and the Eleventh Schedule to the Regulations. While paragraph 3.3 of the Preface is reproduced in paragraph 4 above, paragraph 3.4 of the Preface, Regulation 54 and the relevant portion of the Eleventh Schedule are reproduced below:

> *Preface to the Statements of Accounting Standards*
>
> "3.4 The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public. References to financial statements in this Preface and in the standards issued from time to time will be construed to refer to General Purpose Financial Statements."
>
> *SEBI (Mutual Funds) Regulations, 1996*
>
> "54. Every mutual fund or the asset management company shall prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule."
>
> *Eleventh Schedule*
>
> **"1.** Annual Report
>
> The annual report shall contain–

(i) Report of the Board of Trustees on the operations of the various schemes of the fund and the fund as a whole during the year and the future outlook of the fund;

(ii) Balance Sheet and Revenue Account in accordance with paras 2, 3 and 4, respectively of this Schedule;

(iii) Auditor's Report in accordance with paragraph 5 of this Schedule;

…"

"**3**. Contents of Balance Sheet

(i) The Balance Sheet shall give schemewise particulars of its assets and liabilities. These particulars shall contain information enumerated in Annexures 1A and 1B hereto. It shall also disclose, *inter alia,* accounting policies relating to valuation of investments and other important areas.

…"

"**4.** Contents of Revenue Account

(i) The Revenue Account shall give schemewise particulars of the income, expenditure and surplus of the mutual fund. These particulars shall contain information enumerated in Annexure 2 of this Schedule.

…"

"**5.** Auditor's Report

(i) All mutual funds shall be required to get their accounts audited in terms of a provision to that effect in their trust deeds. The Auditor's Report shall form a part of the Annual Report. It should accompany the Abridged Balance Sheet and Revenue Account. The auditor shall report to the Board of Trustees and not to the unitholders.

(ii) The auditor shall state whether:

1. he has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit,

2. the Balance Sheet and the Revenue Account are in agreement with the books of account of the fund.

(iii) The auditor shall give his opinion as to whether:

1. the Balance Sheet gives a true and fair view of the schemewise state of affairs of the fund as at the balance sheet date, and

2. the Revenue Account gives a true and fair view of the schemewise surplus/deficit of the fund for the year/period ended at the balance sheet date.

…"

13. The Committee notes that as per paragraph 3.3 of the Preface to the Statements of Accounting Standards, Accounting Standards issued by the ICAI are applicable to general purpose financial statements. Paragraph 3.4 of the Preface explains that general purpose financial statements include balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof. The Committee also notes from the above reproductions from the Eleventh Schedule to the Regulations that a mutual fund is required to prepare balance sheet and revenue account giving scheme-wise particulars. The Committee is of the view that balance sheet and revenue account giving scheme-wise particulars are general purpose financial statements referred to in paragraph 3.4 of the Preface. The Committee is, further, of the view that the auditor is also required to give his opinion on the scheme-wise state of affairs and the scheme-wise surplus/deficit of the fund as reflected in the balance sheet and the revenue account respectively. The Committee is of the view that while the reporting entity or the 'enterprise' is a mutual fund, since mutual fund schemes are an integral part of the mutual fund and as per the SEBI (Mutual Funds) Regulations, 1996, schemewise particulars are required to

be given in the balance sheet and revenue account, the various provisions of AS 3, AS 17 and AS 18 are applicable to a mutual fund scheme also.

D. Opinion

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

(i) A mutual fund is required to comply with the Accounting Standards issued by the ICAI generally, except for those requirements of the Accounting Standards for which specific accounting policies and standards have been prescribed by the SEBI (Mutual Funds) Regulations, 1996. AS 3, AS 17 and AS 18 are required to be complied with by a mutual fund while preparing financial statements of various schemes, as discussed in paragraph 13 above.

(ii) If the financial statements of a mutual fund scheme do not comply with one or more of the Accounting Standards except for those requirements of Accounting Standards for which specific accounting policies and standards have been prescribed by the Regulations, and if disclosures required under AS 3, AS 17 and AS 18 if applicable to the mutual fund scheme, are not made, where applicable, the auditor should make adequate disclosures in the audit report for non-compliances with the Accounting Standards.

Query No. 6

Subject: ***(i) Accounting for foreign exchange differences on foreign currency loans taken at different times.***
(ii) Accounting for foreign exchange gains under paragraph 4(e) of AS 16.
(iii) Presentation of foreign exchange gains.[1]

A. Facts of the Case

1. A listed government company is carrying on the business of operating ships. The company does not have any subsidiary company. The company has been taking foreign currency loans for the acquisition of ships which are constructed and delivered over a period of three to four years.

2. The querist has drawn the attention of the Committee to 'Instructions in accordance with which assets should be made out' as contained in Schedule VI to the Companies Act, 1956 which provides that where the original cost and additions and deductions thereto, relate to any fixed asset which has been acquired from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the assets (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset.

3. The querist has also drawn the attention of the Committee to paragraph 13 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' (revised 2003), issued by the Institute of Chartered Accountants of India, which states that

[1] Opinion finalised by the Committee on 30.4.2008

"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 paragraph 15." The querist has stated that paragraph 15 of AS 11 (revised 2003) deals with 'Net Investment in a Non-integral Foreign Operation' which is outside the scope of reference of this query.

4. The querist has stated that the Ministry of Corporate Affairs has vide notification no. G.S.R. 739 (E) dated 7th December, 2006 notifying the Companies (Accounting Standards) Rules, 2006, has stated as a footnote to AS 11 that the accounting treatment of exchange differences contained in AS 11 (revised 2003) has to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956. Further, the querist has also mentioned that in consonance with this Notification, the Institute of Chartered Accountants of India has clarified that the accounting treatment of exchange differences contained in AS 11 (revised 2003) issued by the Institute is applicable and not the requirement of Schedule VI to the Companies Act in respect of accounting periods commencing on or after 7th December, 2006.

5. The querist has further mentioned that paragraph 4(e) of Accounting Standard (AS) 16, 'Borrowing Costs' states that borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

B. Query

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

I. *Accounting for foreign exchange differences on foreign currency loans taken at different times.*

   (a) What should be the accounting treatment of exchange differences in the financial year 2007-08, arising in respect of:

(i) loans taken before 1st April, 2004, which is the date of applicability of Revised AS 11,

(ii) loans taken after 1st April, 2004, but before 7th December, 2006,

(iii) loans taken since 7th December, 2006, and

(iv) loans taken since 1st April, 2007?

(b) Whether the exchange difference on all the above loans can be taken to the profit and loss account or alternatively, be capitalised with the cost of the asset under construction and assets which are already completed and put into operation.

(c) Paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', inter alia, states that the cost of an item of fixed asset comprises its purchase price, including import duties and other non–refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use. In the light of this paragraph, whether the exchange difference on loans for ships under construction should be capitalised or taken to the profit and loss account.

(d) Considering the fact that AS 11 (revised 2003) applies only to transactions entered into after 01.04.2004, whether the exchange difference on loans taken before 01.04.2004 can be taken to the profit and loss account or whether Schedule VI will continue to apply to these transactions and the exchange difference is to be capitalised.

II. Accounting for foreign exchange gains under paragraph 4(e) of AS 16.

7. The querist has drawn the attention of the Committee to Accounting Standards Interpretation (ASI) 10, dealing with interpretation of paragraph 4(e) of AS 16 issued by the Institute of Chartered Accountants of India. The illustration to ASI deals with a scenario where exchange rate has moved upwards, i.e., devaluation

of rupee which results in increase in liability towards the principal amount. However, the present scenario is that the rupee has strengthened and there has been a decrease in liability towards the principal amount. In the light of the above, opinion of the Expert Advisory Committee has been sought on the following:

(a) The accounting treatment in respect of currency exchange gains arising out of loans in foreign currency.

(b) For the purpose of comparison of interest on foreign currency borrowing with interest that could be applicable had the loan been taken domestically in Rupees, what is the benchmark for notional rate of interest to be considered for domestic loan for the purpose of comparison?

(c) Accounting treatment in relation to foreign exchange difference on loan in foreign currency in the event interest rate on foreign currency borrowings is higher than that of local currency borrowings.

III. Presentation of foreign exchange gains.

8. In the event foreign exchange gain arises, what should be the method of presentation in financial statements / disclosures required by SEBI?

(a) Whether it should be disclosed under the head ’Other Income’.

(b) Whether it should be disclosed under the head ‘Other Expenditure’ as a reduction to such expenditure.

(c) Whether it should be disclosed as a separate line item. If so, what is the criteria for warranting such separate disclosure?

(d) Whether it requires disclosure in the Notes to Accounts, if the amount involved is less than 10% of ’total expenditure’ as per SEBI Guidelines.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that the company is acquiring ships which are constructed and delivered to it over a period of 3–4 years. The Committee presumes that the loans were obtained by the company before or during the construction of the ships and, therefore, the ships are considered 'qualifying assets' for the purposes of AS 16.

10. The Committee notes that the preamble to AS 11 (revised 2003) states as follows:

> "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."

11. AS 11, as notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, carries, inter alia, the following footnote:

> "In respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the effective date of the notification prescribing this Standard under Section 211 of the Companies Act, 1956, the applicability of this Standard would be determined on the basis of the Accounting Standard (AS) 11 revised by the ICAI in 2003."

12. The Committee also notes the footnote to notified AS 11, regarding the applicability of AS 11 (Revised) instead of Schedule VI to the Companies Act, 1956, and the ICAI's clarification that AS 11 would apply in respect of accounting periods commencing on

or after December 7, 2006 and not Schedule VI, as mentioned by the querist in paragraph 4 of the Facts of the Case.

13. The Committee further notes that in respect of accounting periods commencing on or after 1-4-2004, the Institute had issued an Announcement on ‘Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-a-vis Schedule VI to the Companies Act, 1956’ stating that a company adopting treatment prescribed in Schedule VI will be considered to be complying with AS 11 for the purposes of section 211 of the Act. Thus, in respect of the exchange differences arising during the period 1.4.2004 to 1.4.2007 on the foreign currency loans taken during that period, Schedule VI would be applicable.

14. The Committee also notes that AS 16 came into effect in respect of accounting periods commencing on or after April 1, 2000 and became mandatory in nature from that date. The Committee further notes that paragraph 4(e) of AS 16 provides that borrowing costs include “exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs”. The said clause applies to 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 borrowing 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.

15. With respect to the foreign exchange gains 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 was 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.

16. As regards the presentation of foreign exchange gains, the Committee notes that paragraph 40(a) of AS 11 requires an enterprise to disclose ***"the amount of exchange differences included in the net profit or loss for the period".*** The Committee further notes that it is not clear as to which SEBI Guidelines have been referred to by the querist in paragraph 8(d) above. In case the query is in the context of the format of quarterly financial results under clause 41 of the Listing Agreement, the Committee notes that the relevant requirement in respect of Expenditure is that "Any item exceeding 10% of the total expenditure to be shown separately" on the face of the results itself. Thus, if the amount of gains is less than 10%, it is not required to be shown separately, either on the face or in the notes.

D. Opinion

17. On the basis of the above, the opinion of the Committee on the issues raised by the querist in paragraphs 6 , 7 and 8 is as follows:

I. Accounting for foreign exchange differences on foreign currency loans taken at different times

(a) In the financial year 2007-08,

(i) in respect of loans taken before April 1, 2004, the pre-revised AS 11 applies subject to applicability of paragraph 4 (e) of AS 16 as discussed in paragraph 14 above;

(ii) and (iii) as per the footnotes to AS 11 notified by the Central Government (see paragraphs 11 and 12 above), AS 11 applies in respect of loans taken on or after April 1, 2004 but before April 1, 2007. In respect of such loans also, consideration would have to be given to paragraph 4(e) of AS 16. It is presumed that the accounting year of the company commences on 1st April, 2007.

(iv) in respect of loans taken on or after 1st April, 2007, the notified AS 11, i.e., AS 11 (revised 2003) applies, which means that Schedule VI is not applicable. Consideration would have to be given to paragraph 4(e) of AS 16.

(b) in the financial year 2007-08, recognition of exchange differences in the profit and loss account and capitalisation thereof would depend upon the following:

(i) Applicability of pre-revised AS 11 and revised AS 11 to the loans as per the recommendations contained in (a) above.

(ii) The exchange differences covered by paragraph 4(e) of AS 16.

(c) In view of the specific requirements of AS 11 and AS 16 issued by the ICAI and these being subsequently notified by the Central Government, the requirements of paragraph 9.1 of AS 10 are not applicable as this paragraph prescribes a general treatment. A general treatment contained in an Accounting Standard does not apply when the requirements contained in a specific accounting standard is applicable.

(d) In respect of transactions entered into before April 1, 2004, the exchange differences can not be recognised in the profit and loss account in case the loans were obtained for the purposes of construction of ships. In such cases, foreign exchange differences would continue to be capiltalised as per the requirements of pre-revised AS 11.

II. Accounting for foreign exchange gains under paragraph 4(e) of AS 16

(a) 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.

(b) As per the Explanation to paragraph 4 (e) of AS 16 notified under the Companies (Accounting Standards) Rules, 2006, the company will have to determine the rate of interest had these loans been raised in the domestic market. It is a company-specific situation, therefore, no specific benchmark can be prescribed.

(c) The querist has separately informed the Committee that the company does not have any such foreign currency loans. The Committee, thus, notes that it is a hypothetical issue, which it can not answer as per Rule 3 of its Advisory Service Rules.

III. *Presentation of foreign exchange gains*

(a) To the extent the exchange gains are not adjusted in the cost of the asset as suggested in paragraph 15 above, the same should be disclosed as a separate line item. This may or may not be disclosed under the head "Other Income".

(b) Such exchange gains can not be disclosed under the head 'Other Expenditure', as a reduction of such expenditure.

(c) Refer to (a) above.

(d) No, if the amount involved is less than 10%, it is not required to be shown in the notes to accounts as discussed in paragraph 16 above.

Query No. 7

Subject: ***Disclosure of income tax reimbursed by the customers in a power generating company.***[1]

A. Facts of the Case

1. A company is engaged in generation of power, having 14 coal based and 7 gas based generating stations located all over the country. The power is supplied mainly to the distribution companies of the State Electricity Boards. In the power sector, tariff for 'sale of energy' is determined by the Central Electricity Regulatory Commission (CERC) and the State Electricity Regulatory Commission (SERC) for central and state utilities, respectively.

2. The querist has informed that the tariff for sale of energy of the company is determined by CERC. CERC has notified by way of Regulations in March 2004, the terms and conditions for the determination of tariff applicable with effect from 1st April, 2004, for a period of five years. As per the Regulation, tariff for sale of energy in case of a thermal power generating station comprises two components, namely, the recovery of annual capacity (fixed) charges and energy (variable) charges, wherein :

(i) The annual capacity (fixed) charges consist of:

(a) Interest on loan capital;

(b) Depreciation including advance against depreciation;

(c) Return on equity;

(d) Operation and maintenance expenses; and

(e) Interest on working capital.

(ii) The energy (variable) charges consist of fuel cost.

3. The querist has further mentioned that the tariff regulations have given a special dispensation for 'tax on income', which is as follows:

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[1] Opinion finalised by the Committee on 30.4.2008

“Tax on income:

(1) Tax on the income streams of the generating company or the transmission licensee, as the case may be, from its core business, shall be computed as an expense and shall be recovered from the beneficiaries.

(2) Any under-recoveries or over-recoveries of tax on income shall be adjusted every year on the basis of income-tax assessment under the Income-tax Act, 1961, as certified by the statutory auditors.

Provided that tax on any income stream other than the core business shall not constitute a pass through component in tariff and tax on such other income shall be payable by the generating company or transmission licensee, as the case may be.

Provided further that the generating station-wise profit before tax in the case of the generating company and the region-wise profit before tax in the case of the transmission licensee as estimated for a year in advance shall constitute the basis for distribution of the corporate tax liability to all the generating stations and regions.

Provided further that the benefits of tax-holiday as applicable in accordance with the provisions of the Income-tax Act, 1961 shall be passed on to the beneficiaries.

Provided further that in the absence of any other equitable basis the credit for carry forward losses and unabsorbed depreciation shall be given in the proportion as provided in the second proviso to this regulation.

Provided further that income-tax allocated to the thermal generation station shall be charged to the beneficiaries in the same proportion as annual fixed charges, the income-tax allocated to the hydro generating station shall be charged to the beneficiaries in the same proportion as annual capacity charges and in case of inter-state transmission, the sharing of income tax shall be in the same proportion as annual transmission charges."

4. According to the querist, income tax computed and paid in each quarter is billed to the beneficiaries. Further, the querist has informed that the company was hitherto disclosing the amount of income tax recoverable from beneficiaries on the face of the profit and loss account as under:

Provision for Current tax :	xxxxxxxx
Less: Current tax recoverable	xxxxxxxx
	xxxxx

5. The querist has further mentioned that in line with the provisions of the tariff regulations, income tax is a reimbursement and is recoverable from the beneficiaries while the components of tariff are accounted for as sales revenue.

6. The querist has drawn the attention of the Committee to the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, which, inter alia, states that "the objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions." The Framework sets out the following four principal qualitative characteristics that underlie the preparation and presentation of financial statements for external users:

(a) Understandability: An essential quality of the information provided in financial statements is that it must be *readily understandable* by users having a reasonable knowledge of business, economic activities and accounting (emphasis supplied by the querist).

(b) Relevance: Further, the financial statements should be useful and the information provided must be *relevant to the users for making decisions*. Information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate the past, present or future events or confirming, or correcting their past evaluations. The ability to make prediction from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed (emphasis supplied by the querist).

(c) Reliability: The Framework further attaches the *importance to the substance over form*. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely in accordance with their legal form (emphasis supplied by the querist).

(d) Comparability: Users must be able to *compare* the financial statements of an enterprise *through time in order to identify trends* in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows (emphasis supplied by the querist).

7. The querist has referred to an earlier opinion on the subject, 'Disclosure of recovery of income tax from customers', given by the Expert Advisory Committee (published in Compendium of Opinions, Volume XXI, Query No. 11). The querist has contended that the disclosure of 'turnover' and 'tax recoverable from customers' by power sector companies need to be re-looked in the light of the above principal qualitative characteristics of the financial statements. In case the income tax reimbursed by the beneficiaries is included in the 'Turnover' of the company, disclosure of the same will not be in the spirit of the presentation of financial statements for external users as has been brought out in the Framework. The querist provides the following reasons to support this contention:

(a) As per the present tariff regulations, the company cannot retain any tax savings on account of tax planning or tax holidays available u/s 80 IA of the Income-tax Act, 1961, which is normally not the case in other industries. Due to such different norms of the industry, the income tax provision in the books and recovery thereof from the beneficiaries depends on the rate of income tax and the tax concessions enjoyed by the company. The incidence of income tax may be substantially lower during certain accounting periods due to tax holidays available to the company on account of new capacity addition.

(b) The most commonly used ratios to ascertain the performance of the company are Gross Margin, Net Margin, EBITDA, Asset–turnover ratios etc., and all of them are related to sales (or the top line). Along with these ratios, the trend ratios and trend lines will also be vitiated, in case the tax recoverable is included in the turnover. This being a factor beyond the control of the company, the ratios related to turnover will not portray the true performance of the company and its management.

(c) The comparison with other enterprises in the same sector will also not give a correct picture since the tax holidays available to a company would depend on the growth trajectory specific to each company and accordingly, the tax provisions will be different for different companies. Due to this, the ratios related to the turnover will not be comparable as they will not reflect the operational performance correctly.

8. The querist has mentioned that the above referred opinion of the Committee draws strength from the definition of the term ‘revenue’ given in Accounting Standard (AS) 9, ‘Revenue Recognition’, wherein revenue has been defined, inter alia, as below:

> “*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.”

Further, according to the querist, as per paragraph 92 of the Framework, the procedure normally adopted in practice for recognising income is that the revenue should be earned. The querist has contended that no element of earning is involved as far as income tax reimbursed by the beneficiaries is concerned. Neither any effort is involved nor is any revenue generating asset used for earning the same.

9. The querist has also drawn the attention of the Committee to Accounting Standards Interpretation (ASI) 14 (revised), 'Disclosure of Revenue from Sales Transactions', issued by the Institute of Chartered Accountants of India, which deals with disclosure of turnover in the following manner :

Turnover (Gross)	xxx
Less: Excise Duty	xxx
Turnover (Net)	xxx

The querist has stated that as per ASI 14 (revised), the amount of excise duty is to be shown as deduction from turnover and the basis for such conclusion is that the financial analysts and other users of the financial statements require the information related to turnover gross of excise duty as well as net of excise duty for meaningful understanding of financial statements. From the aforesaid, the querist has concluded that *this disclosure of turnover and presentation thereof has significance for companies in the manufacturing sector, where excise duty is a key component of turnover, on which the company does not have any control, as the rates are determined by the State. This indicates that every industry could have very specific items/ components of turnover, which would demand appropriate disclosure in financial statements* (emphasis supplied by the querist). As per the querist, while issuing ASI 14 (revised), the Institute of Chartered Accountants of India has recognised and appreciated that the disclosure requirements could be industry specific, and accordingly, the querist has drawn the attention of the Expert Advisory Committee to this aspect while reviewing the extant opinion.

10. The querist reiterates that tariff regulations in the power sector require a specific treatment for income tax provisions on the generation business of the company. Therefore, for better understanding of the financial statements of the power generating

companies, if a parallel is drawn, the presentation of income tax recoverable from beneficiaries as a line item as referred to in paragraph 4 above may be in order and the inclusion of the income tax in the turnover may not be an appropriate presentation considering the peculiarity of the power industry. Further, the querist contends that in order to give a true and fair view of the position of the company's performance and cash flow statement, it would be prudent to present income tax reimbursed by the beneficiaries separately so that the users of the financial statements have a fair idea about the total income tax payable by the company on the non-generation income and the part which is recoverable from the beneficiaries and the net income tax liability.

B. Query

11. Based on the above, the querist has requested the Expert Advisory Committee to review its earlier opinion on the subject, 'Disclosure of recovery of income tax from customers' (published in Compendium of Opinions, Volume XXI, Query No. 11,) keeping in view the regulatory environment of the power sector.

C. Points considered by the Committee

12. The Committee notes the definition of the term 'revenue' as defined in Accounting Standard (AS) 9, 'Revenue Recognition', which, inter alia, states 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."

13. The Committee notes that in the power sector, power is sold at tariff determined as per the tariff regulations, whereby tariff for sale comprises annual capacity (fixed) charges and energy (variable) charges. In addition to this, owing to the peculiar nature of the power sector, the tariff regulations include a special provision

to separately allow for recovery of income tax from the customers. Thus, it can be said that the consideration received by the company for the sale of electricity includes several components and income tax recovered from the customers is one of them. The Committee is of the view that though income tax expense which is reimbursed by the customers is determined in a manner different from that of the tariff charged and the amount of income tax keeps varying due to the changing circumstances faced by the company, it is nevertheless arising as a result of sale of electricity to the customers, and accordingly, as per the definition of the term 'revenue' reproduced above, it is a part of the 'charges made to the customers for goods supplied and services rendered' and hence is revenue. The Committee is also of the view that what is revenue as per AS 9, does not depend upon the manner of determination of quantum of payment by the customer, what is of essence is the consideration receivable in lieu of sale of goods or rendering of services. The fact that some element of expense is not factored in the determination of rate because of its varying nature, as in the case of income-tax expense, and, therefore, is separately recovered, does not change its inherent nature.

14. The Committee notes from the Facts of the Case that the querist has referred to the qualitative characteristics given in the Framework issued by the Institute and has contended that the suggested accounting treatment as per the earlier opinion of the Committee on 'Disclosure of recovery of income tax from customers', whereby recovery of income tax is considered to be revenue, is not in line with these qualitative characteristics. In this context, the Committee notes that the Framework issued by the Institute lays down broad principles with regard to the preparation and presentation of financial statements and it is the individual Accounting Standards which prescribe specific accounting treatments which have to be followed. In this context, the Committee notes paragraph 2 of the 'Framework for the Preparation and Presentation of Financial Statements', which states as follows:

> "2. This Framework is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard."

On the basis of the above, the Committee is of the view that once the requirements of an Accounting Standard are satisfied, if there is any perceived conflict between the said requirements and the Framework, the former prevails. The Committee is of the view that once it is agreed, as discussed in paragraph 13 above that the recovery of income tax is a part of revenue, it is not necessary to examine the qualitative characteristics as described in the Framework for the purpose of determining its treatment.

15. The Committee also notes paragraph 92 of the Framework, referred to by the querist in paragraph 8 above, which states as follows:

> "92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty."

16. The Committee notes from the above that the requirement with regard to earning of revenue is in the context of the timing of recognition of revenue and not in the context of what comprises revenue. For example, revenue is said to be earned when in case of sale of goods, all the significant risks and rewards of ownership of the goods are transferred; it does not lay down what constitutes the consideration for sale of goods. Accordingly, the querist's argument with regard to earning of the income tax which is recovered from the customers is not relevant.

17. The Committee notes that the querist has contended that one reason for not considering recovery of income tax as revenue is that doing so would hamper various performance ratios of the company. In this regard, the Committee is of the view that performance indicators/ratios do not determine what is proper accounting in accordance with the Accounting Standards.

18. The Committee notes ASI 14 (revised) simply deals with the issue/manner of the disclosure of excise duty in the presentation of revenue from sales transactions (turnover) in the profit and loss account and the suggested disclosure does not imply that excise

duty is not a part of revenue (turnover). Further, the Committee notes that though the issue in question also deals with disclosure of income tax recovered from the customers of a power generating company, the main concern is to ascertain its nature. Hence, the Committee is of the view that to draw a parallel with the disclosure treatment given in ASI 14 is inappropriate.

D. Opinion

19. Based on the above, the Committee is of the view that the earlier opinion issued by the Committee on a similar subject 'Disclosure of recovery of income tax from customers' (published in Compendium of Opinions, Volume XXI, Query No. 11) is correct, i.e., the recovery of income tax from the customers should form part of the revenue of the company.

Query No. 8

Subject: Issue of spares and stores to dredgers.[1]

A. Facts of the Case

1. A public sector undertaking, under the Ministry of Shipping, Road Transport and Highways, was incorporated on 29th March, 1976 under the Companies Act, 1956. The main objective of the company is to provide integrated dredging services to all major and minor ports, Indian Navy, fishing harbours and other maritime organisations.

2. The dredging activities are carried out by ocean going dredgers, self-propelled or dumb dredgers. As compared to any other ocean going vessel, the dredger has got a much greater amount of machinery installed. The trailer dredgers have almost twice the amount of machinery fitted as compared to an ocean

[1] Opinion finalised by the Committee on 30.4.2008

going ship of the same size. Most of the time, dredgers operate in various types of soils and sandy waters which affect the outer surface of hull plates as well as the internal plates of the hopper, which in turn, results in wear and tear of hull and other soil touching parts/equipments. These dredgers would normally be working 24 hours a day continuously for a period of about 3 weeks when the machinery will be stopped for undertaking preventive maintenance. Such continuous usage of the machinery in the shallow and sandy waters of the port causes heavy wear and tear necessitating periodic repairs in a dry dock and also the consumption of spares and stores.

3. The querist has informed that the spares used are machinery spares in nature as these spares are intended to be utilised on the fixed assets, i.e., dredgers. The procurement of these spares is need-based and against the specific requirement indicated by Masters/Chief Engineer on board of the dredgers through an indent. Such spares are replacements for parts worn out during usage of the machinery. Thus, replacement may take place at the next following maintenance period or during the next following dry dock of the dredger. Till such time, the spares so procured may generally be delivered on board the particular dredger or sent to the Central Warehouse at Visakhapatnam. In the latter case, the value of the spares is treated as inventory till the time of issue to the dredgers. These spares do not increase the future benefits from the existing assets (dredgers and other crafts) beyond their previously assessed standard of performance. These spares are procured to keep up the original functioning of the machinery on board the dredger.

4. The querist has mentioned that the cost of initial spares, i.e., the spares purchased along with the dredgers is capitalised. The cost of spares and stores purchased subsequently during the operation/repair of the dredgers is charged off as operational expenditure.

5. The current fleet of the company includes dredgers, tugs, survey launches and other ancillary crafts like barges, pontoons, etc. The above crafts are depreciated at the rate of 7% under straight line method (SLM), as provided in Schedule XIV to the Companies Act, 1956. The residual value of 2% is carried in the

books as Written Down Value. Presently, the company owns 12 dredgers, out of which 9 dredgers have been depreciated to 98%. All these dredgers are in operation and all these crafts are expected to have a further useful life of at least 5 to 10 years.

6. During the course of audit of accounts for the year 2006-07, the Comptroller and Auditor General of India (C&AG) (PDCA& MAB, Hyderabad) issued a provisional comment on accounting of stores and spares issued to dredgers. The accounting policy 4(a) in respect of spares and stores and the provisional comment 4(a) on this accounting policy of the company along with the company's reply are reproduced below:

Accounting Policy

"4. Operational Expenses

(a) Spares & Stores:

Spares and stores and lubricants delivered to the crafts during the year acknowledged by the Master/CEO are charged to revenue. Provision is made for the material delivered to crafts upto 31st March in respect of which acknowledgements are not received."

Comment of Government Audit

"4(a) This is understated by Rs. 99.16 crore due to failure to account for the stores and spares which were acknowledged by Masters of the vessels and lying on board the dredgers as on 31 March, 2007. This has resulted in overstatement of consumption of stores and spares for the year by Rs. 29.91 crore and prior period consumption by Rs. 72.25 crore and understatement of net profit after prior period adjustments by Rs. 99.16 crore. There is a need to change the accounting policy so that it is not in conflict with Accounting Standard (AS) 2, 'Valuation of Inventories'."

Reply of the company

"The accounting policy in respect of spares and stores has been consistently followed since inception and the same policy is being followed by other companies in similar business. The accounting policy needs to be viewed in the background of the dredging and shipping industry.

The company is meeting dredging requirements of various major and minor ports in India. Practically, it becomes very difficult to maintain/monitor the suggested method of spares/ stores on board the vessel keeping in view the difficulties involved.

Some of the important factors that need to be considered in this regard include:

(a) Dredgers are manned by floating officers and crew whose skills are highly specialised and confined to dredging operations. They are not accustomed to record keeping, except insofar as it may be necessary to operate the dredger (navigation and dredging).

(b) Floating personnel are continuously changing (3 months on and 2 months off) as per the rules applicable to them and every time there are necessary handing over/ taking over formalities.

(c) Dredgers operate most of the time in sea. They require minimum spares on board all the time.

(d) Spares supplied on board the dredgers are exposed to sea conditions and therefore, deteriorate at comparatively faster rate.

(e) Sometimes spares required by a dredger due to urgency may have to be supplied from another dredger.

(f) Estimating value of spares on board on a particular date will be impractical as these spares may have been carried for several years.

Because of the above factors, the shipping industry is following this specific policy of charging spares as and when delivered.

The value of inventories amounting to Rs. 99.16 crore appears to be based on the Management report furnished by Dredge

Masters. The figures so arrived are not authenticated/supported by necessary documentary evidence, i.e., invoice giving cost, taxes, duties, cost of bringing it to its present location, etc. Besides, the proposed change, if implemented, would seriously distort the true and fair view of the current year profitability.

It is further submitted that AS 2 is not applicable to the subject spares as AS 2 specifically excludes machinery spares in connection with items of fixed assets and therefore, the question of any conflict with AS 2 does not arise. Hence, Audit is requested to drop the Comment."

Further, in respect of the discussions with C&AG (PDCA & MAB Hyderabad), the querist has informed that it was also submitted that such procurement of spares and stores do not satisfy any of the following conditions to capitalise:

(a) enhance the life of the dredger, or

(b) increase the previously assessed standard of performance, or

(c) it results in reduction of cost of production.

7. According to the querist, the subsequent procurement of spares and stores has been only to maintain the normal functioning of the dredger. In view of this position, the cost of such procurement is to be expensed in the year of its incurrence. Further, as per the querist, this accounting treatment is in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets', and also with the rationale of the opinions issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India. Besides this, the querist has mentioned that the accounting policy is in line with the industry practice.

8. The querist has mentioned that after considerable discussions, the C&AG (PDCA & MAB, Hyderabad), agreed to the contentions of the company that it does not fall within the scope of AS 2 and revised the earlier Provisional Comment 4(a) stating that the accounting treatment of the company is not in consonance with AS 10 and forwarded the revised Comment 4(a) to C&AG, New Delhi along with other comments. The querist has provided the

Revised Provisional Comment 4(a) along with the company's reply for the perusal of the Committee, the relevant extracts of which are reproduced as below:

Comment of Government Audit

"Profit and Loss Account

B. Expenditure on:

Operations (Schedule X)
Spares and Stores – Rs. 4534.97 lakh

4(a)(i) This includes spares valuing Rs. 9.86 crore issued to three dredgers which have a residual life. The spares should have been capitalised in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and depreciated over the remaining life period of these dredgers. Failure to do so resulted in overstatement of consumption by Rs. 9.86 crore, understatement of Gross Block to the same extent, understatement of depreciation by Rs. 1.38 crore and profit for the year by Rs. 8.48 crore.

(ii) This also includes spares worth Rs. 35.49 crore issued to remaining dredgers with no residual life. The value of these spares should have been capitalised and then charged off to Profit and Loss Account through depreciation account. This has resulted in overstatement of consumption by Rs. 35.49 crore and understatement of Gross Block and depreciation to the same extent.

(iii) Such incorrect charging-off of spares issued to dredgers in the past but not consumed and lying on board the dredgers as on 31st March, 2007 has led to understatement of Gross Block by Rs. 72.25 crore. Due to adopting an accounting policy which is not in consonance with AS 10, the Gross Block is not being properly accounted for. There is a need to change the accounting policy No. 4(a) relating to issue of spares and stores so that it is not in conflict with AS 10."

Reply of the company

"…For ready reference, we are furnishing below the particular accounting policies adopted by various similar companies in the industry:

A Ltd.

Accounting policy No.7 (e) –

7. Valuation of stocks:

   (e) Store/spares including paints, etc. are charged to revenue as consumed when directly issued to ships. Items of stores/spares, which cannot be delivered immediately are shown under stores/spares in transit and are cleared on receiving acknowledgement from the ship. However, all items of stores/spares purchased within last 3 months of the financial year, for which acknowledgement are not received, are treated as stock and valued at lower of cost or realisable value.

B Ltd.

Accounting policy No. (i) (ii)

(i) Operating expenses:

(ii) Stores and spares delivered on board the ships and rigs are charged to revenue.

C Ltd.

Accounting policy No.(g)

(g) Stores and Spares:

   Stores and spares purchased are directly issued to ships and the value of such purchases is charged to the expenses account as consumed.

Further to above, we would like to reiterate that the values indicated cannot be authenticated/supported by necessary documentary evidence, such as, invoice giving cost, taxes, duties, cost of bringing it to its present location in respect of each item of the spare and its present condition on board the dredger as required to pass necessary accounting entries in the books.

In view of this, we are unable to vouch for the correctness of various figures stated in the modified provisional comments, viz.,

(a) Rs. 9.86 crore in respect of the three dredgers which have a residual life,

(b) Spares worth Rs. 35.49 crore issued to remaining dredgers with no residual life, and

(c) Rs. 72.25 crore purported to have been incorrectly charged off of spares issued to dredgers in the past

…"

9. The querist has informed that the revised comment along with other comments was discussed and clarified at C&AG's office, New Delhi. The C&AG's office has dropped the above comment subject to the company's assurance that the subject Provisional Comment will be referred to the Institute of Chartered Accountants of India for its expert opinion. Further, the querist has mentioned that in this connection, the company has relied on the earlier opinions of the Expert Advisory Committee on the subject published in various volumes of Compendium of Opinions, viz., Query No. 13 of Volume XX, Query No. 32 of Volume XX, Query No. 37 of Volume XX, and Query No. 22 of Volume XXIII.

B. Query

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

(i) Whether the accounting practice followed by the company, viz., for charging off spares to expenditure as and when these are issued to dredgers, as per the facts and circumstances, is in accordance with the provisions of AS 10.

(ii) If not,

(a) whether such subsequent procurement of spares and stores needs to be capitalised and depreciated over the remaining life period of the dredgers as opined by the C&AG Audit.

(b) whether such procurement of spares and stores also needs to be capitalised in respect of dredgers with no residual life. Whether these spares and stores should be capitalised and then charged off to the profit and loss account through depreciation account as opined by C&AG Audit. (The querist has invited reference to the earlier opinion of the Expert Advisory Committee published as Query No. 3 of Volume XXIII of the Compendium of Opinions.)

C. Points considered by the Committee

11. The Committee notes the following paragraph of Accounting Standard (AS) 2, 'Valuation of Inventories', which states as below:

> "4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets'."

12. The Committee also notes the following paragraphs 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."

"**12. Improvements and Repairs**

12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity."

"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."

13. On the basis of the paragraphs of AS 2 and AS 10 reproduced above, the Committee notes that for accounting purposes, there are generally two types of machinery spares. The first type are those machinery spares which cannot be used in connection with a particular/specific item of a fixed asset and whose use is not irregular, and are considered as inventories and accordingly need to be accounted for as per the principles enunciated in AS 2. The second type of machinery spares are those which can be used only in relation to a specific item of a fixed asset and whose use is expected to be irregular, and they should be accounted for as per AS 10. Such spares are commonly known as capital spares/ insurance spares.

14. The Committee notes from paragraph 8 of the Facts of the Case that whereas the Government Audit (New Delhi) has given its opinion on the basis that the machinery spares in question are capital spares, the accounting treatment followed by the company is based on the consideration that the spares are of the nature of inventory except in the instance of initial spares purchased at the

time of the purchase of the dredgers itself. The Committee also notes from paragraph 6 that the Government Audit (Hyderabad) also appears to consider the machinery spares of the nature of inventory. The Committee further notes that the Facts of the Case do not contain information to decide whether the machinery spares are of the nature of capital spares keeping in view the requirements of paragraph 8.2 of AS 10. The Committee is, therefore, of the view that the company should first decide whether the spares are of capital nature or of the nature of inventory keeping in view the requirements of the aforesaid paragraph of AS 10. It is also possible that some machinery spares may be of capital nature while others may not be of that nature, i.e., these may be of the nature of inventory, e.g., in case of spares which can be used by different dredgers and, therefore, not specific to an item of fixed asset as contemplated in paragraph 8.2 of AS 10. In the absence of the facts, the opinion of the Committee hereinafter deals with both the situations, namely, if the spares are of capital nature and in case the spares are of the nature of inventory.

In case the spares are of capital nature

15. Machinery spares of the nature of capital spares/insurance spares are to be capitalised separately, whether purchased along with the principal fixed asset, i.e., the dredgers, or purchased subsequently. The Committee notes that at present the company capitalises the initial spares, i.e., those purchased with the dredgers, and charges to revenue those spares which are purchased subsequently. In this respect, the Committee reiterates that in case the spares purchased by the company are capital spares, these are to be capitalised whenever these are purchased. As per the requirements of AS 10, capital spares purchased along with the dredgers should be depreciated on a systematic basis over a period not exceeding the useful life of the dredger to which they relate. In case of capital spares purchased subsequently, depreciation should be charged on a systematic basis over a period not exceeding the balance/remaining useful life of the particular dredger to which the spares relate. On the date the capital spare is actually put to use, i.e., it replaces the worn out part in the corresponding dredger, the written down value of the capital spare at that date is immediately written off to the profit and loss account.

This is done as the replacement of the spare does not increase the future benefits from the existing dredger beyond its previously assessed standard of performance.

16. In case of spares purchased subsequently in relation to dredgers whose residual life has expired, the Committee notes that as per the accounting treatment given in AS 10, the cost of capital spares should be amortised on a systematic basis over a period not exceeding the useful life of the principal asset, i.e., the particular dredger. Thus, where the useful life of the dredger has expired, i.e., it has been completely depreciated in the books, the Committee is of the view that capital spares, should be first capitalised and then charged to the statement of profit and loss through depreciation in the year of purchase itself. The Committee also notes that this accounting treatment is in consonance with the view expressed by the Committee in its earlier opinion published in Compendium of Opinions, Volume XXIII, Query No.3.

In case the spares are of the nature of inventory

17. The Committee notes from paragraph 8.2 of AS 10 reproduced in paragraph 12 above that the machinery spares of the nature of inventory are usually charged to the profit and loss statement as and when consumed. The Committee notes that the company is treating the machinery spares as of the nature of inventory and are charging the same to the profit and loss account when these are *issued for consumption*. The Committee also notes the accounting policies of certain companies quoted by the querist in paragraph 8 of the Facts of the Case, wherein the spares are being treated as of the nature of inventory and are considered to be consumed when issued for consumption. The Committee is of the view that a spare can be considered as consumed when issued from store in an event the spare is to be immediately used against a specific breakdown of the relevant component of the dredger. However, in case the spares are ordinarily issued to a dredger awaiting breakdown in the dredger, it indicates that spares are lying on the dredgers as inventory. In the latter case, it is imperative for the company to have an appropriate system of inventory management and control on the dredger in case the spares are material in amount. The difficulties indicated by the company in

paragraph 6 of the Facts of the Case do not override the requirements of the Standards. What it indicates is the lack of proper system of accounting for spares of the nature of inventory.

18. The Committee is also of the view that in case the company considers the machinery spares of the nature of inventory, the same should be treated as such even if purchased initially along with dredgers. For this purpose, the value of the spares may have to be estimated on a reasonable basis.

D. Opinion

19. On the basis of the above, the Committee is of the following opinion in respect of the issues raised by the querist in paragraph 10 above:

(i) As per the facts and circumstances of the given case, the current accounting practice of the company of charging off spares to expenditure as and when these are issued to dredgers is not in accordance with the provisions of AS 10.

(ii)(a) If the spares are of capital nature and purchased subsequently, these need to be capitalised and depreciated systematically over the remaining useful life of the particular dredger in whose connection these are purchased and expected to be used as discussed in paragraph 15 above.

(b) In case the spares are of capital nature and where the life of the particular dredger is over, the same should be charged to the profit and loss account through depreciation as discussed in paragraph 16 above.

Query No. 9

***Subject:* *Accounting for maintenance spares supplied free of cost along with the main equipment.*[1]**

A. Facts of the Case

1. A company is a leading engineering product company in public sector under the Ministry of Defence, catering to the vital sectors of the economy, such as, infrastructure, surface transportation, mining and defence. As per the querist, with a turnover of Rs. 2601.79 crore for the financial year 2006-07, the company is market leader in earthmoving and mining equipments and consistently making profits right from its inception. For the financial year 2006-07, the company earned a profit before tax of Rs. 316.04 crore registering a growth of 10.73% over previous year. The company is a fast growing engineering product company with export presence in as many as 42 countries spanning over Asia, Africa, and South American countries. For the financial year 2006-07, the export turnover was Rs. 110.73 crore and, according to the querist, it is expected to increase manifold in the future.

2. The company has three manufacturing units located at Kolar Gold Fields (KGF), Bangalore and Mysore. It has marketing and service centres spread all over India. The KGF unit manufactures dozers, excavators, loaders, walking draglines, rope shovels and sophisticated aggregates catering to the needs of mining and defence sectors. The Bangalore unit manufactures rail coaches, EMU's wagons, overhead inspection vehicles for Indian Railways and also logistics vehicles (tatra variants), mechanised pontoon bridges, ground support system for the integrated guided missiles for use by the Ministry of Defence. In addition, Bangalore unit is manufacturing for the first time in India, metro rail coaches under license from a company of Korea. The Mysore unit manufactures highly sophisticated dumpers, graders, aircraft towing tractors, the weapon loading systems and high powered internal combustion engines. All these products are highly technology intensive and call for an array of manufacturing technologies.

[1] Opinion finalised by the Committee on 30.4.2008

3. The querist has stated that one of the usual terms of sale is that the price of the equipment includes certain specified quantity of maintenance spares supplied free of cost. In other words, the company agrees to supply certain spares free of cost, i.e., without charging anything in excess of the agreed price of the equipment, purely as a marketing strategy.

4. The querist has illustrated the accounting treatment being followed by the company with the help of the accounting entries as follows:

(i) Debit: Sundry Debtors/Customers

Credit: Sales Account-Equipment (value of equipment + value of spares to be supplied free of cost)

Credit: Sales Tax.

(ii) The value of spares supplied/to be supplied free of cost as per the terms of the customer order is intimated through the issuance of a credit note, a copy of which is marked to the concerned sales office located at various states. The accounting entry passed is as follows:

(a) Debit: Sales Account (Equipment) – To the extent of the value of free spares.

Debit: Depot Sales Tax Account – Pro-rata

Credit: Deposit – Customer Account

(b) Thus, the equipment sold is recorded at a net value, i.e., value as per customer order as reduced by the value of free spares.

(iii) The free spares may be supplied either from the production units located at Karnataka or from the concerned sales office(s) located at various places in India. To the extent the free spares are supplied from Karnataka, i.e., in case of inter-state sale, the accounting entry passed is as follows:

Debit: Deposit - Customer Account

Credit: Sales Account - Spare Parts

Credit: Sales Tax

To the extent free spares are supplied from the sales offices, i.e., intra state sales, the accounting entry passed is as follows:

Debit: Deposit - Customer Account

Credit: Sales Account - Spare Parts

Credit: Sales Tax at the appropriate rate as per the statute of the concerned State.

Thus, in the view of the querist, with the passing of the above accounting entries, the total sale value as per the customer order is restored.

5. According to the querist, this is done purely to reflect correctly the value of spare parts sold to customers (either at a price or free of charge or as a part of equipment), as the company has a strategic business unit for spare parts. Also, in the view of the querist, by doing this, the company is not violating Accounting Standard (AS) 9, 'Revenue Recognition', in any manner whatsoever. As per the querist, this method enables the company to fix the price of the equipment as per the market dynamics.

6. The querist has further stated that the statutory auditors of the company are of the opinion that raising invoice separately for spare parts supplied free of cost and accounting thereof by reducing the value of the equipment (to the extent of the value of spares supplied free of cost) is not in order.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting for sale of equipment duly reducing the value of free supply of spares and accounting as sale the value of spares at the time of supply is in line with Accounting Standard (AS) 9, 'Revenue Recognition'.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether or not the accounting of maintenance spares supplied free of cost by reducing the value of equipment (to the extent of the value of the spares) and recording the sale of spares at the time of supply thereof is in order. The Committee has, therefore, restricted its opinion to this issue and has not touched upon any other issue arising from the Facts of the Case, such as, the accounting and valuation of inventories of maintenance spares, accounting for sales tax, basis of measurement of the amount at which revenue from sale of spares should be booked, etc. Further, the opinion expressed by the Committee is purely from accounting point of view and the Committee has not gone into legal interpretation of various enactments, such as those relating to sales tax, etc.

9. The Committee notes on the perusal of the query that the entries passed by the company are not clear in respect of the values at which the entries are passed. Accordingly, the understanding of the Committee in this regard has been illustrated with the help of the following entries:

(a) Assuming the value of sales order of equipment is Rs. 100, inclusive of the value of spares to be supplied along with the equipment Rs. 10; ignoring the effect of sales tax, the entry passed by the company is:

Sundry Debtors A/c	Dr.	100	
To Sales A/c (Equipment)			100

(b) For issuing credit note to the concerned sales office:

Sales A/c (Equipment)	Dr.	10	
To Deposit – Customer A/c			10

(With passing of this entry, the equipment sold is recorded at the net value, i.e., value as per customer order as reduced by the value of free spares)

(c) At the time of supply of free spares from the concerned sales office:

Deposit – Customer A/c	Dr.	10	
To Sales A/c (Spare parts)			10

(With the passing of this entry, the total sales value as per the customer order is restored)

10. The Committee notes from the Facts of the Case that though the company, in the instant case, is supplying spares free of cost, since the spares have a value which otherwise would have been recovered had these spares not been supplied under the agreement of selling of main equipment, in substance, in the view of the Committee, the company is selling two products under one composite selling arrangement. The Committee is, therefore, of the view that principles of revenue recognition, as enunciated in AS 9, should be applied separately to each element of the composite arrangement with a view to recognise revenue. In this context, the Committee notes paragraphs 6.1, 10 and 11 of AS 9, which provide as follows:

"6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes."

"10. Revenue from sales or service transactions should be recognised when the requirements as to performance

set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

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

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

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

11. The Committee further notes from paragraph 4(iii) above that free spares may be supplied either from the production units located at Karnataka or from the concerned sales offices located at various places. Thus, there can be a time lag between the recognition of revenue on account of sale of equipment and that for spares in case significant risks and rewards in respect thereof are transferred to the buyer on different dates, e.g., significant risks and rewards in respect of spares are transferred at the time of delivery thereof to the buyer whereas those of equipment are transferred at the time of the delivery of equipment which might have taken place at an earlier date. In such a situation, passing of a separate entry for spares would be justified.

12. The Committee notes from the above-reproduced paragraphs of AS 9 that the Standard requires recognition of revenue when the significant risks and rewards of ownership in respect of the goods have been transferred to the buyer. Thus, the Committee is of the view that in case the significant risks and rewards in respect of spares are transferred at a time different from the time of transfer of the risks and rewards of the concerned equipment, the

revenue in respect of that equipment should not be recognised at a gross amount, inclusive of value of spares. The revenue in respect of spares should be separately recognised at the time of transfer of significant risks and rewards of ownership of the spares. Therefore, it is not appropriate to first pass the entry for sale of equipment at the gross amount and then to pass a reversal entry for recognising revenue from spares.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the accounting for sale of equipment duly reducing the value of free supply of spares would be in line with AS 9 provided significant risks and rewards of ownership in respect of free spares are transferred at the time of the delivery of spares to the buyer. However, separate entries should be passed for (a) booking recognition of revenue from sale of equipment net of the amount related to revenue from spares when the risks and rewards of ownership of the equipment are transferred and (b) booking recognition of revenue from spares when the risks and rewards of ownership of spares are transferred.

Query No. 10

Subject: Revenue recognition pending physical delivery.[1]

A. Facts of the Case

1. A leading engineering product company caters to the vital sectors of the economy, such as, infrastructure, surface transportation, mining and defence. The company is a public sector enterprise under the administrative control of the Ministry of Defence. With a turnover of Rs. 2601.79 crore inclusive of excise

[1] Opinion finalised by the Committee on 30.4.2008

duty and Rs. 2423.87 crore net of excise duty for the financial year 2006-07, as per the querist, the company is market leader in earthmoving and mining products. The company is consistently making profits right from inception. For the financial year 2006-07, the profit before tax was Rs. 316.04 crore registering a growth of 10.73% over previous year. The company is a fast growing engineering product company with export presence in as many as forty two countries spanning over Asia, Africa and South American countries. For the financial year 2006-07, the export turnover was Rs. 110.73 crore and, according to the querist, it is expected to increase manifold in the future.

2. The company has three manufacturing units located at Kolar Gold Fields (KGF), Bangalore and Mysore. It has marketing and service centres spread all over India. The KGF unit manufactures dozers, excavators, loaders, walking draglines, rope shovels and sophisticated aggregates catering to the needs of mining and defence sectors. The Bangalore unit manufactures rail coaches, EMUs, wagons, overhead inspection vehicles for Indian Railways and also logistics vehicles (tatra variants), mechanised pontoon bridges and ground support system for the Integrated Guided Missiles for use by the Defence. In addition, Bangalore unit is manufacturing for the first time in India, metro rail coaches under licence from a company of Korea. The Mysore unit manufactures highly sophisticated dumpers, graders, aircraft towing tractors, the weapon loading systems and high powered internal combustion engines. All these products are highly technology intensive and call for an array of manufacturing technologies.

3. The company's significant accounting policy (copy of the Annual Report of the company for the year 2006-07 has been furnished by the querist for the perusal of the Committee) on revenue recognition is as under:

> "Policy No. 4(i):
>
> Sales set up for products viz., equipments, aggregates, attachments and ancillary products, is made when these are unconditionally appropriated to the valid sales contract after pre-despatch inspection by the specified authority."

According to the querist, the above policy is being followed consistently by the company. Further, the policy has been validated by both the statutory auditors and the Comptroller and Auditor General of India (C&AG) (Government audit). Further, as per the querist, the accounting policy as stated above provides for setting up sales when the goods are unconditionally appropriated to the sale contract irrespective of delivery, once the Goods Consignment Notes (hereinafter referred to as GC Notes) are issued in favour of consignee, i.e., customers. The company does not retain any further right of disposal over the equipment.

4. During the finalisation of accounts for the financial year 2006-07, it was felt by the Government audit that there is a need to seek the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India regarding the validity and acceptability of the aforesaid accounting policy.

5. As per the policy, the revenue from the sale of equipments, aggregates, components and attachment are recognised based on valid sales contract. This fact is also disclosed by way of notes to accounts. Further, revenue is recognised in respect of these products only on the basis of pre-despatch inspection.

6. During the year 2006-07, the sales set up of Rs. 184.87 crore was based on goods (covered by customer orders) handed over to the transporters and the said handing over was duly evidenced by the GC Notes issued by the said transporters. The Principal Director of Commercial Audit (the 'PDCA') felt that it was not possible to conclude that the company has forgone its right and title to the goods by merely handing over the same to the transporters, especially when such transporters *were not specifically customer nominated transporters* (emphasis supplied by the querist) and goods were in the custody of the company till the transporter was in a position to place a suitable vehicle to transport the equipment.

7. The transit insurance and transportation are arranged by the company wherever the terms of contract so provide. The amounts of insurance premium and freight charges are reimbursed by the customer in such cases. This is a trade practice normally followed in this nature of industry to enhance customer satisfaction and loyalty.

8. The company is of the view that in the case of ex-works sale contracts, once the goods are handed over to the transporters, the company does not retain any effective control/ownership on such goods. The risks and rewards of ownership automatically pass on to the customer. Further, according to the querist, there exists no uncertainty in expecting the ultimate collection of sale proceeds which can be verified by records of subsequent collections.

9. The querist has referred to the Appendix to Accounting Standard (AS) 9, 'Revenue Recognition', which, according to the querist, states that revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. The said Appendix to AS 9 also stipulates that item (goods) must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery. As per the querist, in the case of the company, the items (goods) in question were on hand, duly identified. Thus, according to the querist, the conditions for the recognition of revenue as laid down in paragraphs 10 and 11 of AS 9 have been duly fulfilled.

10. The querist has informed that all the equipments are heavy earth moving machinery which are transported in disassembled condition by either low bed or semi low bed trailers only. Normally, these vehicles (low bed/semi low bed trailers) are in short supply. Even most of the renowned transporters do not own such vehicles in adequate numbers. Hence, such vehicles are perennially in short supply. Also, these transporters do not have adequate storage space and lifting tackles for loading and un-loading in their premises. Hence, the equipments are often in the custody of the company even though the receipt thereof is acknowledged by way of GC Notes.

11. The querist has referred to section 30 of the Sale of Goods Act, 1930, which envisages a situation of a seller, having sold goods, continues or is in possession of the goods or of the documents of title to the goods. According to the querist, the said Act, as such, does not state that the sale can take place only after parting possession of the goods by the seller. The querist has

stated that the said Act, in terms of section 39, prima facie recognises the delivery to a carrier for the purpose of transmission to the buyer as delivery to the buyer where, in pursuance of a contract of sale, the seller is authorised or required to send the goods to the buyer by a carrier, *whether named by the buyer or not* (emphasis supplied by the querist). According to the querist, in law, the goods or the documents of title representing the goods belong to or vest with the buyer though these are in the possession of the seller or the carrier and GC Notes or documents issued by the transporter duly signed acknowledging the receipt of goods, whether actual or constructive, is deemed to be a "Delivery".

12. According to the querist, it is not uncommon that the vehicle as specified in the GC Note is placed by the transporter after the date mentioned in the GC Note. This situation arises due to non-availability of vehicles as mentioned in paragraph 10 above. Hence, it cannot be construed that the delivery – actual or constructive, has not taken place.

13. Also, during the financial year 2006-07, the sales set up of Rs. 84.12 crore was based on goods covered by customer orders, but which were physically available in the premises of the company consequent upon a communication received from the customer/ customers that for the time being, the said customer/customers was/were not able to take delivery of the goods. This is a case of delivery delayed at buyer's request. In this case also, the Government auditors felt that since the items/goods were lying in the premises of the company, the company had not forgone the control/ownership of such goods and consequently the risks/ rewards of such goods had not been passed on to the customer/ customers.

14. It was contended by the company that as per paragraph A1 of Appendix to AS 9 (mentioned in paragraph 9 above), revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made especially when the delivery is delayed at buyer's request. However, items must be on hand, identified and ready for delivery. In the instant case, the items were physically available, duly identified and ready for delivery. It was, therefore,

felt by the company that the sales set up in respect of such cases was in order.

15. The querist has suggested that cognizance may be taken of the earlier opinions issued by the Expert Advisory Committee contained in Compendium of Opinions-Volume VII (query 1.12) and Compendium of Opinions-Volume XI (query 1.39). As per the querist, in these cases, the opinion of the Expert Advisory Committee is to recognise the sales when goods are appropriated to the contract by delivering to the transporter for transmission to the buyer, that too, in respect of FOR destination contracts. The query being raised is in respect of contracts with delivery on ex-works basis. In this background, it is reiterated by the querist that what is applicable to FOR destination cases is much more relevant to the cases where terms of delivery are on ex-works basis.

B. Query

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

(i) Whether booking of sales where delivery is delayed at buyer's request is in order; and

(ii) Whether booking of sales on the basis of GC Notes from the transporter is in line with AS 9.

C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to revenue recognition in respect of the two issues mentioned in paragraph 16 of the query. Therefore, the Committee has examined only these issues and has not examined any other issue that may be contained in the Facts of the Case, such as, measurement of revenue when products are sent in disassembled condition, etc. Further, since the querist has raised the query in the context of AS 9, the Committee proceeds on the assumption that AS 9 is the applicable standard. Incidentally, the Committee notes that the amounts of sales booked merely on basis of GC Notes as well as sales booked for which delivery is delayed at buyer's request as per Facts of the Case (mentioned in paragraphs 6 and 13 above) differ from the respective amounts disclosed in

Notes to Accounts. However, since the query involves revenue recognition issue and not amounts, the said difference does not affect the opinion of the Committee.

18. The Committee notes the following paragraphs from AS 9:

"6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. *However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.* Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes."

"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed."

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

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

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

[Emphasis in paragraph 6.1 of AS 9 supplied by the Committee.]

Paragraph 12 of AS 9 deals with performance for rendering of services, and hence, not reproduced above.

19. The Committee notes from the above that the time of transfer of all significant risks and rewards of ownership may be different from the time of transfer of legal ownership, and that for accounting purposes, revenue in such cases should be recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

20. The Committee is of the view that the question when the transfer of significant risks and rewards of ownership takes place depends on particular facts and circumstances of the case, including the terms of the contract, express and/or implied, and the conduct of the parties. Various factors should be considered for ascertaining the timing of passing of significant risks and rewards of ownership. For example, factors like who bears the risk of damage when the goods are lying in the company's premises after appropriation, who bears the risk of damage during transit, who is taking the insurance, whether the goods produced are substantially complete, whether the company can sell the goods to another party or pledge the same after appropriation to the contract, etc., will have to be taken into account in determining the timing of transfer of significant risks and rewards of ownership. In some situations, the company may be able to transfer risk of damage to insurance company but not to the customers. As such, mere receipt of GC note may not necessarily indicate that all significant risks and rewards of ownership have been transferred to the customers.

21. The illustration given in Appendix to AS 9 mentioned by the querist in paragraphs 9 and 14 above is reproduced below:

"Delivery is delayed at buyer's request and buyer takes title and accepts billing

> Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery."

22. The Committee notes that in the above illustration, it is specifically stated that it deals with a situation where delivery is delayed at buyer's request and buyer takes title and accepts billing. All the three conditions are cumulative which must be met apart from identification of goods, readiness for delivery and expectation of delivery. It appears that the querist is under the impression that mere identification of goods, readiness for delivery and expectation of delivery are sufficient for revenue recognition. If so, the Committee does not agree with the querist's view. Thus, for example, if the buyer simply requests for delayed delivery, but there is express or implied understanding that risk of damage before actual delivery to the carrier rests with the seller, then, revenue recognition before actual delivery to the carrier is not appropriate. Similarly, if the buyer does not accept title and/or billing, revenue recognition is not appropriate.

23. The Committee notes that the querist has not stated whether all the above conditions were met while recognising revenue in respect of goods lying in the premises of the company where delivery is delayed at buyer's request. As stated above, only if all the above conditions are met, revenue recognition will be appropriate where delivery is delayed at buyer's request. In such circumstances, there is no retention of control/ownership of the goods. Even here, an element of caution should be exercised. For example, the condition that there is every expectation that delivery will be made will be met if as soon as the customer asks for delivery and if it is the responsibility of the company to arrange for transport, then the company should be able to deliver the goods within the stipulated time or reasonable time. Otherwise, the risk of loss due to the fault of the company after the delivery request from the customer may be retained by the company.

24. The two earlier opinions of the Committee cited by the querist in paragraph 15 above dealt with the case of actual delivery of goods to the transport carrier and not mere receipt of GC Notes without delivery. Hence, these opinions are irrelevant for the given Facts of the Case. Further, in the cited two opinions, the Committee clearly expressed its view that booking of sales is permitted on delivery to the transporters, if in the facts of the case, significant risks and rewards of ownership in the goods do not remain with the company.

D. Opinion

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

(i) The booking of sales where delivery is delayed at buyer's request is in order only if the buyer takes title and accepts the billing subject to the condition that the items are on hand, identified, ready for delivery, there are no further conditions with respect to acceptability by the buyer and there is every expectation that delivery will be made as discussed in paragraphs 22 to 24 above. Further, other factors, as discussed in paragraph 20 above should also be taken into consideration.

(ii) Booking of sales on the basis of GC Notes from the transporter (without actual delivery) is not in line with AS 9, unless risks and rewards of ownership are passed on to the buyer even before actual delivery to the transporter, having regard to the facts and circumstances of the case, including the terms of the contract, express and/or implied, and the conduct of the parties.

Query No. 11

Subject: Accounting for expenditure in proportion to sales by a hydroelectric power generating enterprise for the purpose of interim financial statements – whether appropriate.[1]

A Facts of the Case

1. A public sector enterprise registered under the Companies Act, 1956, is engaged in construction and operation of hydro-electric power projects.

2. The querist has stated that generation of electricity in hydro projects mainly depends on availability of machine and water. Machine is always available throughout the year except for planned outage and in rare circumstances, break down of machine. Availability of water is seasonal because in summers and monsoon season, availability of water is more due to melting of snow and increase in flow of water due to rains as compared to other seasons. As such, in the first two quarters of the financial year (April to September), being the summer and rainy seasons, generation of electricity is more as compared to the last two quarters of the financial year (October to March).

3. The company is under the regulatory regime, and tariff (sale price) for electricity is fixed by Central Electricity Regulatory Commission (CERC). The regulator fixes tariff in the form of annual fixed charges (AFC). AFC is normally fixed by CERC for a period of 5 years and it is determined keeping in view the capital cost of power station, loan repayment schedule, capital structure, etc. The constituents of AFC are six components as detailed below:

A. Interest on loans

Interest on outstanding loans towards capital cost duly taking into account the schedule of repayments, as approved by the authority, is allowed in AFC.

[1] Opinion finalised by the Committee on 30.4.2008

B. Depreciation

Depreciation is calculated for each year as per straight line method at the rate of depreciation as prescribed by the CERC. Value base for the purpose of depreciation shall be historical cost of assets. Depreciation during the life of the project is limited to 90% of the approved capital cost.

C. Advance against depreciation (AAD)

To meet out cash flow for repayment of loans, this additional amount is provided limited to 1/10th of loan. AAD in a year shall be restricted to the extent of difference between cumulative repayment and cumulative depreciation up to that year. In other words, to facilitate repayment of loan towards capital cost, short fall of depreciation to the extent of 1/10th of the loan amount or actual repayment whichever is lower, is allowed by CERC in the form of AAD.

D. Return on equity

Return on equity is allowed @ 14% p.a. on admitted amount of equity.

E. Operation and maintenance (O&M) expenses

1.5% of approved capital cost further escalated at 4% p.a. for the subsequent years is allowed as O&M expenses.

F. Interest on working capital

Interest on working capital is allowed on the sum of the following amounts:

- O&M expenses for 1 month.
- Maintenance spares @ 1% of the historical cost escalated @ 6% per annum from the date of commercial operation.
- Receivables equivalent to two months of fixed charges for sale of electricity. Interest rate for above purpose is to be taken equivalent to short-term prime lending rate of SBI.

Tariff for a year is fixed in such a way that 90% of the capital cost of the project is recovered through depreciation and AAD over the project life which is around 35 years in addition to other components as explained above.

4. The querist has further stated that the quantum of AFC as fixed above is linked with design energy. The design energy means the quantum of energy which would be generated in a year by a particular power station. Design energy is fixed considering availability of water in each calendar month of the year and installed capacity of the power station and the same remains unaltered throughout the life of the power station. As such, in 1st half of the financial year, being the rainy and snow melting period, design energy has been fixed more as compared to later half of the financial year. Further, design energy is identified for each calendar month of the year. In other words, design energy is a sort of theoretical quantity in terms of million units which is fixed considering all related parameters at the time when a project is sanctioned for construction. Actual generation may be either higher or lower of the design energy. In case actual generation exceeds design energy, extra generation is compensated over and above AFC. Like wise, if the generation is less than a certain percentage of design energy due to reasons within the control of generating company, recovery of AFC is reduced.

5. The AFC is recovered in two parts from the buyers:

(1) Energy charges

(2) Capacity charges

The energy charges are the product of actual generation limited to design energy and "Energy Rate per KWH". The Energy rate per KWH is the lowest variable rate per KWH applicable in case of thermal power station operating in the region. The difference of AFC and annual energy charge is known as capacity charge which is recovered monthly prorata in the ratio of units sold.

6. As per CERC rules, monthly billing is done on the basis of generation data (known as 'Regional Energy Account') received from Regional Power Committee. Keeping in view the principle

explained in paragraph 4 above, in the first half of the year, more recovery of AFC is made as compared to the second half of the year. This implies that in the first half of the year, recovery towards interest on loan, interest on working capital, depreciation, AAD and O&M expenses is more compared to the recovery in the second half of the year, whereas all cost components are recorded in the accounts on actual basis following accrual system. Moreover, in the second half of the year, recovery towards cost (built in AFC) is less and cost actually incurred will be more. Therefore, results of the first half would be showing major portion of annual profit whereas the second half would be showing either low profit or may result even in loss. As such, according to the querist, results of the two halves of the same year would not be comparable and the matching concept of revenue and expenditure would also not be met. Similarly, the quarterly results of all the quarters are not comparable.

7. The querist has informed that to address the problem of comparability and to comply with the matching principle of accounting, for the purpose of interim financial statements, the company has been following the principle of recognising depreciation, AAD, interest on loan and some components of O&M expenses (self insurance contingency and cost of employee benefits based on actuarial valuation) *in proportion to actual sales for the period to projected sales for the year* (emphasis supplied by the querist). This treatment which is being followed consistently and is supplemented by a suitable disclosure through notes to accounts is as under:

> "April to September is the peak period of generation because of availability of water. Accordingly, depreciation, AAD, interest on loan, self insurance and provision for long term employee benefits and post employment benefits in terms of Accounting Standard (AS) 15 (revised 2005), ' Employee Benefits', which form part of O&M expenses have been recognised in the interim financial statements in proportion to actual sales for the period to projected sales for the year."

8. According to the querist, the above treatment is followed to match the revenue of interim period with the cost for that period in

order to present the true and fair view. In the half year accounts for the period ended 30.09.2007, the following disclosure was made through notes to accounts:

> "Tariff is fixed by CERC in terms of prescribed norms, which is known as annual fixed charges (AFC). AFC consists of interest on loan, depreciation including advance against depreciation (AAD), operation & maintenance (O&M) expenses, interest on working capital and return on equity. April to September is the peak period of generation because of availability of water. Accordingly, depreciation, AAD, interest on loan, self insurance and provision for long term employee benefits and post employment benefits in terms of Accounting Standard 15 (revised 2005), which form part of O&M expenses have been recognised in interim financial statements in proportion to actual sales for the period to projected sales for the year resulting into lower profit after tax for the half year ended 30.09.2007 by Rs.259.20 crore."

9. In nutshell, as per the querist, the above treatment is being followed owing to following:

(i) Being under regulatory regime, cost plus assured return in terms of return on equity (ROE) is recovered through tariff.

(ii) Profit should be more or less equal to assured return less short recovery of any expenses. This fact would not be reflected from the financial statements, if all costs are booked as period costs and are not matched with revenue.

10. However, the disclosure as mentioned in paragraph 8 above was referred to by the statutory auditors in their report as below:

> "Refer Para 14 of notes to accounts regarding certain expenses including depreciation, AAD, interest on loan, self insurance and long term employees benefit and post employment benefits having been recognised in the financial statements for the half period ended 30th September, 2007, in proportion to actual sale for the half year to projected sale for the full year.

Consequently, profit for the half year is lower by Rs.259.20 crore."

11. The contention of the auditors is that such costs are period costs and should not be recognised in proportion of actual sales to budgeted sales.

B. Query

12. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed by the company is correct.

C. Points considered by the Committee

13. The Committee notes from the Facts of the Case that at one place (paragraph 6), it is mentioned that all cost components are recorded in the accounts on actual basis following accrual system, whereas at another place (paragraph 7), it is mentioned that the company has been following the principle of recognising depreciation and other cost components in proportion to actual sales for the period to projected sales for the year. Thus, there seems to be a contradiction in the Facts of the Case. The Committee's opinion is based on the presumption that the company in question is charging the annual fixed charges (AFC) fixed by the CERC as expenses in the financial statements, which is in proportion to actual sales for the period to projected sales for the year. The Committee has not examined whether the amounts recognised in respect of the AFC in the financial statements are as per the Generally Accepted Accounting Principles, particularly those prescribed in the Accounting Standards, as that issue has not been raised. The Committee has, thus, examined only the question raised, viz., spreading the AFC over the interim financial statements due to seasonality of operations.

14. The Committee further notes from the Facts of the Case that AFC is fixed by CERC for a period of 5 years. Thus, the Committee presumes that rate of recovery of AFC as a part of tariff does not change over a period of 5 years. The Committee also notes that apart from annual fixed charges which are considered by CERC in the fixation of tariff charges, certain variable charges are also

factored in the tariff fixation which have not been stated by the querist in the Facts of the Case. However, this fact does not affect the opinion on the issue raised.

15. The Committee notes from the Facts of the Case that the revenues generated by the company are seasonal due to more availability of water in the first two quarters of the year. In this context, the Committee notes paragraphs 16, 18, 19, 27, 36 and 37 of Accounting Standard (AS) 25, 'Interim Financial Reporting', which provide as follows:

> "***16. An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:***
>
> ***(a) …***
>
> ***(b) explanatory comments about the seasonality of interim operations;***
>
> ***…***
>
> ***The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period."***
>
> ***"18. Interim reports should include interim financial statements (condensed or complete) for periods as follows:***
>
> ***(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;***
>
> ***(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;***

> ***(c)*** ***cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.***

19. For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful. Accordingly, enterprises whose business is highly seasonal are encouraged to consider reporting such information in addition to the information called for in the preceding paragraph."

> "***27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis."***

> ***"36. Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.***

> 37. Examples include dividend revenue, royalties, and government grants. Additionally, some enterprises consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur."

16. On the basis of paragraphs 36 and 37 of AS 25 reproduced above, the Committee is of the view that the company cannot defer recognition of revenue in the interim financial statements if these are seasonal in nature; these have to be recognised as

these occur during the interim periods. Similarly, keeping in view the requirements of paragraph 27 of AS 25, the company has to follow the same accounting policies in its interim financial statements as are applied in its annual financial statements in respect of expenses also. Recognising the seasonal nature of various industries, AS 25 suggests certain disclosures to be made, e.g., under paragraph 16(b) and paragraph 19 of AS 25 (see also Appendix 2 of AS 25). Thus, AS 25 does not allow different basis of recognition and measurement of revenues and expenses for seasonal industries; only additional disclosures are required or permitted.

D. Opinion

17. On the basis of the above, the Committee is of the opinion that the accounting treatment followed by the company is not correct.

Query No. 12

Subject: Treatment of waiver of interest on loan and adjustment of purchase tax and royalty against the sales tax liability by the State Government.[1]

A. Facts of the Case

1. A government company is engaged in the business of manufacture and sale of paper and sugar. A State Government is the principal shareholder holding 65% of the shares in the company. The company is incurring losses from the financial year 2002 onwards. As per the querist, in the absence of revenue concessions from the Government, the company's operations would have become potentially sick as per the Sick Industrial Companies Act,

[1] Opinion finalised by the Committee on 30.5.2008

1985 (SICA). Therefore, with a view to improve the operations of the company, the State Government granted revenue concessions to the company. The grant of concessions helped the company to keep its operations as an on-going concern and also outside the purview of potential sickness as per SICA.

2. The government grants, inter-alia, included:

   (a) waiver of purchase tax on sugarcane,

   (b) waiver of royalty on purchase of pulpwood from governmental sources, and

   (c) waiver of interest on government loans.

3. The querist has subsequently informed as follows:

   (a) Purchase tax was levied by the State Government on purchase of cane from the farmers. The purchase tax was paid to the Government on monthly basis, i.e., calculated at the rate of Rs.60/MT for the number of tonnes of cane purchased during a particular month. Similarly, royalty is paid on purchase of pulp wood from the Government sources. But the royalty is paid along with every purchase made by the company.

   (b) Waiver of purchase tax/royalty is allowed by the Government at the end of the year so as to help the company to reduce its losses. As both the purchase tax and royalty were paid by the company during that financial year, the waiver by the Government is by way of adjustment against sales tax dues payable by the company subsequent to issue of Government Order, i.e., from April onwards in the subsequent financial year. This procedure has been followed consistently since many years and is accepted by both the statutory auditors and the Accountant General (AG). The Sales Tax Department also carries out the adjustment accordingly.

4. The querist has stated that the company is accounting for these grants as income under the head ‘other income’ as per

Schedule 3.01 forming part of accounts of the company. This practice has been followed consistently and was accepted by both the statutory auditors and also by the Accountant General (AG) till the financial year 2004-05. However, during the course of audit of accounts for the financial year 2005-06, the AG has observed that the rebates and incentives (government grants) should be credited to the respective expenditure heads instead of treating these concessions as income, as the same have a direct impact on the valuation of closing stock. The observations of the AG were not accepted by the company and a detailed reply was furnished to the AG. The replies were not accepted by the AG and preliminary comments on the accounts were issued thereafter. Both the company and the statutory auditors reiterated the earlier replies and requested the AG to withdraw the preliminary comments issued on the treatment of rebates and incentives granted by the government.

5. The querist has further stated that the AG forwarded the audit observations/preliminary comments and replies of the company to the Comptroller & Auditor General of India (C&AG), New Delhi, for his opinion. The C&AG accepted the replies of the company. Accordingly, the AG withdrew his preliminary comments on the accounts on this subject for the financial year 2005-06. Further, the AG has requested the company to refer this issue to the Institute of Chartered Accountants of India (ICAI) for its expert opinion and take action in accordance with the Institute's opinion in the accounts for the financial year 2006-07.

6. According to the querist, the following justifications were given to the AG by the company:

(a) The concessions (revenue in nature) granted by the State Government to the company to revive its operations were accounted under the head 'other income' consistently and accepted by the AG. The income on account of these concessions was shown separately keeping in view the need for proper presentation in the quarterly results and to maintain the costing records. Normally, the concessions are granted at the end of the year and in the absence of specific sanction, this income cannot be credited/accrued in advance and cost statements prepared accordingly. There will be a total distortion in the costing records, if the entire amounts are deducted in reporting the related expenditure for the last quarter only as these are received at the end of the year and will not give a fair comparison when compared to earlier quarter results. So is the case with unaudited results being published by the company as part of the SEBI requirements under the listing agreement. The company, therefore, discloses the same as income and shows it by way of a note in the unaudited results published by the company in the last quarter so as to keep the SEBI and other investors informed accordingly.

(b) Further, under Schedule 1.00 – Statement of Accounting Policies, at paragraph 1.10, forming part of accounts of the company, it is indicated in detail under the head 'accounting for government grants' as to how the revenue grants are treated in the books of account. The accounting policy with regard to revenue grants is that the revenue grants are shown under rebates and incentives as income.

(c) Accounting Standard (AS) 12, 'Accounting for Government Grants', issued by the Institute of Chartered Accountants of India, deals with accounting for government grants. As per AS 12, the revenue grants can be shown either on gross approach basis or on net approach basis. AS 12 does not prescribe any specific approach, hence, the company has discretion to follow any of the two approaches. In the case of gross approach, the amount of grant should be shown as a separate item of revenue or as an item of other income. In the case of net approach, the grants have to be deducted from the relevant expenditure. The AG has suggested the net approach while the company has followed the gross approach. The procedure of following either of the approaches is in order. While the company has followed the gross approach, it has declared an accounting policy as well. If the net approach as suggested by the AG is followed, the accounting policy of the company will be contravened to that extent. The gross approach gives a wider analysis than the net approach proposed by the AG.

(d) In view of the above, the company took a stand that the procedure followed by it is in order and wants to continue the same policy and practice in future.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the policy followed and the treatment given by the company in accounting for the rebates and incentives granted by the government as income is in order or not.

C. Points considered by the Committee

8. The Committee notes from the Facts of the Case that the querist has used various expressions, such as, 'waiver', 'concessions', 'rebates', 'grants', etc., to describe the waiver of interest on loan and the adjustment of purchase tax and royalty against the sales tax paid/payable by the company. The Committee hereinafter uses the expressions 'waiver of interest on loans' and the 'adjustment of purchase tax and royalty against sales tax liability'. The Committee also wishes to point out at the outset that it has considered only the question of the treatment of waiver of interest and the adjustment of purchase tax and royalty against the sales tax liability of the company as 'other income' or adjustment from the relevant items in the financial statements. The Committee has, accordingly, not considered any other issue which may arise from the Facts of the Case, such as, timing of the recognition of the waiver and the said adjustments, as such issues have not been raised by the querist.

9. The Committee notes the definition of the term 'government grants' as contained in paragraph 3.2 of Accounting Standard (AS) 12, 'Accounting for Government Grants', which provides as follows:

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

10. The Committee also notes paragraphs 6.4 and 9.1 of AS 12, which are reproduced below:

> "6.4 In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies[2])."

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

11. The Committee is of the view that waiver of interest on loans and the adjustment of purchase tax and royalty against the sales tax liability fall within the definition of the term 'government grants' as these are provided to the company for the purpose of giving immediate financial support to it. The Committee is, therefore, of the view that as provided in paragraph 9.1 of AS 12, the company can follow the alternative of presenting the aforesaid grants, which are related to revenue items as 'Other Income'.

D. Opinion

12. On the basis of the above, the Committee is of the opinion

[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'.

that the policy of treating the waiver of interest on loans and the adjustment of purchase tax and royalty against sales tax liability of the company as 'other income' is appropriate subject to the considerations stated in paragraph 8 above.

Query No. 13

Subject: Accounting for exchange differences in respect of foreign currency borrowings.[1]

A. Facts of the Case

1. A Government of India enterprise is engaged in the business of transmission of power from the generating units in the central sector to various State Electricity Boards. To meet its expansion plan, funds are also borrowed in foreign currency from foreign financial institutions and banks. Its accounting policy regarding foreign currency transactions is as under:

(a) Transactions in foreign currencies are initially recorded at the exchange rate prevailing on the date of transaction. Foreign currency loans/deposits/liabilities are translated/converted with reference to the rates of exchange ruling at the year-end.

(b) Exchange Rate Variation (ERV) on loans towards fixed assets not acquired from outside India is considered as borrowing cost to the extent it does not exceed domestic borrowing cost in accordance with Accounting Standard (AS) 16, 'Borrowing Costs'.

(c) Exchange Rate Variation (except the amount considered as 'borrowing cost' under paragraph (b) above) arising on transactions contracted prior to 01/04/2004 is adjusted

[1] Opinion finalised by the Committee on 30.5.2008

to the carrying cost of capital work-in-progress/fixed assets in case of capital assets. For the transactions contracted after 01/04/2004, the same is charged to the profit and loss account and is considered incidental expenditure during construction (IEDC) till the commissioning of the project in terms of Accounting Standard (AS) 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates'.

According to the querist, the above accounting policy is as per the Accounting Standards Interpretation (ASI) 10, 'Interpretation of paragraph 4(e) of AS 16' and the clarification issued by the Accounting Standards Board (ASB).

2. The querist has drawn the attention of the Committee to ASI 10 wherein it has been stated that "paragraph 4 (e) of AS 16 covers exchange differences on the amount of principal of the foreign currency borrowings to the extent of difference between interest on local currency borrowings and interest on foreign currency borrowings". Further, it has also been stated that "the likely currency depreciation and resulting exchange loss often offset, fully or partly, the difference in the interest rates. In such cases, the exchange difference on the foreign currency borrowings to the extent of the difference between interest on local currency borrowing and interest on foreign currency borrowing, is regarded as an adjustment to the interest costs".

3. The querist has stated that based on the above, *exchange differences (ERV) whether favourable or unfavourable* are compared with the difference between interest on local currency borrowings and interest on foreign currency borrowings. ERV limited to domestic borrowing cost is considered as part of borrowing cost and accounted for in accordance with the provisions of AS 16. This comparison is made in respect of each loan agreement separately. As the favourable ERV in respect of a particular loan will naturally be less than the difference between the interest on local currency borrowings and interest on foreign currency borrowings, such favourable ERV is reduced from the interest cost. According to the querist, *this treatment is based on the fact that when unfavourable ERV is adjusted to interest cost, the*

favourable ERV also has to be adjusted to the interest cost [emphasis supplied by the querist]. However, the querist has contended that it will be illogical that unfavourable ERV is adjusted to interest cost and charged to revenue, and favourable ERV is adjusted in the carrying cost of the relevant fixed assets (in case of transactions prior to 01/04/2004 which are covered under Accounting Standard (AS) 11(1994), 'Accounting for the Effects of Changes in Foreign Exchange Rates'). The querist has explained this by way of the following illustration:

> XYZ Limited has taken a loan of USD 10,000 on April 1, 2004 @ 5% p.a. from the international market. The corresponding amount of Rs. 4,30,000 (USD 10,000 @ Rs. 43 {assumed exchange rate on 01/04/2004}) could have been borrowed at an interest rate of 11% p.a. on the same date in local market. The exchange rates on different dates are assumed to be as follows:
>
> | | | |
> |---|---|---|
> | I. | On April 1, 2004 | USD 1 = Rs. 43 |
> | II. | On March 31, 2005 | USD 1 = Rs. 45 |
> | III. | On March 31, 2006 | USD 1 = Rs. 43 |
> | | Alternatively | |
> | IV. | On March 31, 2006 | USD 1 = Rs. 42 |
>
> Year 2004-05
>
> (A) Interest cost as per the foreign currency loan agreement will be Rs. 22,500 (5% of USD 10,000 x Rs. 45)
>
> (B) Interest cost at domestic rate of 11% will be Rs. 47,300 (11% of Rs. 4,30,000)
>
> (C) Difference between interest on local currency borrowings and foreign currency borrowings = Rs. 47,300 – Rs. 22,500 = Rs. 24,800
>
> (D) ERV as on 31/03/2005 will be Rs. 20,000 (USD 10,000 x (Rs. 45 – Rs. 43))

Since unfavourable ERV at (D) is less than the difference at (C) above, Rs. 20,000 will be treated as interest cost which will become Rs. 42,500 (Rs. 22,500 at (A) above + Rs.20,000 at (D) above).

Year 2005-06

(A) Interest cost as per the foreign currency loan agreement will be Rs. 21,500 (5% of USD 10,000 x Rs. 43)

(B) Interest cost at domestic rate of 11% will be Rs. 47,300 (11% of Rs. 4,30,000)

(C) Difference between interest on local currency borrowings and foreign currency borrowings = Rs. 47,300 – Rs. 21,500 = Rs. 25,800

(D) ERV as on 31/03/2006 will be Rs. (-) 20,000 (USD 10,000 x (Rs. 43 – Rs.45)) (being the exchange rate difference between 31.03.2006 and 01.04.2005)

Since favourable ERV of Rs. (-) 20,000 at (D) is less than the difference at (C) above, Rs. (-) 20,000 will be treated as interest cost and interest charged to profit and loss account will become Rs. 1,500 (Rs.21,500 at (A) above – Rs. 20,000 at (D) above)

Since the unfavourable ERV of Rs. 20,000 in case of year 2004-05 is treated as interest cost and charged to revenue, it will be logical that same treatment is given to favourable ERV of Rs. 20,000 in case of year 2005-06.

The querist further states that if the exchange rate as on 31/03/2006 is Rs. 42 or below, the favourable ERV will increase and accordingly interest expenditure will become negative which is explained below:

Year 2005-06

(A) Interest cost as per the foreign currency loan agreement will be Rs. 21,000 (5% of USD 10,000 x Rs. 42)

(B) Interest cost at domestic rate of 11% will be Rs. 47,300 (11% of Rs. 4,30,000)

(C) Difference between interest on local currency borrowings and foreign currency borrowings = Rs. 47,300 – Rs. 21,000 = Rs. 26,300

(D) ERV as on 31/03/2006 will be Rs. (-) 30,000 (USD 10,000 x (Rs. 42 – Rs. 45) (being the exchange rate difference between 31.03.2006 and 01.04.2005)

Since ERV of Rs. (-) 30,000 at (D) is less than the difference at (C) above, Rs. (-) 30,000 will be treated as interest cost and interest charged to profit and loss account will become Rs. (-) 9,000 (Rs. 21,000 at (A) above – Rs. 30,000 at (D) above), i.e., interest cost will become negative which seems to be illogical.

4. The querist has further drawn the attention of the Committee to a letter dated April 4, 2005 of the Accounting Standards Board wherein a clarification has been given that "pending the revision to Schedule VI to the Companies Act, 1956, Schedule VI would prevail over ASI 10. Accordingly, for accounting for foreign exchange differences, the provisions of Schedule VI should be followed by the companies to the extent the provisions in AS 11/ASI 10 (relating to AS 16) are inconsistent with the provisions of Schedule VI". The querist has mentioned that in accordance with the above clarification, ERV in respect of loans utilised for acquisition of assets from outside India is capitalised irrespective of whether it is more or less than the difference between interest on local currency borrowings and interest on foreign currency borrowings. Further, the querist has stated that the Ministry of Corporate Affairs (MCA) has notified Accounting Standards vide Notification dated December 7, 2006. In the footnote to AS 11 (2003), notified by MCA, it has been stated that "It may be noted 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". The querist has mentioned that it is observed that provisions of AS 11 (2003) will prevail over Schedule VI. However, since no such clarification has been issued for AS 16

and AS 11 (1994), provisions of Schedule VI will prevail over ASI 10 (relating to AS 16) and AS 11 (1994). As per the querist, the above will have the following implications:

(a) ERV to the extent regarded as an adjustment to interest cost (portion pertaining to AS 16) in respect of loans utilised for acquisition of assets from outside India will continue to be capitalised whether the loan is contracted after 01/04/2004 or before 01/04/2004 (applicability of Schedule VI over AS 16).

(b) ERV above the amount mentioned in (i) above, will be capitalised with cost irrespective of whether or not the loan is utilised for acquisition of assets from outside India in respect of loans contracted prior to 01/04/2004 (Applicability of AS 11 (1994)).

(c) ERV above the amount mentioned in (i) above will be charged to revenue irrespective of whether or not the loan is utilised for acquisition of assets from outside India in respect of loans contracted after 01/04/2004 (Applicability of AS 11, Revised 2003).

B. Query

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

(i) The accounting treatment in respect of favourable exchange variation in case of foreign currency borrowings as given in paragraph 3 above. If the Committee does not agree with the said accounting treatment, then the correct accounting treatment.

(ii) The accounting treatment of exchange rate variations as given in paragraph 4 above.

C. Points considered by the Committee

6. The Committee notes that the query basically pertains to two issues viz., (i) accounting treatment of favourable exchange variation in case of foreign currency borrowings and (ii) clarification regarding

applicability of AS 16, Schedule VI to the Companies Act, 1956 and AS 11 (pre-revised) inter-se with regard to exchange rate variations in case of foreign currency borrowings towards fixed assets acquired from outside India, pursuant to the notification of the Accounting Standards. Accordingly, the Committee has considered only these issues and has not considered any other issue(s) contained in the Facts of the Case.

7. The Committee notes that the querist in paragraph 3 above, has discussed the issue of favourable exchange variation for transactions entered into prior to 1.4.2004. However, in the illustration given by the querist, the loan is assumed to have been taken on 1.4.2004. Therefore, the Committee has considered the issue of favourable exchange variation for both types of transactions, that is, the transactions entered into prior to 1.4.2004 and the transactions entered into on or after 1.4.2004.

8. The Committee notes that AS 11, as notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, carries, inter alia, the following footnote:

> "In respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the effective date of the notification prescribing this Standard under Section 211 of the Companies Act, 1956, the applicability of this Standard would be determined on the basis of the Accounting Standard (AS) 11 revised by the ICAI in 2003."

9. The Committee notes that the preamble to AS 11 (revised 2003) states as follows:

> "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."

10 From the above, the Committee is of the view that in the year 2007-08, for the transactions entered into prior to 1.4.2004, the pre-revised AS 11 continues to apply, and for transactions entered into on or after 1.4.2004, the revised AS 11 (2003) applies even in respect of the exchange differences mentioned in Schedule VI to the Companies Act, 1956.

11. The Committee also notes that Accounting Standard (AS) 16, 'Borrowing Costs,' came into effect in respect of accounting periods commencing on or after April 1, 2000 and was mandatory in nature from that date. The Committee further notes that this implies that AS 16 applies to all loans whether raised before April 1, 2000, or on or after April 1, 2000. The Committee also notes that paragraph 4(e) of AS 16, as notified by the Central Government under 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 costs". The Committee notes that with the notification of the Accounting Standards, Accounting Standards Interpretation (ASI) 10, Interpretation of paragraph 4(e) of AS 16, has been incorporated in the notified AS 16 by way of 'Explanation' which states 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."

12. From the above, the Committee notes that as per paragraph 4(e) of notified AS 16, exchange loss on foreign currency loan is capitalised to the extent it amounts to adjustment towards interest costs. However, 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 decapitalisation can be done only during the period over which the fixed asset towards which the foreign currency loan has been taken continues to be a qualifying asset. With respect to transactions entered into prior to 1.4.2004, to which AS 11 (pre-revised) is applicable, the exchange gains will be adjusted to the cost of the fixed assets.

13. The Committee further notes that with regard to the applicability of Schedule VI to the Companies Act, 1956, the notified AS 11 by way of a footnote provides that the accounting treatment of exchange differences as contained in the notified AS 11 would apply irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956. This implies that in respect of accounting periods commencing on or after December 7, 2006, the date from which the Accounting Standards have been notified, the requirements of notified AS 11 would prevail over Schedule VI with regard to the treatment of exchange differences. The Committee also notes that the 'Scope' paragraph of the notified AS 11 (as well as AS 11 (revised 2003)) provides the following with regard to exchange differences:

> "6. This Standard does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs [see paragraph 4(e) of AS 16, Borrowing Costs.]"

Thus, the Committee is of the view that in the year 2007-08, without regard to the treatment of exchange differences contained in Schedule VI to the Companies Act, 1956, with respect to capitalisation of exchange differences that are of the nature of borrowing costs, paragraph 4(e) of AS 16 applies. With respect to other exchange differences, AS 11 (revised 2003) applies for transactions entered into on or after 1.4.2004. With respect to exchange differences arising on transactions entered into prior to 1.4.2004, AS 11 (pre-revised) will continue to apply subject to the consideration of paragraph 4(e) of AS 16.

D. Opinion

14. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

(i) The Committee does not agree with the accounting treatment as given in paragraph 3 above. The correct accounting treatment is contained in paragraph 12 above.

(ii) The Committee does not agree with the accounting treatment as given in paragraph 4 above. The correct accounting treatment is contained in paragraph 13 above.

Query No. 14

Subject: Accounting for deferred taxes.[1]

A. Facts of the Case

1. A Government of India enterprise under the Ministry of Steel had been incurring losses from the financial year 1998-99 to 2003-04. As a result, the company is having unabsorbed depreciation and accumulated losses. However, the company is

[1] Opinion finalised by the Committee on 30.5.2008

paying Minimum Alternative Tax (hereafter referred to as 'MAT') under section 115JB of the Income-tax Act, 1961.

2. The querist has referred to paragraph 17 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India, which states that where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised. The querist has informed that though the company had unabsorbed depreciation and losses from financial year 1998-99 to 2003-04, as per the above provisions of AS 22, it did not recognise deferred tax assets due to lack of virtual certainty that sufficient future taxable income will be available for realisation of the deferred tax assets. For the year 2004-05 also, it did not recognise deferred tax assets since the 'virtual certainty' condition was not met. The querist has further informed that upto the financial year 2004-05, as per financial data, only deferred tax asset was arising and hence, the question of providing for deferred tax liability did not arise.

3. During the financial year 2005-06, for the first time, the company recognised deferred tax liability for Rs.170 lakh based on provisional accounts. Again, during the financial year 2006-07, deferred tax assets arose, which were not recognised for the reasons stated in paragraph 2 above. At the same time, the company did not reverse the opening deferred tax liability for Rs.170 lakh (created in the year 2005-06) during the financial year 2006-07 and maintained the same figure in the balance sheet as at 31st March, 2007.

4. The querist has informed that there were some items which were getting reversed in the financial year 2006-07, like, provision for bad debts, provision for liquidated damages, provision for gratuity, expenditure on voluntary retirement scheme, etc.

5. The querist has supplied provisional computation of MAT under section 115JB of the Income-tax Act, 1961 for the financial year

2005-06 and provisional calculation of deferred tax which is contained in the Annexure, for the reference and perusal of the Committee.

B. Query

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

(i) Whether the company should reverse the deferred tax liability created previously and make it nil during the current year or the company should maintain the same figure as deferred tax liability unless and until further deferred tax liability is created or reduced as long as the deferred tax asset is not recognised by the company.

(ii) Whether book profit as per the provisions of MAT will be considered as taxable income for the purpose of calculation of timing difference as per AS 22, when the company is paying MAT or taxable income shall be computed as per regular provisions of the Income-tax Act to find out timing difference (i.e., difference between accounting income and taxable income before permanent difference).

C. Points considered by the Committee

7. The Committee notes that AS 22 deals with accounting for both current tax and deferred tax. The principle underpinning accounting for deferred taxes is that tax consequences of a transaction should be recognised in financial statements during the same period in which the underlying transaction is recognised in the financial statements. Thus, accounting for deferred taxes ensures proper matching of tax expense (saving) and the related income (expense) recognised for accounting purposes.

8. From the information supplied by the querist in the Annexure, the Committee notes that the basics of deferred tax accounting have not been properly followed. The querist has started from accounting income and made some adjustments to derive what has been described as 'taxable income before permanent differences'. The difference between the two, which is naturally

equal to the net effect of the adjustments made, has been described as 'timing differences', which is multiplied by the tax rate and the resulting figure has been stated as deferred tax liability or deferred tax asset, as the case may be. Apart from deviation from the principles of AS 22, this approach can lead to misleading results. For example, some items, like, creation of provision for bad and doubtful debts may result in deferred tax asset while excess of depreciation for income-tax purposes over book depreciation originating during the period may result in deferred tax liability. Clubbing all differences into a one-line figure and describing the same as 'timing differences' will result in set-off of deferred tax assets against deferred tax liabilities even before prudence test is applied which will distort the real picture. This may result in understatement of deferred tax liabilities and overstatement of profit, if prudence test fails on assessment of deferred tax assets separately instead of mixing up with deferred tax liabilities. There are other errors of principle also. For example, dividend income exempted from tax has been deducted from accounting income while deriving the so called 'taxable income before permanent differences'. It is a permanent difference. But, the one-line figure described as 'timing differences' includes effect of dividend exempted from tax. In other words, a permanent difference is included in, and wrongly described as, timing difference. Thus, though the querist has listed some sources of differences between accounting income and taxable income, these have not been properly segregated into permanent differences and timing differences. Further, failure to segregate the timing differences into originating and reversing differences may lead to incorrect results. For example, a reversing timing difference in respect of a deferred tax liability might be wrongly understood as an originating timing difference in respect of a deferred tax asset. Also, there is no such concept of 'taxable income before permanent difference' as mentioned by the querist. There is only accounting income adjusted for permanent differences. There are also differences in the amounts of some items between the provisional calculation sheet of deferred taxes and the financial statements. While the Committee notes the above points, it has not gone into the correctness of computation of MAT and deferred tax liability, since the query relates to principles only.

9. The requirements of AS 22, so far as measurement of deferred taxes is concerned, are briefly summarised below:

(i) Normally, differences arise between accounting income and taxable income. Such differences are classified as timing differences and permanent differences. Timing differences originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of income and expenses are included in taxable income does not coincide with the period in which these are included or considered in arriving at accounting income. Unabsorbed depreciation and losses are also considered as timing differences. Permanent differences are those that arise in a period but do not reverse subsequently.

(ii) Permanent differences affect only current tax. They do not affect deferred taxes.

(iii) Timing differences that are originating in a period may result in creation of either deferred tax assets or deferred tax liabilities, with corresponding credit/debit to the profit and loss account. The deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

(iv) Timing differences that are reversing during the period will result in liquidation (i.e., clearance) of the whole or part of deferred tax assets/ deferred tax liabilities, already created at the time of origination of timing differences, with corresponding debit/credit to the profit and loss account. For example, if depreciation for accounting purposes for the period is less than depreciation for income-tax purposes, a deferred tax liability arises. This is because in future, depreciation for income-tax purposes will be less than depreciation for accounting purposes. Thus, while tax based on taxable income for the current period is less than tax based on accounting income due to difference in depreciation, for future period, tax based on taxable income will be more than tax based on accounting income. Hence, a deferred tax liability is provided for in the current period and cleared in future when the depreciation difference reverses. This matches tax expense with accounting income both for the current period and the future period.

(v) While deferred tax liabilities should be recognised as such, deferred tax assets should be considered separately from deferred tax liabilities and recognised only if the 'prudence test' is met. Accordingly, deferred tax assets should be recognised and carried forward only if there is a reasonable certainty that sufficient taxable income will be available against which such deferred tax assets can be realised. However, in case an enterprise has unabsorbed depreciation or carry forward losses, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised. The concepts of 'reasonable certainty' and 'virtual certainty' have been explained in relevant portions of AS 22. Deferred tax liabilities such as those in (iv) above should be recognised even if the deferred tax assets are not recognised.

(vi) As a corollary to point (v) above, originating timing differences resulting in deferred tax assets and those resulting in deferred tax liabilities should be separately considered. They should not be mingled to see their overall net effect. Further, to the extent a deferred tax asset is not recognised in respect of an originating difference due to failure to meet the prudence test, both the origination and reversal of that difference will not have deferred tax effects.

(vii) At each balance sheet date, an assessment should be made of both unrecognised and recognised deferred tax assets. To the extent prudence test is met, the former should be recognised and to the extent it is not met, the carrying amount of the latter should be written down. The corresponding adjustment should be recognised in the profit and loss account. Reversal of a previous write-down of deferred tax assets is also permitted to the extent prudence test is subsequently met.

10. The Committee notes that as per an announcement made by the Council of the Institute of Chartered Accountants of India, tax effect of any item should be recognised and presented in a manner consistent with the manner in which that item itself is recognised and presented. Thus, for example, if an item of income/expense is directly adjusted in reserves, it should be net of tax effect. In other words, the tax effect is also recognised in the reserves.

11. Thus, the basic steps involved in deferred tax accounting are as follows:

(i) Identify the sources of differences between accounting income and taxable income and their amounts.

(ii) Classify the differences between permanent differences and timing differences.

(iii) Make further analysis of each item of timing difference into originating differences and reversing differences.

(iv) Recognise deferred tax liabilities in full in respect of originating timing differences during the period using tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

(v) Liquidate deferred tax liabilities to the extent of reversal of timing differences during the period in respect of which they were created.

(vi) Recognise deferred tax assets in respect of originating timing differences during the period to the extent prudence test is met, using tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

(vii) Liquidate deferred tax assets to the extent of reversal of timing differences during the period in respect of which they were created.

(viii) Reassess at each balance sheet date both unrecognised and recognised timing differences. To the extent prudence test is met, recognise deferred tax asset for the former, using tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date and to the extent the prudence test is not met, write-down the carrying amount of the latter. Such write-down can be reversed to the extent prudence test is subsequently met.

(ix) Any deferred tax assets and liabilities previously created and still appearing in the balance sheet because the whole or a part of the timing differences in respect of which they were created are yet to reverse, should be adjusted for the effect of changes in tax laws and tax rates, if any, enacted or substantively enacted by the balance sheet date.

12. Thus, difference between accounting income adjusted for permanent differences, and taxable income computed under tax laws should be the net effect of originating as well as reversing timing differences. As already explained, such a difference should be analysed source-wise with further analysis into originating and reversing differences, to ascertain and account for their deferred tax impact. The Committee notes that this has not been followed as per the Facts of the Case.

13. Further, the Committee notes that AS 22 has transitional provisions, which should have been followed on the date on which it became mandatory for the company.

14. The company should pass necessary rectification entries. For this purpose, the company should ascertain the entries that should have been passed in accordance with the principles stated above, right from the time AS 22 became mandatory to it, assess their net effect and consequential changes, if any (such as, initial adjustment

of transitional deferred tax liability against debit balance in the profit and loss account because of inadequacy of revenue reserves and clearance of the said debit balance against subsequent profits), and compare the same with the effect of the entries actually passed right from the time AS 22 became mandatory. Adjustments pertaining to previous periods should be treated as prior period items in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. The Committee is of the view that though AS 5 deals with prior period items in the context of profit and loss account only, the accounting principles of prior period items are equally applicable to balance sheet items also.

15. As regards 'MAT', the Committee notes that the Institute of Chartered Accountants of India has issued Accounting Standards Interpretation 6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', which has been subsequently withdrawn and the consensus of the same has been inserted as Explanation to paragraph 21 of AS 22 notified by the Central Government under the Companies (Accounting Standards) Rules, 2006. This Explanation reads as below:

"Explanation:

(a) ***The payment of tax under section 115JB of the Income-tax Act, 1961 (hereinafter referred to as the 'Act') is a current tax for the period.***

(b) ***In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under this Standard, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.***

(c) ***In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising***

> ***during the current period, tax effect of which is required to be recognised under AS 22, is measured using the regular tax rates and not the tax rate under section 115JB of the Act."***

16. As regards the computation of timing differences in the context of 'MAT', the Committee notes that section 115JB is an independent section which operates in a particular situation where the tax payable under the normal provisions is less than 10 per cent of the book profit as determined under that section. The 'book profit' for the purposes of 'MAT' may or may not be equal to accounting income. Section 115JB does not in any way alter the taxable income computed under the normal provisions of the tax law.

17. From the above, the Committee is of the view that while arriving at timing differences, treatment of items of income and expense for accounting purposes should be compared with the treatment of such items for computation of taxable income under the normal provisions of tax law. Those differences, if any, which are not permanent in nature, will be timing differences. Treatment of incomes and expenses for computation of book profit for the purposes of MAT is irrelevant for computing timing differences. The timing differences should be analysed item-wise and also further analysed into originating and reversing differences.

D. Opinion

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

(i) The company should have followed the proper approach to deferred tax accounting as explained above. Since this was not done, necessary rectification entries as stated in paragraph 14 above should be passed. Thereafter, the reversal of the deferred tax liability created in accordance with the aforesaid procedure should be done, if appropriate, as explained in the above paragraphs.

(ii) Book profit as per the provisions of MAT should not be considered as taxable income for the purposes of AS

22. Differences in treatment of items of expenses and income for accounting purposes as compared to computation of income for tax purposes under normal tax provisions (instead of computation of book profit for MAT purposes), which are not permanent in nature, should be considered in arriving at timing differences in the year of payment of MAT.

Annexure

PROVISIONAL COMPUTATION OF MAT U/S 115JB OF INCOME-TAX ACT, 1961 FOR F.Y. 2006-07

		Rs. In Lakh
Net Profit as per P & L A/c		**2,338.15**
Adjustment		
Add:		
Provision for Bad & Doubtful Debts	470.27	
Provision for L. D. Recovered	43.47	
Provision for Claims receivable	1.46	
Provision for EMD	-	
Provision for Leave Encashment	645.52	
Provision for Deposit with Others	67.16	
Depreciation	272.60	**1,500.48**
Less:		
Disallowed Provisions written back	82.59	
Fringe Benefit Tax	95.50	
Dividend from Indian Company	4.00	
Depreciation excluding depreciation on a/c of revaluation of assets	247.96	
Amount withdrawn from Rev. Reserve and credited to P&L A/c:-	24.64	
The amount of loss brought forward (26513.34 or unabsorbed depreciation (1659.64) as on 31.03.06 whichever is less as per Books	1,659.64	**2,114.33**
Book Profit u/s 115JB		**1,724.30**

Tax @ 10.00% thereof	**172.43**
Surcharge @10%	**17.24**
Education Cess @ 2% on Tax and Surcharge	**3.79**
MAT	**193.47**
Add: Interest (Prov.)	**10.33**
Total Provision for Tax including Interest	**203.80**

PROVISIONAL CALCULATION OF DEFERRED TAX

			F.Y. 2005-06 Amount (Rs.)		**F.Y. 2006-07** Amount (Rs.)
A.	**Accounting Income (Prov.) as per P/L A/c (PBT)**		**2,234.00**		**2,338.15**
Add: Disallowances etc.					
a)	Depreciation as per Book	250.53		247.96	
b)	Provision for Bad & Doubtful debts	417.03		470.27	
c)	Provision for L. D. Recovered	83.20		43.47	
d)	Provision for Claims Recoverable	-		1.46	
e)	Provision for Deposit with Others	-		67.16	
f)	Provision for Leave Encashment	-		645.52	
g)	Provision for Gratuity	56.00	-		
h)	DRE written off as per book	1,554.68		1,335.38	
i)	Articles up to Rs. 1000/- each	0.77		9.59	
j)	Loss on sale of Assets	25.93		5.09	
			2,388.14		**2,825.90**
Sub-Total			**4,622.14**		**5,164.05**
Less: Allowances etc.					
a)	Depreciation u/s 32 (Prov.)	256.00		260.00	

b)	Disallowed provisions utilised	599.98		193.06	
c)	VRS Expenditure u/s 35DDA	1,470.86		1,335.37	
d)	Profit on sale of assets	1.65		73.96	
e)	Dividend (exempt)	1.50		4.00	
f)	Disallowed Prov. Written back	563.69		82.59	
Sub-Total			**2893.68**		**1,948.98**
B.	**Taxable Income before Permanent Differences**		**1,728.46**		**3,215.07**
C.	**Timing Differences (A-B)**		**505.54**		**(876.92)**
D.	**Deferred Tax Liability/(Assets) (@ 30%+ SC @ 10% + EC @2 %)**		**170.16**		**(295.17)**

Query No. 15

Subject: Combining and segmenting of construction contracts.[1]

A. Facts of the Case

1. A company, which is a Government of India undertaking, is a leading engineering and consultancy company in the field of petroleum refineries, pipelines, oil and gas processing, petrochemicals, offshore structures and platforms, ports and terminals, metallurgy, fertilisers, power, highway and bridges, airports and intelligent buildings and urban development.

2. A client in the process of setting up grass-root refinery invited

[1] Opinion finalised by the Committee on 30.5.2008

the company to submit its offer for providing engineering consultancy services.

3. The company submitted its offer for carrying out consultancy services for setting up of refinery project under three proposals namely Proposal 'A' (Process Design, Environmental Impact Assessment/ Rapid Risk Analysis, etc.), Proposal 'B' (Project Management Consultancy Services), Proposal 'C' (Engineering, Procurement, Construction Management Services) with price for each such proposal totaling to Rs. 665 crore plus service tax as applicable.

4. The client, vide its Letter of Acceptance (LOA) dated 22nd November, 2006, awarded the work (copy of LOA has been furnished by the querist for the perusal of the Committee) for consultancy services comprising the scope of work as above at a price of Rs. 606 crore plus service tax as under :

- The work shall be bifurcated into two contracts to cover the total scope of work.
- The first contract will be for Rs. 21 crore for the work of defined preparatory services to be rendered between 1st September, 2006 and 31st March, 2007.
- The balance price of Rs. 585 crore for the remaining scope of work will form part of the second contract which will be entered into at a later date. The first contract will be suitably referenced in the second contract.

5. The first contract for Rs. 21 crore was formally entered into, the work was executed and full payments were received. (Copy of the contract has been furnished by the querist for the perusal of the Committee.)

6. According to the querist, contract revenue for the year ending 31st March, 2007 was recognised as per the provisions of Accounting Standard (AS) 7, 'Construction Contracts', treating the above two contracts as a single construction contract for Rs. 606 crore in terms of paragraph 8 of AS 7. The total consideration for overall project was negotiated as a single package with total cost and overall profit margin for total price at Rs.606 crore. The

bifurcation of fees in Part I and II was purely based on commercial considerations without any relevance to the corresponding cost of the each part. Since the nature of transactions satisfied all the conditions as mentioned in paragraph 8 of AS 7, the same was treated as a single contract for accounting purposes in the financial year 2006-07. Accounts for the year 2006-07 were approved by the Board on 30th May, 2007.

7. Pending finalisation and signing of the second contract, an interim agreement/ arrangement was entered into on 15th May, 2007 with effect from 1st April, 2007 to provide uninterrupted services within the scope of work forming part of the second contract, wherein a lump sum amount of Rs. 7 crore plus applicable taxes was paid to the company per month for a period of four months for the defined scope of work. The interim arrangement was for a period of 4 months or signing of the contract II, whichever earlier. (Copy of the interim arrangement agreement has been furnished by the querist for the perusal of the Committee.) As per the interim arrangement, the activities covered under the said arrangement shall be a part of contract II and the payments made under this interim arrangement shall be adjusted against the lump sum price of contract II, i.e., Rs. 585 crore.

8. The above interim arrangement was further extended for a month till 31st August, 2007, pending finalisation/ signing of the second contract. All payments under the interim arrangement, i.e., Rs. 35 crore (Rs. 7 crore * 5) and applicable taxes have since been received. This interim arrangement was neither extended beyond August, 2007 nor was contract II signed.

9. Meanwhile, in July/August, 2007 the client invited fresh proposal from various consultants including the company for providing consultancy services to execute the refinery project for prospective services with new methodology and terms. Accordingly, proposal dated 2nd August, 2007 and 6th August, 2007 were submitted to the client for providing the desired services, detailing the methodology of work execution, terms and conditions and remuneration for its services totalling to Rs. 970.53 crore. (Copies of proposals have been furnished by the querist for the perusal of the Committee.)

10. The company, after negotiations, submitted its final offer along with justification amounting to Rs. 773.50 crore vide its Term Sheet dated 25th October, 2007 (copy of the Term Sheet has been furnished by the querist for the perusal of the Committee).

The price of Rs.773.50 crore was arrived at as below:

(a) Base price agreed : Rs.635.5 crore (i.e., midpoint between Rs.606 crore and Rs.665 crore)

(b) Add: Escalation (as proposed by the company): Rs.128 crore

(c) Less: Price paid by the client : Rs. 25 crore (although Rs.56 crore has been invoiced).

(d) Add: extra price for changed terms : Rs.15 crore

(e) Add: extra price for FEED package:Rs.20 crore

Total price : Rs.773.50 crore

The querist has informed that though the company has received the total amount of Rs.56 crore as invoiced, only Rs.25 crore has been offered as reduction against the same (in the justification for increase in the fees) as some part of the work done earlier would need to be redone due to change in methodology for completing the balance work.

The escalation of Rs.128 crore was sought as increase in fees for the overall project due to delays on the part of the client in implementation of the project and the consequent increase in the cost to the company for the job. Thus, it was for increase in fees from the originally quoted/agreed consideration i.e., Rs.665 crore / Rs.606 crore respectively for the total execution of the project covering Part I/interim arrangement/balance work.

The changed terms for which Rs.15 crore was proposed mainly cover changes in the time schedule for the completion of the project and related bonus/penalties, additional terms of guaranteeing the estimated project cost, consequent penalty, etc.

11. The client accepted the company's final offer and issued LOA dated 14th November, 2007 specifying the scope of work and remuneration for prospective services to be rendered for the project with a project completion schedule of 42 months from the date of LOA. (Copy of the final offer and LOA dated 14th November, 2007 have been furnished by the querist for the perusal of the Committee.)

The aforesaid LOA contained the following clause:

> "All other terms & conditions will be in line with the draft contract PRP/EPCM/001B dated March 23, 2007 except for amendments required in the contract which both parties shall mutually agree."

The draft contract mentioned above is intended for Part II of earlier LOA dated 22.11.2006 for Rs.606 crore.

12. The querist has informed that all other consultants had given their price and terms for the total project/jobs without considering the scope of the work completed by the company. However, depending on the acceptability of the portion of the engineering work already completed by the company upto the date of award of the work, other consultants could have given some discounts on the price which is not ascertainable. If at any stage, the client wants to discontinue the services of a consultant, balance portion could be contracted to other consultants and in that case the consultant may be required to redo the substantial work to make it compatible with their methodology of project execution and give their terms accordingly.

13. Further, the querist has informed that in the event a consultant's job is discontinued at the mid stage, the contract needs to be terminated. As per the querist, in the instant case though LOA dated 22nd November, 2006 was in place, since there was no formal contract with the company for the Part II of the job, probably the question of termination of contract would not apply and the company would have only received the payments for the first part and interim arrangement totaling Rs.56 crore.

14. As per the querist, cost has been estimated for the total job

involved in execution of the project and proposal submitted to the client accordingly. As such no separate costing has been done for part I, II/balance work. As mentioned in paragraph 6 above, the bifurcation of the fees in the Part I and balance portion of work was purely on commercial consideration without estimating and considering the cost separately. However, estimated cost for the balance portion of the job can be ascertained taking into account the cost already incurred for completed portion of the job under Part I/interim arrangement.

15. The querist has given the following arguments for combining as well as segmenting contracts:

Alternative I- For combining contracts

New LOA dated 14.11.07 for prospective services is to be considered as group of contracts along with earlier contract/arrangement in terms of paragraph 8 of AS 7 due to the under noted reasons:

(a) The scope of services remained the same as were envisaged in the original LOA dated 22.11.2006 with some changes in the price due to escalation factor and some additional scope of work and changes in methodology of execution. As such, this should be construed as an extension of the original job which is also referred in the term-sheet dated 25.10.07 submitted by the company and forming part of LOA dated 14.11.07. Hence, LOA dated 14.11.07 should be construed as re-negotiation of the price and terms due to temporary withholding of the job. [The querist has clarified that the additional scope and change in methodology of execution are not significantly different from what was originally contemplated.]

(b) The scope of services pursuant to earlier LOA as well as new LOA pertains to construction of same asset and activities contemplated under the project are also primarily the same except for some modifications/additions/deletions in the scope of work. The price of the services has been negotiated with reference to the original LOA terms and remuneration taking into account the services already rendered and as such all the contracts/arrangement are inter-related and are part of a single project with overall profit margin. Further, the term 'escalation' used in the term-sheet dated 25.10.07 submitted by the company can be construed with reference to existing contract or an already negotiated consideration.

(c) LOA dated 14.11.07 stipulates that *"All other terms & conditions will be in line with the draft contract PRP/EPCM/001B dated March 23, 2007 except for amendments required in the contract which both parties shall mutually agree."* [Emphasis supplied by the querist.]

Alternative II-For segmenting contracts

Work done pursuant to earlier LOA/Contract/interim arrangements against which the company had rendered services and received payment of Rs.56 crore should be treated as a separate construction contract in view of the following observations:

(a) The services in accordance with earlier LOA/interim arrangement have been rendered and full payments received.

(b) Client has obtained separate offer from various consultants including the company for prospective services of the project with certain modifications including additional scope and change in execution methodology. The company had submitted its offer against the same which has been accepted and LOA has been issued for prospective services only and fresh contract for such services should be entered into.

B. Query

16. The querist has sought the opinion of the Expert Advisory Committee as to whether the amount of Rs. 56 crore received from the client for the services rendered under the earlier contract/

interim arrangements (which have since been closed) can be recognised as 'revenue' in the books of account of the company considering them as a separate construction contract, distinct and separate from scope of work under LOA dated 14th November, 2007 for Rs. 773.50 crore in compliance with the provisions of AS 7.

C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to the treatment of the receipt of Rs. 56 crore as revenue from a separate contract *de hors* the balance scope of work under the subsequent LOA dated 14th November, 2007. 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. In particular, the Committee has not examined the issue whether the LOA dated 14th November, 2007 itself is to be segmented for scope change, since this issue has not been raised by the querist. The Committee notes from the copies of documents furnished by the querist that the amount of Rs. 773.50 crore includes, inter alia, (i) an amount of Rs. 52 crore towards services of the company in respect of crude oil receipt facilities at Mundra and cross country crude oil pipeline from Mundra to Bhatinda and in case the client excludes services related to these two items from the scope of work awarded to the company, then, a reduction of Rs. 52 crore will be made from the lump sum price of Rs. 773.50 crore and (ii) an amount of Rs. 20 crore towards FEED package. Though the item (i) consisting of the two facilities is also found in the original scope of work, it appears that no specific price is mentioned for it in the original scope of work. (Of course, the client has the right to request for any changes, modifications, deletions and/or deletions to the scope of work for which impact proposal should be submitted by the company, if the changes can be performed). The Committee has not addressed the issue of treatment of these elements of contract, since this issue has not been raised by the querist.

18. The Committee notes that Accounting Standard (AS) 7, Construction Contracts, issued by the Institute of Chartered Accountants of India has subsequently been notified by the Central

Government under the Companies (Accounting Standards) Rules, 2006. The Committee notes the following paragraphs from AS 7:

> ***“2.1 A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.”***
>
> “3. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.
>
> 4. For the purposes of this Standard, construction contracts include:
>
> (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
>
> (b) …”
>
> “6. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.
>
> ***7. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:***
>
> ***(a) separate proposals have been submitted for each asset;***

(b) ***each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and***

(c) ***the costs and revenues of each asset can be identified.***

8. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) ***the group of contracts is negotiated as a single package;***

(b) ***the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and***

(c) ***the contracts are performed concurrently or in a continuous sequence.***

9. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) ***the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or***

(b) ***the price of the asset is negotiated without regard to the original contract price."***

"Contract Revenue

10. Contract revenue should comprise:

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

(b) ***variations in contract work, claims and incentive payments:***

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured."

"11. Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) a contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) …"

19. From the above, the Committee notes that the principles related to accounting treatment for construction of an asset (including combining and segmenting of construction contracts) are equally applicable to services directly related to the construction of that asset. Hence, engineering consultancy services and other services which are directly related to the construction of the refinery will be accorded the same accounting treatment as the treatment for the construction contract of the refinery.

20. The Committee notes that for accounting purposes, initially the company combined the two contracts, viz., preparatory services (for which contract was signed) and the balance scope of work (which was supposed to be entered into later). There was an interim arrangement pending the signing of second contract. This

interim arrangement makes appropriate reference to the second contract to be entered into in future. While the work under the interim arrangement was in progress, the client invited fresh proposal from various consultants including the company for providing consultancy services to execute the refinery project with new methodology and terms. After negotiation, the price for the balance scope of work (excluding for the work already completed) was arrived at by the company, which was accepted by the client. Invitation of fresh bids and separate LOA dated 14^{th} November, 2007 with net price for balance scope of work may apparently suggest that the scope of the original contract has been reduced to the extent of work already done and that the balance scope of work is a separate contract, though the latter includes pending portion of original scope (which is substantial for the facts of the case) with some changes. However, for accounting purposes, whether the balance scope of work is to be treated as a separate contract or to be combined with earlier contract/interim arrangement with scope reduced to the extent of work already done depends on application of relevant provisions of AS 7 quoted above and not on legal aspects.

21. The Committee is of the view that in the present case, paragraph 7 of AS 7 is not applicable since it is not a case of single contract covering a number of assets with separate proposals for each asset. While paragraph 8 of AS 7 does not directly deal with a case where during the course of execution of a contract fresh bidding takes place resulting in a new contract for balance scope of work, the Committee is of the view that the principle enshrined in paragraph 8 of AS 7 can be applied as a guiding factor in such situations. The Committee is also of the view that a group of contracts should be combined if all the three conditions stipulated in paragraph 8 of AS 7 are met, and, should not be combined if any one or more of the three conditions stipulated therein are not met. This is because paragraph 8 of AS 7 uses the word ‘and’ at the end of condition (b).

22. The Committee notes that basically the consultancy services are in respect of construction of a refinery. There is only change in the methodology of execution of the project with some scope

change and not the asset being constructed. The asset is still refinery. All the bidders had based their price for the entire work and the successful bidder was expected to discount the price on the assessment of the work already done by the company. The company too started from the base price and made some adjustments to arrive at the price for the balance scope of work. Thus, the balance scope of work is not separately negotiated without regard to the original contract/interim arrangement. This is fully supported by the facts mentioned in paragraph 10 above. For example, the escalation element is not only for the balance scope of work but for the entire project. Though Rs. 56 crore was billed and accepted, only Rs.25 crore was reduced from the base price since the company has to redo some part of work done earlier due to change in methodology for completing the balance work. As mentioned in paragraph 14 above, no separate costing was done for original contract/interim arrangement/balance scope of work. Cost was estimated for the total job involved in the execution of the project. Price was allocated to each such part purely on commercial consideration without estimating and considering the cost separately. While estimation for balance work could have been done not separately but after considering cost already incurred, that has not been done. This indicates that only overall profit margin has been contemplated at all stages. The balance scope of work, when undertaken as a continuation of work already done, will complete the whole project. The LOA dated 14th November, 2007 also specifies that all other terms and conditions are as per draft of the originally contemplated second contract, except for mutually agreed amendments. The Committee is of the view that all these facts indicate compliance with conditions stipulated in paragraph 8 of AS 7.

23. From the above, the Committee is of the view that the original contract, the interim arrangement and the LOA dated 14th November, 2007 for balance scope of work are interconnected and should be treated as such for accounting purposes. The entire services are related to the construction of the refinery, though there is change in methodology of execution and there are some scope changes. Further, the Committee is of the view that the paragraph 10(b) of AS 7 is applicable whether it is a single contract or a group of contracts treated as a single contract for accounting

purposes. Accordingly, the difference between (a) the price for balance scope of work as increased by Rs.25 crore offered as reduction in respect of work already done and (b) the original contract price should be viewed as contract revenue towards 'variations in the contract work, claims and incentive payments' mentioned in paragraph 10(b) of AS 7 quoted above. Paragraph 11(a) of AS 7 quoted above acknowledges that a contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed. The Committee is of the view that this variation can happen even in the case of fresh bidding process as has happened in the present case. In working out the aforesaid variations and claims, the point whether the LOA dated 14th November, 2007 itself is to be segmented for accounting purposes in respect of scope changes (such as additional scope of work relating to services of the company in respect of the items mentioned in paragraph 17 above) should also be considered. For the reasons stated in paragraph 17 above, the Committee is not expressing any view in this regard.

24. With respect to the part of the work done earlier in respect of which the amount of Rs. 56 crore has already been received, the Committee is of the view that Rs. 25 crore represents the work to be adjusted in the final offer and, therefore, the portion amounting to Rs. 31 crore {i.e., Rs. 56 crore received less: Rs. 25 crore} which is separated from the final offer, should be booked as revenue.

D. Opinion

25. On the basis of the above, the Committee is of the opinion that out of the amount of Rs.56 crore received from the client for the services rendered under the earlier contract/interim arrangements, Rs. 25 crore cannot be separately recognised as 'revenue' considering them as a separate construction contract distinct and separate from the scope of work under LOA dated 14th November, 2007 for Rs. 773.50 crore. However, the balance portion of Rs. 31 crore should be recognised as 'revenue' separately.

Query No. 16

Subject: Valuation of investment in shares of a subsidiary for non-cash consideration.[1]

A. Facts of the Case

1. A State Government company (hereinafter referred to as 'the company') in which the State Government is holding 99.99% shares, is engaged in mining and selling of Rock Phosphate, Gypsum, Limestone and Lignite. Its mines are located at different places in the State of Rajasthan. The State Government company is also having Wind Power Mills installed in one of the districts of the State.

2. The Government of India (GOI), vide its letter dated 13.11.2006, has allocated coal blocks in certain Lignite mines in favour of the company for mining of Lignite in the State. As per the condition mentioned in the allotment letter, 'in principle approval' for the mining rights was given to the company for carrying out the Lignite mining either by that company or a separate company to be created with participation of the company provided that the separate company created is a Government company eligible to do mining as per the provisions of Coal Mines (Nationalisation) Act, 1983.

3. In view of the above, the company has entered into a Joint Venture (JV) Agreement on 27.12.2006 with a private company to form a JV company (JVC) in which the company shall be holding 51 % equity shares. As per the JV Agreement, the private company should make all the investments and the company shall have no financial liability with respect to the JVC. (Copy of the JV Agreement has been furnished by the querist for the perusal of the Committee.)

4. As per the terms and conditions of JV agreement, the company should obtain mining lease of the Lignite mines in reference from the Government of Rajasthan and transfer the same to the JVC. The company should also obtain all necessary licenses/consents/approvals from the Government and regulatory approvals/consents from the Central as well as the State Government for use, operation,

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[1] Opinion finalised by the Committee on 30.5.2008

development and management of the mines. As per the terms of the agreement, all the expenses incurred /to be incurred by the company shall be borne by the JVC/private company. After transfer of mining leases in favour of JVC, the Lignite mines would be developed and operated by JVC/private company and the Lignite to be mined from the mines is to be consumed by the private company for power generation by lignite based power plant to be established by the private company.

5. In compliance with the terms of JV Agreement, a JVC was incorporated on 19.01.2007 with initial paid up capital of Rs. 5,00,000 and as per the terms of JV Agreement, 51% of the share capital of Rs. 5,00,000, i.e., shares having face value of Rs. 10 each, valuing Rs. 2,55,000 of JVC were allotted to the company. In future also, as and when subscribed and paid-up capital of the JVC is increased by the private company, 51% shares would be allotted in favour of the company and the value of such shares may be few crores of rupees depending upon the investment to be made in the JVC by the private company.

6. Since the company has not invested/paid any money for obtaining the shares in the JVC, the company treated the face value of shares (Rs. 2,55,000) as 'Investment' and credited the Capital Reserve in its Balance Sheet for the year ended on 31.3.2007. Besides, the company has also made disclosure in the 'Notes to Accounts' by giving a note as reproduced below:

> "The company has formed a joint venture company with … (name of the private company) namely ... (name of the JVC). The JVC will undertake the work of Lignite mining in… areas of ... District and supply the same to… (name of the private company) which is going to install Lignite based pit head power plant. As per terms of agreement between the company and … (name of the private company), the company shall have 51% shares in the JVC and ...(name of the private company) will hold the remaining 49% of the equity of the JVC. The shares will be issued to the company in lieu of fulfillment of various obligations and for transfer of mining lease rights by the company to the JVC. The company will not take any financial liability for its holding in the JVC. The JVC

has allotted shares worth Rs. 5.00 lakh till 31.03.2007, out of which shares worth Rs. 2.55 lakh being 51% of the shares so allotted have been issued to the company.”

7. As per the querist, the statutory auditors of the company were of the view that the accounting treatment given by the company was not correct and have qualified the balance sheet of the company by stating that the company had shown under the head investment in a subsidiary company, the equity shares issued by the JVC of Rs. 2,55,000 being 25,500 equity shares, 51% of the paid up share capital. In their opinion, the same should be shown at zero value as the company had not paid any consideration for the same and therefore, the investment in subsidiary company and capital reserve had been overstated by Rs. 2,55,000.

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the correct accounting treatment for the value of shares of the JVC issued/to be issued in future in favour of the company for which it will not pay any consideration in cash as per the terms of JV Agreement.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to valuation of investments in the shares of the JVC with 51% equity held by the company for presentation in the separate financial statements of the company. 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, accounting for the mining license received by the company, accounting in the books of the JVC, whether the JVC should be considered as a subsidiary or a jointly controlled entity, etc.

10. The Committee notes that the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 13, ‘Accounting for Investments’. Paragraphs 28 and 29 of AS 13 read as below:

> ***“28. The cost of an investment should include acquisition charges such as brokerage, fees and duties.***

> ***29. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident."***

11. From the above, the Committee notes that AS 13, inter alia, deals with the determination of the cost of acquisition of an investment by way of either issue of securities or in exchange of another asset. The other asset may be either monetary or non-monetary. Though AS 13 does not deal with acquisition of shares in exchange of services, the Committee is of the view that the above principles are equally applicable for investments acquired in exchange for services also. Further, the Committee is of the view that the above principles are equally applicable for securities to be issued/ assets to be transferred/ services to be rendered as consideration for the investment already acquired.

12. The Committee notes that in the present case, under the terms of the JV Agreement, the company in question is obliged to obtain and transfer the mining licenses to the JVC and to fulfill certain obligations. However, all the expenses under the JV Agreement incurred by the company are to be borne by the JVC/ private company. In addition, 51% of shares are also allotted to the company. The passing on of expenses to the JVC/private company is an additional benefit given to the company. That does not alter the principle that cost of the investment in shares of the JVC should be equal to fair value of the license and other services rendered by the company. Alternatively, if fair value of the investments is more clearly evident, that may be taken as cost of the investment as permitted in paragraph 29 of AS 13 quoted above.

13. The Committee notes paragraph 88 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, which reads as below:

> "88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably."

14. The Committee notes that the company is entitled not only to 51% of initial share capital but also to 51% of share capital to be issued in future without consideration in cash. The shares so obtained/to be obtained constitute investment by the company in the JVC. Further, it seems that the mining licenses are yet to be obtained and transferred to the JVC, since what is obtained is only 'in principle approval'. From the copy of the JV Agreement furnished by the querist, the Committee notes that apart from obtaining licenses, approvals, etc., the company should also contribute its local knowledge, technical knowledge and other expertise in relation to mines, while the private company shall provide the management support and the entire investment to the JVC (clause 2 of the JV Agreement).

15. In case, there is a reliable measure of fair value of the license and the service, that fair value should be recorded as the cost of investment. The corresponding credit should be reflected as a liability to the extent of the fair value of obligations (to be fulfilled including license to be obtained) and to profit and loss account to the extent of fair value of obligations already fulfilled. As and when the obligation is fulfilled, the appropriate portion of the liability should be cleared by transfer to the profit and loss account.

16. In case the fair value of investment is more clearly evident and adopted as cost of investment, that should be allocated on a reasonable basis to fair value of obligations fulfilled and fair value of obligations yet to be fulfilled so that corresponding credit aspect of investment account can be accounted. Subsequent accounting will be as explained in paragraph 15 above.

17. The Committee is of the view that if the fair values as stated

in the above paragraphs are not reasonably determinable, then, investment should be recorded at a nominal value, say, Re. 1.

D. Opinion

18. On the basis of the above, the Committee is of the opinion that the correct accounting treatment in the books of the company for the shares of the JVC issued/to be issued in future in favour of the company for which it will not pay any consideration in cash as per the terms of JV Agreement would be to recognise the same at fair value of the services and the license to be provided by the company to the JVC. However, in case the fair value of the shares is more clearly evident, the same should be recognised at fair value thereof.

Query No. 17

Subject: Capitalisation of interest under AS 16.[1]

A. Facts of the Case

1. A company, engaged in the business of providing health and beauty solutions, has almost 100 centers all over the country and expanding further by opening new centers in various other locations. For starting up a center, the company invests in leasehold improvements and slimming and beauty equipments that are necessary for providing services, and other electrical fittings, furniture and office equipments.

2. The company takes the premises on rent, pays security deposit which is equivalent to 6-10 months' rent, develops the center within a span of 3-5 months with the aesthetic interiors, cabins, beauty salon area, gym floorings, etc. and thereafter, installs the necessary equipments which are affixed with the specific workstation

[1] Opinion finalised by the Committee on 30.5.2008

requirement, air conditioner and ducting plants, etc. According to the querist, each project is being completed with the project period of 3-5 months and with an investment ranging from Rs. 60 lakh to Rs. 100 lakh depending upon the size of the carpet area covered ranging from 2500 sq.ft to 5000 sq.ft. The capital expenditure has been incurred on premises which are generally taken for nine years' lease with the extendable option with the lessee (the company). The querist has informed that the capital expenditure on leasehold improvements and equipments are capitalised and allowed by auditors.

3. The querist has stated that the company develops 20 centers in a year by investing almost Rs. 15-20 crore on fixed assets, such as, leasehold improvements, equipments, etc. To fund these capital additions, the company borrows from a bank by availing term loan, the disbursement of which is based on the capital outlay/security deposit paid by the company during the period. The term loan is being disbursed on producing a Chartered Accountant's certificate certifying the assets introduced during the period. The company pays a coupon rate of 10-13% (PLR linked) for the term loan facility. Thus, the company has 20 projects during the year with a gestation period of 3-5 months each and is spending *60-100* project months with the capital outlay of Rs. 15-20 crore (emphasis supplied by the querist).

4. The querist has informed that the company does not get the disbursement in excess of the capital outlay and thus, does not hold unutilised borrowed funds at any point of time and hence, does not earn any interest/ return on the unutilised borrowed funds.

5. The querist has also stated that there is a practical difficulty of not capitalising the interest. As per proviso to section 36(1)(iii) of the Income-tax Act, 1961 (the Act), which reads thus:

> "**Provided** that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction."

Thus, as per the querist, if the interest on borrowings for the qualifying assets as per Accounting Standard (AS) 16, 'Borrowing Costs', is not capitalised, the same shall be disallowed for the purpose of income tax computation as per section 36(1)(iii) of the Income-tax Act. Further, if interest on qualifying assets is not capitalised as per AS 16, then there is disparity between the book profit and profit for the purpose of income tax computation. Also, arriving at the amount that is to be added back to the cost of asset (as it is not allowed as deduction) to claim depreciation shall be disputed by the Income-tax Department, as the calculation of the same is not certified by the auditors and there is high risk that the income-tax department shall disallow all the interest cost on the term loans (i.e., interest expenses incurred for acquiring the assets even after the assets were put to use).

6. The querist has informed that the query is only related to capitalisation of interest cost on borrowings (till the centers are operational) which is specifically raised for fixed assets additions.

B. Query

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

(i) whether the capital addition of lease hold improvements and equipments installed in 20 medium scale projects with the capital outlay of Rs. 60-100 lakh each shall be considered as 'qualifying assets' as defined under AS 16.

(ii) whether the project period of 3-5 months for developing the centers shall be considered as 'Substantial Period of Time' under the Accounting Standards Interpretation (ASI) 1, Substantial Period of Time (Re. AS 16)[2].

(iii) whether the interest cost on the amount borrowed for payment of security deposit during the project period shall be considered as 'activity that is necessary to prepare the asset for its intended use or sale in progress' under AS 16 and should be capitalised in the books of account.

[2] The ASI has subsequently been withdrawn by the Council of the Institute of Chartered Accountants of India and the Consensus portion thereof has been as 'Explanation' to the relevant paragraph of AS 16.

C. Points considered by the Committee

8. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to whether the period of 3-5 months taken for developing the centers can be considered as 'substantial period of time' as per the provisions of AS 16 and, accordingly, whether, on that basis, an asset can be called as a qualifying asset. The Committee has, therefore, answered only this issue and has not touched upon any other issue arising from the Facts of the Case, such as, allocation of borrowing costs over various qualifying assets, etc. The opinion of the Committee contained hereinafter is from the accounting point of view only, and not from the point of view of income-tax considerations.

9. The Committee notes from the Facts of the Case that the company is incurring various types of expenditure on development of the centers. In the view of the Committee, the first and foremost issue in the query is whether the expenditure results into creation of an asset. In this regard, the Committee notes the definition of the term 'asset' as contained in the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, which states as follows:

> "An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

10. From the above, the Committee is of the view that only that expenditure in respect of which future economic benefits are expected to arise and over which the enterprise has a control can be considered as an asset. Accordingly, the expenditure that does not result into creation of an asset (e.g., repair charges) should be expensed and, therefore, it can not be considered as a qualifying asset in the context of capitalisation of borrowing costs as per AS 16.

11. As far as the issue relating to determination of qualifying asset is concerned, the Committee notes that in the context of the query, there can be broadly two types of assets:

(i) assets which are ready to use when acquired, e.g., airconditioners, furniture, certain slimming and beauty equipments, etc.

(ii) self-constructed assets, such as, cabins.

12. As far as the first type of assets, i.e., those which are ready to use when acquired are concerned, in the view of the Committee, these cannot be considered as qualifying assets within the meaning of AS 16, although there may be some time lag between their acquisition and actual use, in view of the definition of the term 'qualifying asset' and paragraph 5 of AS 16, as reproduced below:

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

> "5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets."

13. As regards second type of assets, i.e., self-constructed assets, the Committee notes that these can be considered as qualifying assets only if these take substantial period of time to get ready for intended use or sale thereof. In this context, the Committee notes that the consensus portion of ASI 1 issued by the Institute of Chartered Accountants of India, has been included as an Explanation to the definition of the term 'qualifying asset' in AS 16, 'Borrowing Costs', notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, which provides as follows:

> **Explanation:**
>
> ***"What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is***

> ***considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered."***

14. On the basis of the above, the Committee is of the view that ordinarily, 3-5 months cannot be considered as a substantial period of time. The company should itself evaluate what constitutes a substantial period of time considering the pecularities of facts and circumstances of its case, such as nature of the asset being constructed, etc. In this regard, time which an asset takes, technologically and commercially to get it ready for its intended use should be considered. Accordingly, the assets concerned may be considered as 'qualifying assets' as per the provisions of AS 16.

15. As regards the borrowing costs incurred in relation to security deposit made to acquire the premises on lease, the Committee is of the view that the security deposit is made in respect of the lease transaction and, accordingly, it is not directly attributable to the activities necessary to make various assets ready for their intended use, and accordingly, the payment of security cannot be considered as 'the activity necessary to prepare the assets for its intended use or sale' under AS 16 as is being argued by the querist in paragraph 9(iii) above. In this connection, the Committee also notes paragraph 6 of AS 16 which states as follows:

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

Thus, in order to be capitalised, borrowing costs should be directly attributable to acquisition, construction or production of a qualifying asset. The test of directly attributable borrowing costs is that these borrowing costs would have been avoided if the expenditure on the qualifying asset had not been incurred. In the present case, the Committee notes that the security deposit would have to be made to acquire the leasehold property irrespective of the fact whether the improvements on the leasehold property had been made or not. Thus, in the view of the Committee, the borrowing costs incurred in relation to the security deposits cannot be capitalised.

16. As far as the querist's contention regarding practical difficulties of not capitalising borrowing costs on account of proviso to section 36(1)(iii) of the Income-tax Act, as argued by the querist in paragraph 5 above, is concerned, the Committee has not examined that issue as in accordance with Rule 2 of the Advisory Service Rules of the Expert Advisory Committee, the Committee does not answer issues involving legal interpretation of various enactments, such as, the Income- tax Act, 1961.

D. Opinion

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

(i) The assets that are ready for their intended use when acquired cannot be considered as 'qualifying assets'. However, self-constructed assets can be considered as qualifying assets provided these take substantial period of time as per the provisions of AS 16 as discussed in paragraph 14 above.

(ii) Ordinarily, the project period of 3-5 months cannot be considered as 'substantial period of time'. However, keeping in view the various factors peculiar to the facts and circumstances of the case of the company it may be considered as substantial period of time, as discussed in paragraph 14 above.

(iii) The payment of security deposit cannot be considered as the activity that is necessary to prepare the asset for its intended use or sale. Moreover, the borrowing costs incurred in relation to security deposit are not directly attributable to the construction/acquisition/development of assets in the present case and, accordingly, the same incurred during the project period cannot be capitalised, as discussed in paragraph 15 above.

Query No. 18

Subject: Accounting treatment of capital/insurance spares if the year of purchase and consumption is same, and if the replaced spare can be repaired for re-use.[1]

A. Facts of the Case

1. A company is a Government of India undertaking incorporated in the year 1975 under the Companies Act, 1956. One of the objectives of the company is to set up power plants in various geographical locations in the country and to supply bulk power to the various state electricity boards. The company, being an electricity generating company, is also governed by the provisions of the Electricity Act, 2003. As per the querist, since the Government has not prescribed any statement of accounts for the central undertakings engaged in generation of electricity, the company is preparing its financial statements in the format prescribed in Schedule VI to the Companies Act, 1956.

2. The querist has stated that in line with the provisions of Accounting Standard (AS) 2 ‘Valuation of Inventories’ (revised 1999) and Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, the company has identified certain spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular. These spares are classified as ‘capital spares’ and are capitalised alongwith the related plant and machinery and their total cost is amortised over the useful life of the related plant and

[1] Opinion finalised by the Committee on 30.5.2008

machinery. Other spares are classified as 'machinery spares' and are included in inventories. According to the querist, 'capital spares' identified by the company are capitalised alongwith the value of related principal items of fixed assets whether procured alongwith the related principal item or subsequently. The total cost of the capital spares, whether purchased alongwith the related plant and machinery or subsequently, is amortised on a systematic basis over a period not exceeding the useful life (remaining useful life in case of subsequent procurement) of the related plant and machinery.

3. The querist has further stated that when the capital spare is issued for consumption, i.e., replaces the worn out spare in the fixed asset, the following accounting treatment is carried out in the accounts:

- In case the taken out spare is irrepairable:
  - the gross block and accumulated depreciation of the spare taken out is de-capitalised.
- In case the taken out spare is repairable:
  - the gross block and accumulated depreciation of the spare taken out and repaired is kept in the books of account; and
  - the repair charges are debited to the profit and loss account.

4. The querist has referred to the opinion of the Expert Advisory Committee on Query No. 40 contained in the 'Compendium of Opinions – Volume XXI' wherein the Committee has, inter alia, opined:

> *Paragraph 14 of the Opinion*
>
> "Machinery spares of the nature of capital spares/insurance spares are capitalised separately at the time of their purchase whether procured at the time of the purchase of the fixed asset concerned or subsequently. Depreciation on capital spares purchased along with the fixed assets is charged on a

systematic basis over a period not exceeding the useful life of the fixed asset to which they relate. When the capital spare/ insurance spare is actually used, i.e., it replaces the worn out spare in the fixed assets, 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. The capital spare/machinery spare purchased subsequent to the purchase of the machine is capitalised and depreciated on a systematic basis over a period not exceeding the remaining useful life of the related fixed asset and when replaced should be treated in the manner explained above."

Paragraph 18 (d) of the Opinion

"An item of capital/insurance spares should be charged to revenue, if the year of purchase and consumption is the same."

The view is based on the provisions of paragraph 23 of AS 10 which provides ***"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."***

5. In the view of the querist, the opinion of the Expert Advisory Committee regarding capital/revenue spares to be charged to revenue in case the year of purchase and consumption is same may need review considering the following:

(i) Normally, the items of capital spares in a company are identified much before their procurement by a group of technical experts considering the provisions of AS 2 and AS 10, viz., usage with an item of fixed asset and expected irregular use. Based on this, capital spares are identified and capitalised alongwith the related plant and machinery.

(ii) The cost of spares both fitted in the main plant and the other spare (whether procured alongwith the related main plant or subsequently) kept in stores as capital spare is included in the cost of related plant and machinery even though there was no increase in the future benefits from the existing assets beyond its previously assessed standard of performance from the spare kept in store.

(iii) Paragraph 14 of the aforesaid opinion suggests the accounting treatment of capital spares based on the accounting periods and not on the principles laid down in AS 2 and AS 10 regarding usage with an item of fixed asset and expected irregular use.

(iv) The accounting of the capital spares should be based on the nature of items, i.e., usage with an item of fixed asset and expected irregular use as defined in AS 2 and AS 10 and should not be on the basis of purchase/ issue of the spares, i.e., a capital spare purchased on 31st March, 2007, i.e., at the balance sheet date and it replaces the taken out spare on 1st April, 2007, i.e., 1st day of the following accounting year is to be capitalised. But in case the capital spare is purchased on 1st April 2007, i.e., at beginning of the balance sheet date and it replaces the taken out spare on 31st March 2008, i.e., last day of the accounting year, it is to be charged to revenue.

(v) The taken out spare can be repairable and the repair cost is charged to revenue. The repaired spare can be used again for replacing the taken out spare.

In the view of the querist, capital spares should be charged to revenue only in those cases where the taken out spares are irrepairable and of no future use.

B. Query

6. Based on the above, the querist has requested the Expert Advisory Committee to review its earlier opinion published as Query No. 40 of 'Compendium of Opinions – Volume XXI with respect to the issues reproduced in paragraph 4 above.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to the accounting treatment for replacement of worn-out part in the fixed asset with the spare and particularly, when the year of purchase and consumption of the spare is the same. The Committee, has therefore, considered only these issues and has not touched upon any other issue arising from the 'Facts of the Case', such as, appropriateness of the identification of the spares as capital spares, etc.

8. In the context of replacement of spares, the Committee notes paragraph 23 of AS 10, which states as follows:

> "***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."***

On the basis of the above, the Committee is of the view that at the time of subsequent expenditure, in order to determine accounting treatment thereof, it should be evaluated as to whether the subsequent expenditure increases the future benefits arising from the asset beyond its previously assessed standard of performance in terms of its useful life, or its production capacity, or in terms of decreased operational costs, etc. Applying the above principles, the Committee notes that since the replacement of a part of the fixed asset with its spare does not increase the future benefits arising from the fixed asset beyond its previously assessed standard of performance, the cost of replacement should be charged to revenue and should not be added in the value of fixed asset. When the worn-out part of the fixed asset is replaced by a previously capitalised capital spare, the written down value of the capital spare should be charged off to the profit and loss account. It would be appropriate to write off the written down value of the part taken out from the fixed asset only if the said part was capitalised separately when the fixed asset was purchased applying the principles contained in paragraph 8.3 of AS 10.

9. As far as the accounting treatment of replacement of spares when the year of purchase and consumption thereof is same is

concerned, extending the above principles, the Committee is of the view that the cost of replacement in the present case is the cost of new spares and accordingly, the same should be charged off to the revenue account at the time of replacement. In case, it is not consumed in the same year and is replaced in a subsequent year, the depreciated amount in respect thereof is expensed. Thus, the principle is the same whether the spare is replaced in the year of purchase or in a subsequent year. At best, the entity may charge pro-rata depreciation in the year of purchase till it is consumed, but the total effect will remain the same whether the full amount of replaced spare is expensed or it is expensed as depreciation for part of the year. The Committee notes that the same accounting treatment has been prescribed in the earlier opinion referred by the querist in paragraph 4 above.

10. As regards the arguments of the querist in paragraph 5 above, the Committee is of the following view:

(i) Identification of capital spares with an item of fixed asset does not allow the capital spares to be capitalised as a part of the fixed asset concerned. A capital spare procured subsequent to the purchase of the fixed asset should be capitalised separately.

(ii) The capital spare, whether procured along with the fixed asset or subsequently, is capitalised because it has future economic value of being put to use when the part of the fixed asset needs replacement. Upon actual replacement, the capital spare kept in store looses its identity and becomes a part of the fixed asset when the worn-out part is taken out. Therefore, applying the principles of paragraph 23 of AS 10, the written down value of the capital spare kept in store is charged to the profit and loss account.

(iii) The suggested accounting treatment is in line with the principles of AS 2 and AS 10. In accordance with the principles of AS 2, an item of capital spares is not considered as an inventory rather the same is capitalised as per the provisions of AS 10 at the time of purchase and the total cost thereof is also allocated over the useful life of the fixed asset. However, upon replacement of a part of the fixed asset by its spare when the year of purchase and year of consumption of the spare is same, in view of the principles of paragraph 23 of AS 10, the cost of the spare purchased should be charged to revenue as it does not increase the level of performance of the fixed asset. This has been discussed in paragraph 9 above in detail.

(iv) The accounting treatment prescribed above is based on the nature of the item, viz., replacement expenditure incurred. As per the provisions of paragraph 23 of AS 10, it requires evaluation as to whether the expenditure increases the future benefits arising from the fixed asset beyond its previously assessed standard of performance. If not, the expenditure is considered of the nature of revenue and accordingly, charged off to revenue and if yes, it is of capital nature and accordingly, it is capitalised. Accordingly, a capital spare when purchased is capitalised, and when actually put to use, i.e., when it replaces the worn-out part of the fixed asset, is expensed. Whether the two events occur in the same financial year or different financial years is incidental. This has also been explained in paragraph 9 above.

(v) As far as the accounting of the repairable capital spares is concerned, the Committee observes that in those cases, since the original part removed from the fixed asset can be used again for replacing the taken out spare, the original part still has an economic value and accordingly, when the spare replaces the original part in the fixed asset, the written down value of the spare should not be charged off to the profit and loss account, instead depreciation should be continued to be charged on the spare as a separate capital spare. The reason being that no replacement has taken place. The repair charges incurred should be charged to the profit and loss account.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that the earlier opinion of the Committee published as Query No. 40 of the 'Compendium of Opinions – Volume XXI' with respect to the issues reproduced in paragraph 4 above, is correct and there is no need of revising it.

Query No. 19

Subject: Accounting treatment of receipt and utilisation of project-specific funds.[1]

A. Facts of the Case

1. A joint venture company is a 'special purpose vehicle' incorporated to implement the rail component of 'City Urban Transport Project' (CUTP). The shareholders of the company are Ministry of Railways (MoR) and a State Government (SG) in the ratio of 51:49. The cost of the project is estimated to be Rs. 3,125 crore, which is sanctioned by the Government of India (GoI). The cost of CUTP project is to be shared between the MoR and SG in the ratio of 50:50. The implementation of the rail component envisages a loan from the World Bank which is to be disbursed to the MoR and the SG in the ratio of 50:50. However, the funds are given to the company by way of annual budgetary support by the MoR. The allocation of funds by the SG is through City Metropolitan Region Development Authority (herein after referred to as XYZ Authority). There are various works, which are to be executed under CUTP. Executions of these works are divided among various agencies, e.g., Western Railways, Central railways and XYZ Authority. Some works are to be executed by the company itself. For execution of the company's works under CUTP, the company

[1] Opinion finalised by the Committee on 17.7.2008

has entered into various agreements with the MoR, SG, Western Railways, Central Railways and XYZ Authority. The funds received from the MoR and SG are distributed to various agencies which are executing the work on behalf of the company as per their requirements. The company also spends funds on projects executed directly by it. (The querist has furnished copies of various documents for the perusal of the Committee.)

2. When the works are executed by the Western Railways or Central Railways, either there is advance payment or reimbursements are made by the company to these agencies. In the case of work executed by XYZ Authority, no payments are made, but credit for the amount of work executed by XYZ Authority is given to the SG and adjusted against its share to the total cost of CUTP as the SG has to bear 50% of the total cost of CUTP. For the portion of CUTP works, which are directly executed by the company, payments are made directly by the company to the vendors and contractors as per the terms of the contract.

3. The querist has stated that as per a clause in the Memorandum of Understanding (MoU) entered into with the MoR, assets created under this project would be the property of Indian Railways and not of the company. Hence, all the assets, which are created under this project, could not be accounted for as fixed assets in the books of the company.

4. As per the querist, the present accounting treatment followed by the company is as follows:

For Receipt of funds for CUTP

At present, the company is accounting receipt of funds from the MoR and the SG as 'Funds received for CUTP' under 'Unsecured Funds for Projects' just below Shareholders' Funds.

For Payment of funds for CUTP

To execute CUTP work, amount is provided to agencies and on periodical basis, expenditure statements are given by these agencies to the company. All the CUTP expenditures incurred by these agencies and the company are accounted as 'CUTP

Funds Utilised' as a deduction from CUTP Funds received under 'Unsecured Funds for Projects'.

5. The querist has clarified that the company is a project executing company and does not have any profit motive. The company is exempt from the payment of income-tax under section 12A of the Income-tax Act, 1961, and as a precondition for this exemption, the dividend clause has been deleted with the prior approval of the MoR and the SG. The company prepares income and expenditure account instead of profit and loss account. To meet the organisational expenses, the company has been authorised to levy direction and general (D&G) charges to the extent of 1% to 5% on the cost of the works executed. Other than D&G charges, there is no consideration flowing to the company. It also earns interest income by placing short-term funds with banks. Both D&G charges and interest income are used for meeting the organisational set-up of the company.

B. Query

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

(i) Whether the accounting treatment given to receipt and expenditure/payment of CUTP funds is correct.

(ii) Whether the works executed directly by the company and/or through agencies can be shown as turnover or value of work completed as per Part II of Schedule VI to the Companies Act, 1956.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to accounting for receipt of, and payment from CUTP funds, by the company and presentation of works executed by the company, directly or through other agencies. Hence, 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 propriety of preparation of income and expenditure account instead of profit and loss account, etc.

8. From the facts and circumstances of the case, it appears to the Committee that there exists an agency relationship between the company and the MoR and the SG, where the MoR and the SG act as principals and other agencies like Western Railways and Central Railways are responsible for execution of their portion of the project. The company merely receives funds from MoR/SG and disburses the same to the executing agencies and monitors the progress of the project and consolidates information on expenditure incurred for the project. However, considering the facts and circumstances of the case, the Committee notes that two other situations can also be contemplated in the present case, viz., (i) the company is not acting as an agent and the economic benefits or service potential of the assets created will flow to the company, and (ii) the company is not acting as an agent and the economic benefits or service potential of the assets created will not flow to the company.

9. The Committee further notes that Part II of Schedule VI to the Companies Act, 1956 requires disclosure of turnover in the profit and loss account, while Part I of the said Schedule requires presentation of fixed assets on the face of the balance sheet. The Committee is of the view that accounting treatment should be decided based on which of the above mentioned situations prevails. The accounting treatment to be followed for each of the above situations is explained in-principle in the paragraphs that follow.

10. The Committee is of the view that in the situation of agency relationship as discussed above, the accounting treatment mentioned in paragraph 4 above (i.e., accumulating the expenditure as 'CUTP Funds Utilised' and showing the same as deduction from 'Funds received for CUTP in the balance sheet) as followed by the company in respect of project-related expenditure is in order. When expenses are not directly paid by the company to XYZ Authority for work done by that agency but adjusted against the share of cost of the project to be borne by the SG, 'CUTP Funds Utilised' should be debited and 'Funds received for CUTP' should be credited (it being a case of constructive receipt of funds and constructive payment for expenses). In respect of advances given by the company to other executing agencies, the same may be treated as 'Advances disbursed', which should also be shown

as deduction from 'Funds received for CUTP'. As and when expenditure statements are received from those agencies and accepted, the 'Advances disbursed' should be cleared by transfer to 'CUTP Funds Utilised'. However, consideration for the agency, like D&G charges should be treated as revenue and expenses incurred for that purpose (including establishment expenses) and should be recognised in the income and expenditure account. In this connection, the Committee notes that paragraph 4.1 of Accounting Standard (AS) 9, 'Revenue Recognition', *inter alia*, reads as below:

> "In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

The corresponding debit for the above revenue should be treated as a receivable from the MoR/SG, which should be cleared by transfer to 'CUTP Funds Utilised'. The timing of this entry should be on the lines explained in paragraph 13 below.

11. As regards the situation where the company is not acting as an agent and the economic benefits or service potential of the assets created will flow to the company, the Committee notes that paragraphs 49 and 88 of the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India give, respectively, the following definition of, and recognition criteria for, an asset:

> "An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

> "An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably."

The Committee also notes that Accounting Standard (AS) 10, 'Accounting for Fixed Assets', defines 'fixed asset' as follows:

> "6.l *Fixed asset* is an asset held with the intention of being used for the purpose of producing or providing goods or

services and is not held for sale in the normal course of business.”

12. From the above and having regard to the nature of the project and the fact that the company is without profit motive, the Committee is of the view that if the future economic benefits or service potential associated with the assets created will flow to the company, then, the company should recognise fixed assets in its own books with a clear description that the company is not the legal owner of the assets created. In this situation, the mere fact that the legal title in respect of the assets created lies with the Indian Railways does not affect recognition of fixed assets in the books of the company. This is in consonance with the principle of ‘Substance over Form’ as explained in Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’. In this situation, until the project is complete, project-related expenditure will be accumulated as ‘capital work-in-progress’. This will also include advances given to other executing agencies. When expenses are not directly paid by the company to XYZ Authority for work done by that agency but adjusted against share of cost of the project to be borne by the SG, ‘capital work-in-progress’ should be debited and ‘Funds received for CUTP’ should be credited (it being a case of constructive receipt of funds and constructive payment for expenses). The amount to be capitalised should be determined in accordance with applicable accounting standards (for example, AS 10). In this situation, funds received from the MoR/SG should be shown as ‘Funds received for CUTP’ without any deduction towards utilisation of the funds for assets created and recognised as fixed assets by the company as these funds are of the nature of capital contribution. However, disclosure of utilisation should be made in the accounts. In this situation, there can also be revenue, such as, D&G charges to be recognised in the income and expenditure account. The corresponding debit for the revenue should be treated as a receivable from the MoR/SG, which should be cleared by debit to ‘CUTP Funds Utilised’. The timing of this clearance entry should be on the lines explained in paragraph 13 below.

13. As regards the situation where the company is not acting as an agent and the economic benefits or service potential of the

assets created will not flow to the company, the Committee is of the view that the company should recognise both project-related expenses and turnover in respect of its own scope of work executed directly and/or through other agencies in accordance with the applicable accounting standards (for example, Accounting Standard (AS) 7, 'Construction Contracts') in the income and expenditure account. The corresponding debit for turnover will be a receivable from the MoR/SG. To the extent the work is in progress, the income and expenditure account should be credited as work-in-progress with corresponding debit to work-in-progress (balance sheet). The receivables mentioned above should be cleared by debit to 'CUTP Funds Utilised'. The timing of this entry should be in accordance with the terms of award of work or the mutual agreement, as the case may be. This may be at the time of revenue recognition or at a subsequent point of time. In the absence of terms of award of work or the mutual agreement (which will be rare), the entry should be passed as soon as the receivables are determined. When expenses are not directly paid by the company to XYZ Authority for work done by that agency but adjusted against the share of cost of the project to be borne by the SG, expenses should be debited to income and expenditure account and 'Funds received for CUTP' should be credited (it being a case of constructive receipt of funds and constructive payment for expenses). The credit to receivables towards the share of the SG in the cost of CUTP by transfer to 'CUTP Funds Utilised' should be done through a separate accounting entry at the appropriate time as explained above. In this situation, advances given to other executing agencies should be shown under 'Current Assets, Loans and Advances' and as and when expenditure statements are received from those agencies and accepted, the said advance should be transferred to project-related expenses, to be recognised in the income and expenditure account in accordance with the applicable accounting standards. Further, in this situation, revenue includes not only project expenses to be met out of Funds for CUTP but also D&G charges.

14. The Committee notes that in all the above situations, there may be other items of revenue which should be accounted for in accordance with the applicable accounting standards. If the corresponding receivables are due from the MoR/SG and are to

be adjusted against the Funds for CUTP, the receivables should be transferred to 'CUTP Funds Utilised' as explained in paragraph 13 above.

15. The Committee notes that section 211(1) of the Companies Act,1956 requires the balance sheet to be prepared in accordance with the form set out in Part I of Schedule VI, or as *near thereto as circumstances admit.* The Committee is of the view that under all the above situations, funds received for the project may be shown separately as 'Funds received for CUTP' and for situations where the company is acting as an agent, and where the company is not acting as an agent and the economic benefits or service potential of the assets created will not flow to the company, 'CUTP Funds Utilised' may be shown as deduction from 'Funds received for CUTP'. As regards the heading under which the funds should be exhibited in the balance sheet, in case the company is required to repay the funds back to the MoR/SG (possibly out of any future sources), the funds may be exhibited as a liability to be repaid under 'Loan Funds'. If there is no such requirement, the funds should be exhibited within Shareholders' Funds, after 'Reserves and Surplus'. In this connection, the Committee also notes that there is only dividend prohibition clause and it appears that there is no specific prohibition for repayment of funds received.

D. Opinion

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

(i) Accounting treatment for expenditure/payment of CUTP funds should be as explained in paragraphs 10 to 13 above depending on the situation. Funds received may be presented as 'Funds received for CUTP' in all the situations mentioned in paragraph 8 above, while 'CUTP Funds Utilised' may be shown as deduction from 'Funds for CUTP' in the situations where the company is acting as an agent and the situation where the company is not acting as an agent and the economic benefits or service potential of the assets created will not flow to the company. The heading under which the funds should be exhibited in the balance sheet will be as explained in paragraph 15 above.

(ii) The works executed directly by the company and/or through agencies (in respect of the company's own scope of work) should be shown as turnover as per Part II of Schedule VI to the Companies Act, 1956 only in the situation where the company is not acting as an agent, and the economic benefits or service potential of the assets created will not flow to the company as explained in paragraph 13 above. Further, as explained in paragraphs 10 to 14 above, there can be other items of revenue also.

Query No. 20

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

A. Facts of the Case

1. A company is engaged in retail business operations over the years. The company has been in footwear business since 1965 and has entered into Large Format Retail (hereinafter referred to as 'LFR') business from the year 2005. Both the business lines have been operated through 'Hub 'n Spoke' module. At present the footwear business of the company is being operated through wholesale and retail outlets, and distribution centres across 22 Indian states and one manufacturing unit at Kolkata. Approximately 80% of the total footwear products traded under the company's brand name are procured from outside suppliers and the rest 20% are manufactured at the company's own manufacturing unit. Under LFR business, the large number of rapidly changing merchandise includes apparels, home need items, grocery items, etc. and the

[1] Opinion finalised by the Committee on 17.7.2008

stores have been operated with a central warehouse. 100 per cent of the products traded under LFR business are procured from outside suppliers.

2. The operation activity flow of the company is as follows:

Footwear division:

(i) All finished goods are either manufactured at company's factory or procured from outside suppliers.

(ii) Purchased finished goods are branded and packed at company's own distribution centres either for further despatch to the retail locations of sales across the country or sold in bulk under wholesale terms at the distribution centres itself.

(iii) Finished goods despatched to retail outlets from distribution centres are stored at retail locations for sale in due course.

LFR division:

(i) Life style retail merchandise are procured from outside suppliers.

(ii) Own branded merchandise are branded and packed at supplier end.

(iii) Suppliers deliver merchandise, both own brand or other brand, either at central warehouse or direct to stores locations.

(iv) Merchandise received in central warehouse is affixed with bar code, packed and forwarded to stores locations.

(v) From stores location, own brand and other brand, merchandise are sold to retail customers.

3. As per the querist, the method and basis of inventory valuation presently followed are as below:

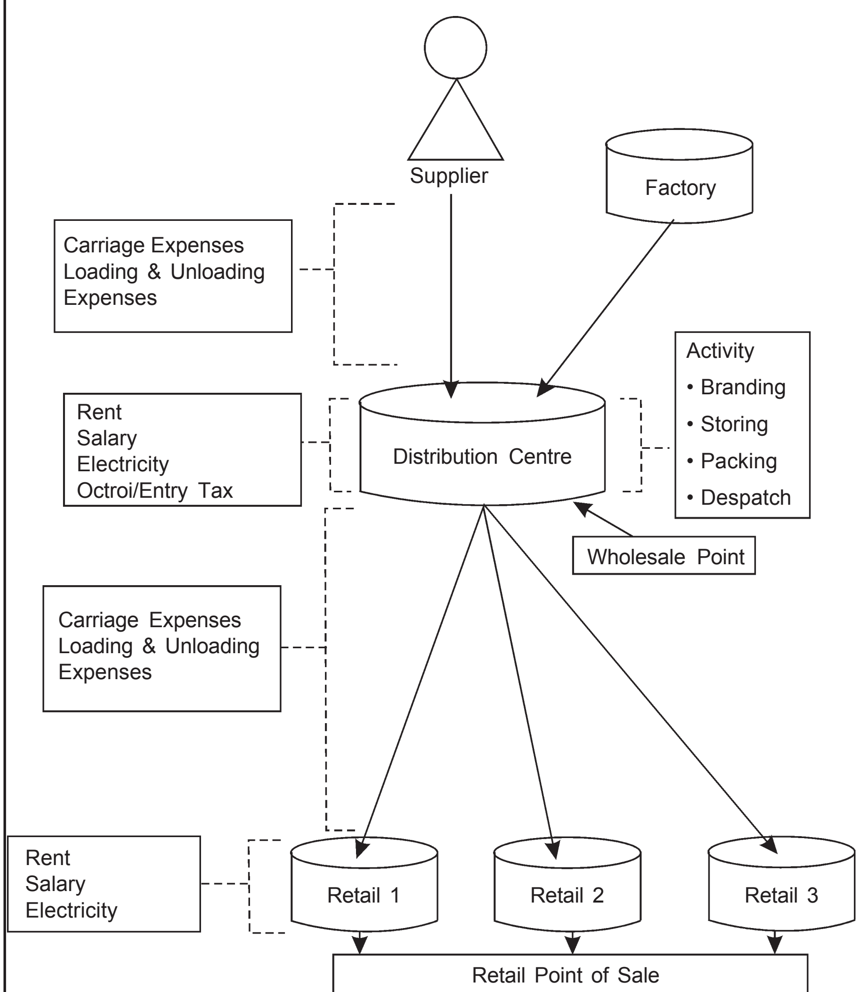
(i) In line with Accounting Standard (AS) 2, 'Valuation of Inventories', paragraph 18, inventories at different locations are considered under cost method for measurement of value.

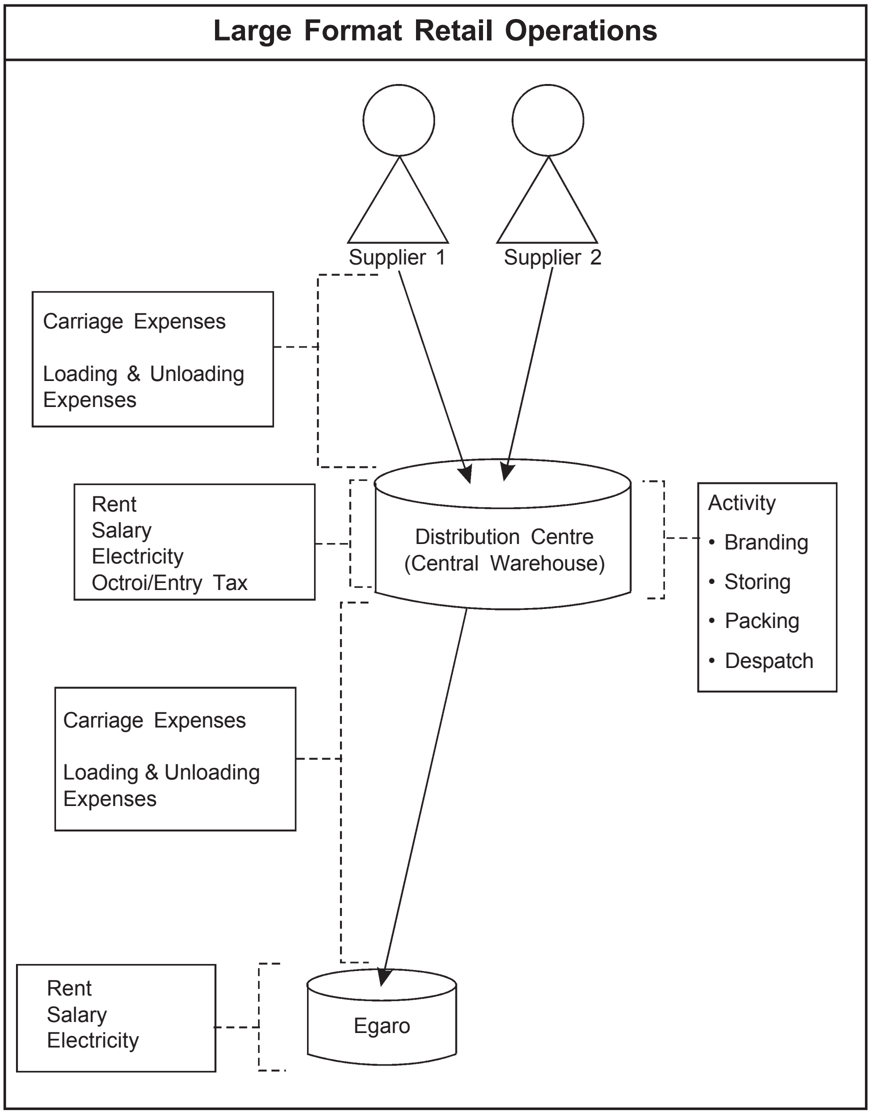
(ii) Similarly, the value of inventories has been assigned by using FIFO formula as per paragraph 16 of AS 2.

4. The operation flow charts of both the divisions are as follows:

OPERATION FLOW CHART

Footwear Operations





B. Query

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

(i) Whether *rent, electricity and salary* of the personnel working for footwear distribution centres (DCs) where merchandise are branded, packed and stored primarily before despatch towards retail point of sales, should be considered in determining *cost of footwear inventory at DC level*. (Emphasis supplied by the querist.)

(ii) As the company is operating through 'Hub 'n Spoke' module, whether, *carriage inwards cost and loading and unloading costs* incurred at footwear retail outlet points in bringing the inventories to their present condition and location, on being despatched from distribution centers, should be included in determining *cost of inventory at footwear retail level*. (Emphasis supplied by the querist.)

(iii) Whether *rent and part of electricity charges that is directly relatable to footwear storage, paid for footwear retail outlets* where merchandise has to be stored, as per retail industry business practices, irrespective of merchandise type/nature, time of sale, quantum of sale, should be considered in determining *cost of inventory at footwear retail level*. It is also to be considered that goods have to be kept and maintained at retail store for a considerable time before sale. (Emphasis supplied by the querist.)

(iv) Whether *rent, electricity charges and salary of procurement and merchandising staff* should be considered in arriving at *landed cost of merchandise held at LFR–DC*. [At LFR - DC major activities are (a) branding, (b) tagging, (c) packing (d) storing and (e) despatch to LFR retail store.] (Emphasis supplied by the querist.)

(v) Whether *rent, salary of logistics staff* and *portion of electricity charges that is directly relatable to merchandise storage at LFR store* should be considered in arriving at *landed cost of merchandise held at LFR store.* [At LFR store major activities are (a) merchandise supply chain management at store level, (b) storing, (c) merchandise display and (d) sale. In LFR business, numerous and variety of merchandise, backed by intelligent logistics support, has to be maintained and carried at store level as per industry demand.] (Emphasis supplied by the querist.)

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to inclusion of certain items as costs of inventories in distribution centres (hereinafter referred to as 'DCs') and retail outlets of Footwear and LFR businesses. 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, valuation of inventories, cost formula, etc. Further, the Committee restricts itself to the specific activities mentioned by the querist in the issues raised. The Committee also notes that the querist has used the expression 'landed cost of merchandise' in the Facts of the Case without explaining its meaning. The Committee, in its opinion given hereinafter, has considered the expenses referred to in this regard from the point of view of whether the same should be included in the cost of inventories concerned.

7. The Committee notes that the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 2, 'Valuation of Inventories', which has also been notified by the Central Government under the Companies (Accounting Standards) Rules, 2006. The Committee notes the following paragraphs from AS 2:

> ***"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.***
>
> **Costs of Purchase**
>
> 7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods…"

"11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."

"13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

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

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

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

(d) selling and distribution costs."

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

9. The Committee is of the view that the term 'distribution costs'

referred to in paragraph 13(d) of AS 2 reproduced above read with paragraph 6 of AS 2, should be construed as distribution costs which are incurred by the seller in making the goods available to the buyer from the point of sale. In other words, distribution costs used in the expression 'selling and distribution costs' would include only those costs which are incurred for moving the goods from the premises of the seller, whether from the factory or DCs or retail outlets to the premises of the buyer. It does not include the cost of moving the goods from the factory to DCs or from DCs to seller's retail outlets before sale.

10. The querist refers to the activities of the Footwear DCs as branding (seems to be for purchased items), packing and storing before despatch to retail outlets. The Committee is of the view that rent, electricity and salary of the personnel working for Footwear DCs are, in effect, product costs to the extent they are related to branding because these are incurred in changing the condition of the product from unbranded to branded. Since these expenses are incurred in bringing the inventory to a saleable condition, i.e., branded condition as intended by the management, the same should be included in the cost of footwear inventory in accordance with paragraph 6 of AS 2. The Committee also notes that the above-mentioned expenses are storage cost to the extent these are related to storage activity. Since the footwear merchandise at the DCs are already finished goods requiring no further processing, the storage cost incurred at the DCs is not of the type which is necessary in the production process prior to a further production stage. Hence, inclusion of such storage cost in the cost of footwear inventory at DC level is prohibited by paragraph 13(b) of AS 2. As regards packing, the treatment of the aforesaid expenses related to packing depends on whether packing material cost itself is includible in the cost of inventories or not, which, in turn, depends on the nature of packing.

11. As regards carriage inwards cost and loading and unloading costs incurred at footwear retail outlet points in bringing the inventories to their present condition and location, on being despatched from DCs, the Committee is of the view that the same should be included in the cost of inventories at retail footwear level as required by paragraph 11 read with paragraph 6 of AS 2, whether or not 'Hub 'n Spoke' module is operated. For the reasons

stated in paragraph 9 above, the Committee is of the view that these are not 'distribution costs' mentioned in paragraph 13(d) of AS 2.

12. The Committee notes that at the footwear retail outlets, the footwear merchandise are already finished goods requiring no further processing. Hence, the cost of storing such goods in the retail outlets is not of the type which is necessary in the production process prior to further production stage. Hence, rent and part of electricity charges, whether or not directly relatable to footwear storage, paid for footwear retail outlets should not be included in the cost of footwear inventory at the retail level as the inclusion of the same is prohibited by paragraph 13(b) of AS 2.

13. The querist states that at the LFR – DC (which is the central warehouse), major activities are (a) branding, (b) tagging, (c) packing (d) storing and (e) despatch to LFR retail store. All merchandise at LFR-DC are meant for despatch to retail outlets. The Committee is of the view that to the extent the activities of the procurement and merchandising staff are related to branding, the salary of staff would be product costs for the reasons stated in paragraph 10 above and, hence, should be considered in arriving at the cost of inventories held at LFR-DC. Further, the Committee is of the view that to the extent their activities are related to tagging, their salary would also be product costs. In reaching this conclusion, the Committee presumes that 'tagging' refers to attaching a tag containing price and dimension details etc., to the product as required under various laws, such as the Standards of Weights and Measures Act, 1976 and, therefore, the Committee is of the view that to attach a tag is a legal requirement to bring the product to a saleable condition and is not an activity to promote sales. To the extent the activities of the procurement and merchandising staff are related to packing, the treatment of their salary depends on whether the packing material cost itself is includible in cost of inventories or not, which, in turn, depends on the nature of packing. Since no further processing activity takes place in LFR-DC, storage costs incurred at LFR-DC are not of the type which is necessary in the production process prior to further production stage. Inclusion of the same in the cost of inventories is prohibited by paragraph 13(b) of AS 2. Hence, to the extent, the activities of the procurement and merchandising staff are related

to storage activities at LFR-DC, their salary should not be considered in arriving at the cost of inventories held at LFR-DC. For the reasons stated in paragraph 9 above, despatch to retail outlets is not a distribution activity. To the extent the activities of the procurement and merchandising staff are related to despatch to retail stores, their salary should not be considered in arriving at the cost of inventories held at LFR-DC which are meant for despatch to retail stores. However, such cost should be considered in arriving at the cost of inventories held at retail outlets as required by paragraph 11 read with paragraph 6 of AS 2 since this expenditure is incurred in changing the location of the merchandise, i.e., bringing the inventories to the intended point of sale. The above principles in respect of salary of procurement and merchandising staff are equally applicable for rent and electricity charges incurred at LFR-DC.

14. The Committee notes that at LFR stores, the merchandise are already finished goods, not requiring any further processing. Therefore, the storage cost is not a cost of the type which is necessary in the production process prior to further production stage. Inclusion of the same in the cost of inventory is prohibited by paragraph 13(b) of AS 2. Consequently, rent, salary of logistics staff and portion of electricity charges, whether or not directly relatable to merchandise storage at LFR store, should not be considered to derive the cost of inventory held at LFR store.

D. Opinion

15. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 5 above:

(i) Rent, electricity and salary of the personnel working for Footwear DCs related to the activities of branding should be considered in determining cost of footwear inventory at DC level. To the extent these expenses are related to storing, the same should not be considered in determining cost of footwear inventory at DC level. As regards packing, these expenses related to the same can be included in the cost of the said inventory, if the packing material cost itself is includible, which, in turn, depends on the nature of packing.

(ii) Carriage inwards cost and loading and unloading costs incurred at footwear retail outlet point in bringing the inventories to their present condition and location, on being despatched from distribution centres, should be included in determining cost of inventory at footwear retail level. This will be so whether or not 'Hub 'n Spoke' module is operated.

(iii) Rent and part of electricity charges, whether or not directly relatable to footwear storage, paid for footwear retail outlets where merchandise have to be stored, as per retail industry business practices, irrespective of merchandise type/nature, time of sale, quantum of sale, should not be considered in determining cost of inventory at footwear retail level.

(iv) Rent, electricity charges and salary of procurement and merchandising staff related to branding and tagging activities should be considered in arriving at the cost of inventories at LFR–DC as discussed in paragraph 13 above. To the extent these expenses are related to storing, the same should not be considered in arriving at the cost of inventories held at LFR-DC. As regards packing, expenses related to the same can be considered in arriving at the cost of inventories, if the packing material cost itself is includible, which, in turn, depends on the nature of packing. As regards despatch to retail stores, to the extent the above expenses are related to the said activity, the same should not be considered in arriving at the cost of inventories held at LFR-DC meant for despatch to retail stores, rather the same should be considered in arriving at the cost of inventories held at retail outlets.

(v) Rent, salary of logistics staff and portion of electricity charges, whether or not directly relatable to merchandise storage at LFR store, should not be considered in arriving at the cost of inventories held at LFR store.

Query No. 21

Subject: Accounting treatment in respect of part renewal of railway track and change of sleepers, permanent way (P.way) material, etc. for railway sidings owned by a coal producing company.[1]

A. Facts of the Case

1. A company is a public sector undertaking engaged in mining of coal having touched a production capacity of 363 million tonnes during the fiscal year 2006-07. The company is the holding company of eight of its subsidiaries out of which seven are coal producing and one is being mine planning and designing service oriented subsidiary. As per the querist, the company is the largest coal producing company in India and is having a share of about 84% of total coal production in India. There are both underground mines as well as open cast mines. The share of production from underground mines is about 43 million tonnes whereas the production from open cast mines is 317 million tonnes.

2. The company is an unlisted company having a share capital of Rs. 6316.36 crore which is entirely held by the Government of India. All the subsidiaries of the company are owned 100% by it.

3. Since long, one of the subsidiary companies is having, as one of its assets, some railway sidings. These railway sidings run through the coalfield areas/pit heads under its operational jurisdiction. Through railway sidings, coal stock of the concerned areas is despatched. In two areas under the subsidiary company, namely, Parasia and Pandabeshwar, railway tracks in Parasia railway sidings and Khottadh railway sidings respectively, have outlived their commercial lives and become unusable/unsafe due to corrosion and wearing out. Some parts of these railway tracks were replaced by the company with new tracks. The replacement job was done through Railways as they were experts in this area. The expenditure incurred for the replacement job, by way of payment to the Railway authorities, included the following:

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[1] Opinion finalised by the Committee on 17.7.2008

(a) Complete renewal of track,

(b) Change of sleepers,

(c) Change of permanent way (P.way) material, etc.

4. Both the above railway sidings were originally capitalised in the year 1981-82 and were being carried at 5% residual value in the books from the year 1999-2000. The details of cost and depreciation (at straight line method @ 4.75% p.a.) appearing in the books are as follows:

Railway Sidings	Rate of Depreciation	Cost	Depreciation	Net Cost
Parasia	4.75%	Rs. 29.50 lakh	Rs. 28.03 lakh	Rs. 1.47 lakh
Khottadih	4.75%	Rs. 64.00 lakh	Rs. 60.80 lakh	Rs. 3.20 lakh

The part renewal of railway sidings took place in the year 2006-07 and the entire cost of such renewal (by way of payment to Railways) amounting to Rs. 71.82 lakh, was capitalised with effect from the year 2006-07 since the expected future benefits of the entire railway sidings were enhanced, due to their replacement. However, the life to be considered for fresh capitalisation of railway tracks at the aforesaid cost will be determined by the technical persons, which is yet pending.

B. Query

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

(a) Whether or not such capitalisation on account of part renewal of railway sidings is commensurate with various Accounting Standards in force.

(b) Whether or not cost of such renewal should have been charged off as revenue expenditure in the year in which the same was incurred.

C. Points considered by the Committee

6. The Committee notes paragraph 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which reads as follows:

> ***"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."***

7. The Committee is of the view that expenditure on fixed assets subsequent to their installation may be categorised into (i) repairs, and (ii) improvements or betterments. Repairs, in the Committee's view, implies the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated useful life or capacity. Expenditure on repairs, including replacement cost necessary to maintain the previously assessed standard of performance, is expensed in the same period. On the other hand, in the view of the Committee, expenditures on improvements or betterments are expenditures that add new fixed asset unit, or that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs. Such expenditures are capitalised. The Committee is of the view that 'previously assessed standard of performance' is not the actual performance of the asset at the time of repair, improvement, etc., but the standard performance of the same asset expected at this stage of life, as assessed when the asset was installed.

8. The Committee notes from the Facts of the Case that the railway sidings have become unusable/unsafe due to corrosion and wearing out and the same are being carried in the books at their residual value, implying thereby that their useful life is already over. The Committee further notes that the querist has stated that the expenditure incurred on renewal/replacement of the railway tracks by the company has enhanced the expected future benefits of the entire railway sidings, however, the determination of useful life thereof is pending. Thus, considering the facts and circumstances of the case, the Committee is of the view that

though the expenditure incurred on replacement/part renewal is generally expensed, it can be capitalised by the company only if it is established by technical experts that the useful life of the asset has substantially increased.

D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in the paragraph 5 above:

(a) Capitalisation on account of part renewal of railway sidings would be commensurate with various Accounting Standards in force only if such expenditure has resulted into substantial enhancement in their useful lives.

(b) The cost of such renewal should generally be charged off as revenue expenditure in the year in which the same was incurred unless the said expenditure has substantially enhanced the previously estimated useful life as established by technical experts.

Query No. 22

Subject: Valuation of food stuff held in stock to be distributed to tea-plantation workers at subsidised rate.[1]

A. Facts of the Case

1. A public sector company is carrying on a business, which, *inter alia*, includes cultivation and manufacturing of black tea. The querist has informed that as per the Plantations Labour Act, 1951, the company is required to distribute food stuff to the workers at a subsidised rate as welfare expenditure. Accordingly, the company purchases such food stuff in bulk and maintains the stock, so that

[1] Opinion finalised by the Committee on 17.7.2008

the same is available for distribution at the appropriate time. The said food stuff is purchased at the 'pool rate' as fixed from time to time by the appropriate authority and issued to the workers at a subsidised rate. The loss, i.e., difference between the pool rate (bulk quantity rate) and the subsidised rate is booked in the accounts as 'loss on food stuff' when such food stuff is issued to the workers. As per the querist, this practice is followed by the tea industry.

2. During the closing of accounts for the year 2005-06, the company made a provision of Rs.16.54 lakh *for the first time* (emphasis supplied by the querist), being the difference of pool rate and subsidised rate applied over the total quantity of stock of food stuff lying on 31.03.06 at various gardens of the company. As per the querist, this provision was made on the consideration of prudence, since, the loss is ascertained in the following months as and when such stock is issued.

3. In the next year, i.e., 2006-07, as per the querist, the company realised that as the loss is booked on actual basis every year once the food stuff is issued, and, since this practice is followed *consistently over the* years (emphasis supplied by the querist) by the company and also by tea industry, creation of provision in one year and write back of such provision in subsequent year to book actual loss on food stuff is not practicable. Moreover, as per the querist, food stuff is not covered under the definition of 'inventories' as per Accounting Standard (AS) 2, 'Valuation of Inventories', being neither an item of material /supplies to be consumed in production process nor to be held for sale in the ordinary course of business / in the process of production for such sale. Accordingly, as per the querist, the principle of inventory valuation as per AS 2, which requires valuation of inventories at 'lower of cost and net realisable value' is not applicable in case of food stuff. In addition, such food stuff is distributed to tea workers at a subsidised rate as welfare expenditure and the differential amount between pool rate and subsidised rate is concurrently charged off in the accounts in the year of consumption/ distribution. In effect, the differential amount is recognised as expense when services are rendered by the employees. Any balance left out is valued and accounted for at the pool rate, which, in general, remains lower than the market

rate. Considering the facts stated above, the company, in the year 2006-07, wrote back the provision of Rs.16.54 lakh (created in the year 2005-06) and did not create any provision against closing stock of food stuff in the year 2006-07.

4. As per the querist, the auditors insisted that once the provision has been made in the year 2005-06, though for the first time, the same principle has to be continued in the year 2006-07 and non-provisioning of the same has understated the loss for the year as well as the amount of the provision, which, according to their calculation, is to the extent of Rs.21.72 lakh.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee as regards correctness of the treatment given by the company in the year 2006-07 by not making provision against closing stock of food stuff to the tune of Rs. 21.72 lakh in compliance with the generally accepted accounting principles and treatment adopted in tea industry together with adherence to AS 2.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to the appropriateness of non-provision of difference between pool rate and subsidised rate in respect of quantity of food stuff in stock as on 31.03.2007 and relevance of AS 2 to the valuation of such stock. Therefore, the Committee has examined only these issues and has not examined any other issue that may be contained in the Facts of the Case.

7. The Committee notes the following paragraphs from Accounting Standard (AS) 15, 'Employee Benefits':

> "5. Employee benefits include benefits provided to either employees or their spouses, children or other dependants and may be settled by payments (or the provision of goods or services) made either:
>
> (a) directly to the employees, to their spouses, children or other dependants, or to their legal heirs or nominees; or
>
> (b) to others, such as trusts, insurance companies."

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

"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."

"8. Short-term employee benefits include items such as:

(a) wages, salaries and social security contributions;

…

(d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees."

8. From the above, the Committee notes that distribution of food stuff to workers at subsidised rate is a short-term employee benefit as defined in AS 15 and the accounting treatment of the said benefit should be in accordance with AS 15 irrespective of whether any stock of food stuff is maintained.

9. The Committee notes the following definition given in AS 2:

"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."

The Committee agrees with the querist that food stuff meant for distribution to workers at subsidised rate is not inventory as per the definition quoted above, and hence, the valuation principles stipulated in AS 2 are not applicable for the food stuff held in stock. The Committee is of the view that the food stuff should be valued at cost only. However, where the stock of food stuff represents entitlement of the workers to buy food stuff for the services already rendered, the value of such food stuff should be reduced by the amount recognised as employee cost under AS 15, and accordingly, such food stuff should be disclosed at the value to be recovered from the workers, i.e., the concessional price. The Committee is of the view that for determining the cost of food stuff and cost formula to be used for determining cost of food stuff in stock, the principles enunciated in AS 2 should be followed. Further, if there is any shortage, to that extent stock value of food stuff should be written down. If there is any damaged stock which can be disposed of, it should be valued at the lower of cost and expected net disposal proceeds. However, in the view of the Committee, the aforesaid is subject to the considerations of materiality as explained in paragraph 17(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', and various provisions of Standard on Auditing (SA) 320 (AAS 13), 'Audit Materiality', issued by the Institute of Chartered Accountants of India.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that the non-making of provision against closing stock of food stuff in the year 2006-07 is correct having regard to the applicable accounting principles and inapplicability of AS 2 to valuation of closing stock of food stuff in the facts and circumstances of the case. However, the stock of food stuff should be valued keeping in view the considerations stated in paragraphs 8 and 9 above.

Query No. 23

Subject: Deferred tax aspects of assets given on finance lease.[1]

A. Facts of the Case

1. A Government of India enterprise, incorporated as a public limited company in 1986, was engaged in providing rolling stock

[1] Opinion finalised by the Committee on 17.7.2008

assets to the Ministry of Railways (MOR) on finance lease terms. It raises funds from the capital market through issue of bonds, loans from banks/financial Institutions and overseas markets for the acquisition of rolling stock assets which are given on lease to MOR. The legal ownership of the assets vests with the company, but they are put to economic use by MOR. The assets are leased by the company to MOR under a lease agreement spanning a primary lease period of 15 years. The company does not have any business of operating lease.

2. Upto the year 2000-01, the company was following the 'Guidance Note on Accounting for Leases (revised 1995)', issued by the Institute of Chartered Accountants of India (ICAI). According to the querist, as per the said Guidance Note, the rolling stock assets given on finance lease were capitalised in the accounts of the company as fixed assets. Similarly, the gross lease rental received was accounted as income. Depreciation on the leased assets was provided as per Schedule XIV to the Companies Act, 1956. The depreciation so provided was adjusted against the capital recovery component of the lease rentals and the difference was provided in lease equalisation account. As such, the net finance income was reflected in the profit and loss account. In the income-tax return filed, the company was adding the depreciation as per the Companies Act, 1956 to the profit and claiming depreciation as per the Income-tax Act, 1961.

3. From the accounting year 2001-02, the ICAI made Accounting Standard (AS) 19, 'Leases', mandatory. In accordance with AS 19, the rolling stock assets given on finance lease are not capitalised in the books of the lessor company and, instead, are shown as 'lease receivables' at an amount equal to the net investment in the leased assets. Accordingly, the company does not charge depreciation on leased assets in its accounts as leased assets are not shown as fixed assets in the accounts.

4. The querist has stated that post-AS 19, the finance income is recognised in the profit and loss account and the capital recovery portion of the lease rentals is treated as repayment of principal, the balance constituting net investment in the leased assets. By virtue of owning rolling stock assets, the company is allowed

depreciation under the Income-tax Act, 1961. As per the querist, even after adoption of AS 19, the company continued the practice of adding depreciation as per the Companies Act, 1956 to the profit and claiming deduction of depreciation as per the Income-tax Act, 1961. Even though the leased assets are not reflected as fixed assets in the books of account, the company has been maintaining a memoranda account of fixed assets and calculating depreciation as per the Companies Act, 1956. Because of the additional acquisition of assets each year, and the fact that rate of depreciation under the Income-tax Act is higher than the Companies Act, the unabsorbed depreciation has been increasing from year to year. However, in the recent years, decrease in the rate of depreciation admissible under the Income-tax Act has necessitated utilisation of some of the unabsorbed depreciation. Further, the querist has stated that on account of the depreciation adjustment in the manner outlined above, the company has been paying Minimum Alternative Tax (MAT) under section 115JB of the Income-tax Act.

5. As per Accounting Standard (AS) 22, 'Accounting for Taxes on Income', the company is required to make provision for deferred tax liability (DTL) each year based on the accounting profits. As per the querist, the rationale behind providing for DTL primarily is to provide matching tax expense against the profit each year.

6. AS 22 defines timing differences as "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". DTL representing the tax effect due to timing differences is required to be included in the tax expense in the statement of profit and loss. As per the querist, the company has provided the DTL as required by AS 22.

7. The querist has furnished the following views of the auditors and the company:

Views of the Auditors

The accounting treatment outlined above, as adopted by the company for providing for DTL, met with the concurrence of the statutory auditors up to the year 2005-06. However, the newly appointed statutory auditors of the company, who conducted the audit for the year 2006-07, were of a different opinion. Their view is that there is no deferment of tax on account of depreciation on the finance leased assets for the reason that such assets are neither recorded as fixed assets nor depreciation is provided for in the books of account in compliance with AS 19, even though depreciation is allowed to be claimed under the Income-tax Act on such assets. The difference between book profit and taxable profit arises on account of *different treatment* being given to such depreciation expense in books and as per tax law. The difference is not arising on account of the *difference in the amount* of depreciation expense. There is, therefore, no likelihood of providing for depreciation on such assets in the books of the company because the DTL will continue to get accumulated. In their opinion, the company should treat the same as permanent difference and there should be no requirement for the company to provide for deferred tax liability on this account.

Views of the Company

Since the company is adding depreciation as per the Companies Act and claiming and obtaining depreciation benefit as per the Income-tax Act in its Return of Income, the company is required to make provision for DTL. The fact that the tax treatment of depreciation as claimed by the company is in consonance with views of the tax authorities, reflected in the assessments on the basis outlined above getting completed, lends credence to the stand of the company. Further, as stated earlier, the company has already started utilising the assessed unabsorbed depreciation in the recent years, and there could possibly be little scope for following an alternative approach.

B. Query

8. In view of the difference of opinion between the auditors and the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the depreciation differential in case of assets given on finance lease, where depreciation is not debited in the books of the lessor company but the lessor being the legal owner of the assets is allowed depreciation under the Income-tax Act, represents a permanent difference or timing difference.

(ii) Whether the depiction of depreciation adjustment in the Return of Income wherein depreciation on finance lease assets calculated under the Companies Act is first added to the book profit and then depreciation calculated under Income-tax Act is deducted for arriving at taxable income is correct, particularly in view of the fact that depreciation on such assets is not debited in the books of the company.

(iii) As the company is paying tax on 'Book Profits' under section 115JB of the Income-tax Act, i.e., MAT, whether it can still be said that there is a divergence between accounting profit and taxable profit and deferred tax is to be accounted for.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised by the querist relate to deferred tax aspects of assets given on finance lease in the context of AS 19 and also deferred tax implications of Minimum Alternative Tax (MAT). Therefore, the Committee has examined only these issues and has not examined any other issue that may be contained in the Facts of the Case. The exact amount/manner of determining taxable income in the Return of Income for the purposes of income taxes is not being commented upon by the Committee as the Committee is prohibited to answer issues involving pure interpretation of the relevant enactments under Rule 2 of its Advisory Service Rules.

10. The Committee notes that the Central Board of Direct Taxes, vide Circular No. 2 dated 9th February, 2001, has, inter alia, clarified as below:

> "It has come to the notice of the Board that the New Accounting Standard on "leases" issued by the Institute of Chartered Accountants of India requires capitalisation of the asset by

> the lessees in financial lease transaction. By itself, the accounting standard will have no implication on the allowance of depreciation on assets under the provisions of the Income-tax Act".

In view of the above Circular, it is apparent that the lessor will continue to avail the depreciation benefit for tax purposes even though for accounting purposes the asset would be recognised in the balance sheet of the lessee. Thus, for the lessor, in the case of assets given under finance lease, there will be finance income for accounting purposes, while, for the income-tax purposes, if depreciation is allowed, the entire lease rent will be treated as income (the difference between the two, i.e., lease rent and depreciation, can be termed as 'tax finance income'). The total finance income recognised for accounting purposes over a period of time will be equal to the total lease rent treated as income for tax purposes minus total depreciation allowed as expense for income-tax purposes, subject to the provisions of the Income-tax Act. However, on a year-to-year basis, there will be difference between accounting finance income and tax finance income.

11. For applying AS 22 in the situation of a finance lease, a question arises as to whether, for computing timing differences, individual items, such as, finance income for accounting purposes and depreciation and lease rentals for tax purposes should be considered in isolation or the total impact of the finance lease transaction on the accounting income and taxable income should be considered.

12. The Committee is of the view that, with a view to reflect the true impact of the lease transaction on accounting income and taxable income, the lease transaction as a whole should be considered since the individual items are related. Accordingly, the difference between finance income for accounting purposes and tax finance income representing difference between the lease rental income and depreciation allowance for income-tax purposes originating in a particular year should be treated as timing difference for applying AS 22. This is based on the principle of 'substance over form'.

13. The Committee notes that the company adds back 'notional depreciation' as per the Companies Act to profits which includes finance income and deducts depreciation as per the Income-tax Act to recognise the same effect as the difference between the accounting finance income and tax finance income. Presumably, the company adds 'notional depreciation' to profits with a view to adjust the finance income included in the profits to arrive at a figure, which is more or less, equivalent to lease rent for the period. However, it may not be so as the amount to be added back should be the difference between the lease rental for the period and the finance income for accounting period – this difference may not be equal to the 'notional depreciation', and, accordingly, may not represent the timing difference of accounting finance income and tax finance income.

14. As regards treatment of depreciation differential in the context of Minimum Alternative Tax (MAT) under section 115JB of the Income-tax Act, the Committee notes Explanation to paragraph 21 of AS 22 notified by the Central Government under the Companies (Accounting Standards) Rules, 2006. The said Explanation reads as below:

"Explanation:

(a) ***The payment of tax under section 115JB of the Income-tax Act, 1961 (hereinafter referred to as the 'Act') is a current tax for the period.***

(b) ***In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under this Standard, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.***

(c) ***In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is***

required to be recognised under AS 22, is measured using the regular tax rates and not the tax rate under section 115JB of the Act."

15. From the above, the Committee is of the view that even during the period when the company pays 'MAT', timing differences should be considered for recognition of deferred tax effects, subject to consideration of prudence in case of deferred tax asset.

D. Opinion

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

(i) The depreciation differential, in case of assets given on finance lease, where depreciation is not debited in the books of the lessor company but the lessor being the legal owner of the assets is allowed depreciation under the Income-tax Act, represents a timing difference, on a consideration of treating the finance lease transaction as a whole as explained in paragraphs 10 to 13 above.

(ii) As regards correctness of depiction of depreciation adjustment made in the Return of Income, the Committee has not examined the same from the angle of correctness of the exact amount/manner of determining taxable income in the Return of Income keeping in view the prohibition under Rule 2 of the Advisory Service Rules of the Committee. However, from a purely accounting point of view, the depreciation adjustment would be correct if it is equal to the difference between the lease rental income and the accounting finance income as discussed in paragraph 13 above.

(iii) Even when the company is paying tax on 'Book Profits' under section 115JB of the Income-tax Act, i.e., MAT, it can be said that there is a divergence between accounting profit and taxable profit and deferred tax is to be accounted for, subject to considerations of prudence in case of deferred tax asset.

Query No. 24

Subject: Treatment of initial quantity of in-process material.[1]

A. Facts of the Case

1. A private limited company manufactures nickel sheets using the electroforming process. The key plant and machinery for the manufacturing process is an electroplating tank consisting of:

(i) Pure nickel in pellet form, and

(ii) Nickel Sulphamate Solution.

2. The principle of operation is that of electroplating. In electroplating, there are two electrodes dipped in an electrolyte solution (Nickel Sulphamate solution). They are given opposite electric charges; the electrode having positive charge is called Anode and the one having negative charge is called Cathode. When the electric charge is applied, Anode dissolves in the electrolyte and the metal that has dissolved gets deposited on the Cathode. The Anode consists of a perforated titanium basket filled with the nickel pellets. The nickel in the basket dissolves in the nickel sulphamate solution. The Cathode consists of a metal sheet. The nickel that dissolves from the Anode gets deposited on the Cathode, thus the product is ready. In the normal course of operation, whatever nickel is taken away from the Anode is replenished by way of addition of fresh nickel pellets.

3. To get the production started and then to maintain the desired quality of product, it is absolutely essential that the quantity of nickel in the Anodes as well as the quantity and concentration of nickel sulphamate solution be maintained as per the standards. Unless nickel and nickel sulphamate solution is added to the tank the same cannot be put to use.

4. In short, according to the querist, the quantity of initial nickel and nickel sulphamate solution that is put inside a tank stays for the entire operational life of the tank. Hence, the cost of initial nickel and nickel sulphamate solution is treated as capital cost for

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[1] Opinion finalised by the Committee on 17.7.2008

the purpose of obtaining term loan for buying six new tanks in the financial year 2007-08. Besides the six new tanks added in the financial year 2007-08, the company has twelve old tanks where the cost of initial nickel and nickel sulphamate solution has not been considered as capital cost and the balance stock in the tanks as on the balance sheet date is shown as work-in-progress. As per the querist, this being major addition, management of the company felt it necessary to ascertain as to whether capitalisation of cost of initial nickel and nickel sulphamate solution is proper.

B. Query

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

(i) Whether the accounting treatment given by the company to treat the cost of nickel and nickel sulphamate solution in the six new tanks, acquired in the financial year 2007-08, as capital expenditure is correct.

(ii) In case the answer to the above question is in the affirmative, then whether it is necessary to declare the same as a change in the accounting policy for fixed assets, since nickel and nickel sulphamate solution in earlier tanks has not been capitalised.

(iii) In case the answer to (i) above is in the affirmative whether it is possible to transfer the work-in-progress (WIP) to capital asset in respect of earlier 12 tanks in the financial year 2007-08. This, according to the querist, will be done by transferring WIP to fixed assets. If it is possible, the following questions arise:

  (a) At which price transfer from WIP to Fixed assets should be made, whether at today's price (carrying cost) or the price at which it was originally purchased, i.e., 1998 price.

  (b) Whether depreciation from the date of capitalisation (1998) to date should be considered.

(c) If WIP is transferred at 1998 price, what treatment should be given for the balancing amount (difference between the present WIP value and 1998 price).

(iv) Whether the company can adopt dual accounting policy, i.e., continue to show the nickel and nickel sulphamate solution in the earlier 12 tanks as WIP and capitalise the nickel and nickel sulphamate solution in the new 6 tanks during the financial year 2007-08.

(v) In case the nickel and nickel sulphamate solution, in respect of 12 old tanks, is to be capitalised, whether the Income-tax Department will permit depreciation thereon.

C. Points considered by the Committee

6. The Committee notes the definition of the term 'fixed asset' as given in paragraph 6.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', as reproduced below. The Committee also notes the definition of the term 'inventories' and paragraph 4 of Accounting Standard (AS) 2, 'Valuation of Inventories', which state as follows:

AS 10

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

AS 2

"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 and supplies to be consumed in the production process or in the rendering of services."

> "4. …Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise…"

7. The Committee further notes the definition of 'Work in Process' as contained in the Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, which provides as follows:

> "Work in Process includes all materials which have undergone manufacturing or processing operations, but upon which further operations are necessary before the product is ready for sale."

8. The Committee notes from the Facts of the Case that the initial nickel and nickel sulphamate solution put into the tank get consumed in the production process through electroplating and are not held as such for producing the goods, as in the case of fixed assets. The quantity of nickel and nickel sulphamate solution in the tank have to be replenished by way of fresh additions in order to continue the production process and thus, it is only the *quantity* of initial nickel and nickel sulphamate solution that stays in the tank for its entire life and not the one originally put into the tank. Accordingly, the contention of the querist in paragraph 4 above to capitalise the cost of initial nickel and nickel sulphamate solution on this ground is not valid. Thus, the Committee is of the view that the initial nickel and nickel sulphamate solution that are contained in the tank are of the nature of work-in-progress to be disclosed as inventory.

D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 5 above:

(i) No, the accounting treatment given by the company to treat the cost of initial nickel and nickel sulphamate solution in the six new tanks, acquired in the financial year 2007-08, as capital expenditure is not correct.

(ii) Since the answer to the above question is not in the affirmative, the answer to this question does not arise.

(iii) Since the answer to (i) above is not in the affirmative, the answer to this question does not arise.

(iv) No, the company cannot adopt dual accounting policy for similar items purchased at different points of time.

(v) Answer to this question does not arise as the cost of nickel and nickel sulphamate solution is not to be capitalised. In any case, as per Rule 2 of the Advisory Service Rules, in accordance with which the Committee replies to the queries received, the Committee does not answer the issues involving legal interpretation of various enactments, such as, the Income-tax Act, 1961.

Query No. 25

Subject: Revenue recognition pending physical delivery.[1]

A. Facts of the Case

1. A company is a public sector enterprise under the administrative control of the Ministry of Defence. It is a leading engineering product company and is a market leader in earthmoving and mining products. The query pertains to the issue of revenue recognition pending physical delivery based on same facts as of an earlier query (Query No. 10 of Compendium of Opinions Volume XXVIII) referred by the same querist for the opinion of the Committee. According to the querist, the Committee has stated in its opinion for the earlier query that booking of sales on the basis of goods consignment (GC) Notes is not in line with Accounting Standard (AS) 9, 'Revenue Recognition', unless risks and rewards of ownership are passed on to the buyer even before the actual delivery to the transporter. The querist has once again sent a

[1] Opinion finalised by the Committee on 17.7.2008

fresh query with some additional arguments and copies of some additional documents. According to the querist, any opinion has to be based on facts and also on law. The applicable law needs to be analysed, interpreted and applied to the facts presented. To substantiate the facts, copies of the following documents relating to order received from a customer have been furnished by the querist for the perusal of the Committee:

(i) Notice Inviting Tender by the customer in respect of supply of three BD 155 (410 HP) Crawler Dozer.

(ii) Order released by the customer to the company.

(iii) Sale order/order acceptance issued by the company. The purpose of this document is to intimate:

  (a) The production division to take necessary action regarding production of the equipment;

  (b) Finance and shipping and various offices of production division and research and development (R & D) division regarding acceptance of order;

  (c) Detailed technical features;

  (d) The price and various commercial clauses.

(iv) Work order Opening and Closing Advice.

(v) Pre-despatch inspection report (issued by the Inspection Engineer of the customer) towards acceptance and despatch of the equipment.

(vi) Despatch Advice raised by the shipping department of the company, giving the details, like equipment number, engine number, Excise Despatch Advice Note, GC Note number, etc. By a copy of this despatch advice, Finance department is intimated to raise the bill or invoice on the customer.

(vii) Goods consignment (GC) Note issued by the transporter. This document indicates the handing over of the equipment to the transporter.

(viii) Invoice raised by the company on the customer in respect of one dozer out of three dozers ordered, as a sample for understanding the flow of transaction.

2. As per the querist, the above documents show that the company normally responds to tender enquiry. The company makes an offer based on the tender parameters which is followed up by certain correspondence. After techno-commercial evaluation, orders are placed on the company provided the company satisfies the tenderer techno-commercially.

3. The querist has informed that normally the terms relating to price and delivery are as follows:

> Prices: price is F.O.R. (Free-on-Rail) ex-works, XYZ unit inclusive of packing and forwarding charges. However, the transit insurance and transportation is arranged by the company wherever the terms of contract so provide. The amount(s) of insurance premium and freight charges are reimbursed by the customer in such cases. This is a trade practice normally followed in this nature of industry to enhance the customer satisfaction and loyalty.
>
> Delivery is ex-works, XYZ unit. Further, pre-despatch inspection at the company's works and final inspection at destination are also stipulated.

As per the querist, most of the orders for earth moving machinery are with similar stipulation.

4. The querist has furnished the following information and arguments:

(i) On receipt of customer order, a sale order is generally generated containing time schedule and other significant contents of the contract. This sale order is a document which enables the production department of the company to plan and start production of the equipment.

(ii) On completion of the production, a call letter is issued to the inspecting authority of the customer and pre-despatch inspection is carried out and report is prepared which clearly certifies that the equipment offered for inspection has undergone all functional checks and is meeting the specification of the supply order and also clearance is accorded for the despatch of the equipment.

(iii) Also, the Pre-despatch Inspection Note makes it clear that the equipment may be despatched after dismantling, if necessary, for convenience of transportation.

(iv) Based on the pre-despatch inspection certification, a Despatch Advice is generated by the shipping department. Such Despatch Advice clearly identifies equipment regarding its model, make and serial number, customer order and the sale order raised thereafter. It also stipulates chassis number, the machine number and the number of packing cases.

(v) Thereafter, the goods are handed over to the carrier(s) which is evidenced by issuance of GC Notes. Incidentally, all the equipments are heavy earth moving machinery which are transported in disassembled condition by either low bed or semi low bed trailers only. Normally, these vehicles (low bed/semi low bed trailers) are in short supply. Even most of the renowned transporters do not own such vehicles in adequate numbers. It is a well known fact that the concerned vehicles, especially low bed and wide bodies vehicles are in great demand, especially during the last quarter of the year, with premium price and thus, the transporters make available to the company, vehicles at contracted rate much later. Hence, such vehicles are perennially in short supply. Also, these transporters do not have adequate storage space and lifting tackles for loading and un-loading in their premises. Hence, the transporter uses the finished goods inventory stores of the company and the equipments are often in the premises of the company even though the receipt thereof is acknowledged by way of GC Notes.

(vi) Based on the above documents, the company issues invoice addressed to the purchaser giving full particulars of the equipment and referring thereon GC Note number (date and particulars of the transporter, etc.), thus, transferring the ownership of the equipment to the buyer.

(vii) Equipment(s) in question meets the definition of goods as defined in clause (7) of section 2 of the Sale of Goods Act, 1930 which states, "'goods' means every kind of movable property…".

(viii) Thus, there is no doubt, whatsoever that the equipment(s) in question are movable property.

(ix) Section 4 of the Sale of Goods Act, 1930 provides that a contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in the goods to the buyer for a price. According to the querist, where under a contract of sale, the ownership of property in goods is transferred, the contract is called a sale; whereas when the transfer of goods takes place at a future time or date, the said contract is called an agreement to sell. In the instant case, the tender invitation and the response thereto is in the nature of invitation to bid on an offer. The Purchase Order issued by the customer is acceptance of the offer and has to be construed as agreement to sell. Since the goods are generally manufactured by the company after making of the contract, the said would be an agreement to sell unascertained or future goods.

(x) Section 23(1) provides that in the case of contract for the sale of unascertained or future goods by description and goods of that description are in deliverable state and are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes on to the buyer. The assent may be given either before or after the appropriation.

(xi) Section 23(2) provides that in pursuance of the contract, the delivery of the goods to the buyer or carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, constitutes appropriation of goods to the contract.

(xii) Section 39 also, inter alia, provides that the delivery of goods to carrier is prima facie deemed to be a delivery to the buyer.

(xiii) In the case of Marwar Tent Factory vs. Union of India, the Hon'ble Supreme Court had decided that in the case of F.O.R. (Free on Rail) ex-works contract, the transfer of property in the goods takes place by delivery of goods to the carrier and accordingly the significant risks and rewards of ownership pass on to the buyer.

(xiv) The Committee, in the Compendium of Opinions, Volume XXII (Query No. 16) has also, inter alia, opined that the accounting policy of a seller, to recognise sales under "Godown Storage Facility" scheme when the goods are delivered to the transporter for despatch to the customer's godown and the relevant sale invoice is issued, appears to be proper and in accordance with AS 9. The Committee is also of the opinion that the seller is transferring the property in the goods for a price and all significant risks and rewards of ownership are also transferred though the lock and key of the godown are very much with the seller and also the insurance of the godown is obtained by the seller. Further, the Committee has specifically stated that in such cases of deemed possession of goods, the contract of sale does not adversely affect the parameters prescribed by AS 9.

5. As per the querist, in view of the above, the company's action of recognising revenue on delivery of equipment to the transporter does not vitiate the parameters laid down by AS 9.

6. The querist has also obtained a legal opinion in this regard. In the opinion, there is a discussion on the provisions of the Sale of Goods Act, 1930 and the judgement of the Supreme Court in Marwar Tent Factory vs. Union of India reported in 1990 AIR (SC) 1753. Further, some of the documents mentioned in paragraph 4

above have also been discussed. After making some remarks on the Committee's opinion on the earlier query raised by the querist, the legal opinion concluded that the company can recognise revenue as sales upon issuance of GC Notes and that the opinion of the Committee is not sustainable and not in conformity with law.

B. Query

7. The querist has requested the Expert Advisory Committee to reconsider its earlier opinion on the subject in the light of the facts and law set out above.

C. Points considered by the Committee

8. The Committee notes that copies of some additional documents (mentioned in paragraph 1 above) have been furnished by the querist for the perusal of the Committee and flow of a sample transaction has been explained by the querist by way of such additional documents. Further, reliance has been placed on the judgement of the Hon'ble Supreme Court in Marwar Tent Factory vs. Union of India. The querist has also drawn the attention of the Committee to one of its earlier opinion published in Volume XXII of the Compendium of Opinions (mentioned in paragraph 4(xiv) above).

9. The Committee notes that actually, two issues were raised by the querist in the earlier query referred in paragraph 1 above. As per the facts of that query, the company recognised revenue merely on the receipt of GC Note from the transport carrier without physical delivery, since adequate trailers are generally not available at the time of issue of GC Notes. Further, in some cases, at the request of some customers, delivery was delayed but revenue was recognised.

10. As regards the first issue, the Committee notes that the Facts of the Case and the copies of documents furnished (mentioned in paragraph 1 above) do not clearly indicate the point of time at which all significant risks and rewards of ownership are passed on to the customer. For instance, it is stated in the Facts of the Case (paragraph 3 above) that *normally,* the price terms are 'F.O.R. (Free on Rail), ex-works, XYZ unit' and delivery terms are 'ex-works, XYZ unit'. It is also stated that the transit insurance and

transportation is arranged by the company *wherever the terms of contract so provide*. The amount(s) of insurance premium and freight charges are reimbursed by the customer in *such cases*. Further, pre-despatch inspection at the company's works is also stipulated and final inspection at destination is also stipulated. It is also stated that *most of the orders* for earth moving machinery are with similar stipulation. Thus, all contracts *may not be identical*.

11. The Committee notes that for the sample transaction explained by the querist in paragraph 1 above, in both the purchase order and sale order, price was mentioned as 'F.O.R. ex-works, XYZ unit basis, inclusive of packing and forwarding charges while place of delivery was mentioned as 'ex-works, XYZ unit'. Further, both freight and transit insurance charges were to be paid to the company in addition at actuals subject to a ceiling. The Committee also notes that in the copy of pre-despatch inspection report furnished by the querist, it is mentioned that the dozer is found to meet the specifications of the relevant supply order and clearance was accorded for despatch of the equipment to the consignee *without delay*. In that report, it was further mentioned that the dozer may be despatched after suitably dismantling, if necessary, for the convenience of transportation. However, the Committee notes that apart from pre-despatch inspection mentioned by the querist, there is one more inspection, viz., final inspection. Clause 11 of the Terms and Conditions of the purchase order placed by the customer on the company (furnished by the querist for the perusal of the Committee) states that on final inspection, stores found defective or not in accordance with the supply order's specification will be rejected and intimated for free replacement within 30 days from the date of intimation. Performance guarantee is also involved. A portion of the price (20%) is payable within 21 days of successful installing, commissioning and final acceptance of the equipment/ accessories at site. Further, it is not clear as to who bears the risk of damage between the date of obtaining the GC Note and the date of actual placement of dozers on the trailers. The Committee also notes a very important clause in the purchase order released by the customer. Clause 1 of the Terms and Conditions of the purchase order states, inter alia, that *safe delivery of materials to destination shall be the responsibility of the company*. The Committee is of the view that this is an indication that all

significant risks and rewards of ownership in the goods do not pass on to the customer at least until the safe delivery of the goods to the destination. In addition, final inspection and acceptance at site may also be relevant in determining the timing of transfer of all the significant risks and rewards of ownership to the customer. Hence, mere mentioning of place of delivery as 'ex-works, XYZ unit' in the purchase order and sale order does not establish that all significant risks and rewards of ownership are passed on to the customer on mere obtaining of the GC Notes without even placement of the trailers by the transporter.

12. The Committee notes that the opinion expressed by the Committee in 'Compendium of Opinions', Volume XXII, mentioned by the querist in paragraph 4(xiv) above was based on facts which were different from the present facts of the case. In that case, it was clearly mentioned that the goods were under the lock and key of the selling company only to secure payment from the buyer. Further, it was clearly mentioned that all the significant risks and rewards of ownership were transferred to the buyer. It was also mentioned in that case that risk of loss of goods while they were in the buyers' godowns though under lock and key of the seller, was in substance, borne by the buyer. Excess or shortage of insurance proceeds over the amount of loss was paid to, or recovered from, the buyer, as the case may be. If the buyer defaulted to take delivery and a resale was made, any profit/loss arising on the resale was paid to, or recovered from, the buyer, as the case may be. Since these factors clearly indicated that all the significant risks and rewards of ownership were transferred to the buyer, the Committee expressed its opinion in that case that recognition of sales was proper on delivery of goods to the transporters for despatch to the godowns of the buyers, *provided* no uncertainty existed regarding the amount of the consideration that will be derived from the sale of the goods and it is not unreasonable to expect ultimate collection of the consideration. The querist has not stated that all the above situations prevail in the present case also. Further, in the case quoted by the querist from Volume XXII of the 'Compendium of Opinions', it was not mentioned that GC Notes were obtained even before the goods were placed on the trailers. The querist has only stated in the previous query referred for the opinion of the Committee

(mentioned in paragraph 1 above) that there was no uncertainty in expecting the ultimate collection of sale proceeds. Other information clearly indicating timing of passing of all significant risks and rewards of ownership to the customer were not furnished by the querist. Hence, the Committee could not express an unreserved opinion for the case of the querist.

13. As regards the provisions of the Sale of Goods Act, 1930 and the judgement of the Hon'ble Supreme Court in the case of Marwar Tent Factory cited in paragraph 4(xiii) above, the Committee notes that as per Rule 2 of the Advisory Service Rules, the Committee is prohibited from answering queries which involve legal interpretation of various enactments. The Committee also notes the principle of 'Substance over Form', according to which the accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by their legal form. Thus, for example, a finance lease is treated as a sale in the books of the lessor and a purchase in the books of the lessee as per the provisions of Accounting Standard (AS) 19, 'Leases', even though legal ownership is not transferred at the inception and even if it is not intended to be transferred at the end of the lease period. Similarly, as per paragraph 9 read with paragraph 10 of AS 9, even if all the significant risks and rewards of ownership of goods are transferred to the buyer, revenue recognition is not permitted, if it is not reasonable to expect ultimate collection or if significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods. This is despite the legal effect of the sale transaction.

14. As regards the legal opinion obtained by the querist, the Committee notes that that opinion also deals primarily with the provisions of the Sale of Goods Act, 1930 and the aforecited judgement of the Hon'ble Supreme Court. The Committee's views in this regard have already been stated in paragraph 13 above. The legal opinion, inter alia, states that paragraph A1 of Appendix to AS 9 was not considered by the Committee. The Committee wishes to point out that the said portion of AS 9 was duly discussed in paragraphs 22 and 23 of its earlier opinion. This portion of AS 9 is relevant only for the second issue raised by the querist, viz., delivery delayed at the request of the customer.

15. As regards the second issue (viz., delivery delayed at the request of the customer), the Committee notes that the querist has neither furnished any documents nor given any fresh arguments. The querist has, thus, not raised the second issue.

16. The Committee also wishes to make it clear that in its earlier opinion, the Committee has not simply expressed the view that recognition of sales was inappropriate. It has added the qualifying remarks implying that if the necessary conditions were met, sales could be recognised.

D. Opinion

17. On the basis of the above, the Committee reiterates its earlier opinion in the case referred to by the querist.

Query No. 26

Subject: Provision for balance works of rehabilitation and resettlement based on estimated cost.[1]

A. Facts of the Case

1. A company was incorporated on May 24, 1988 as a joint venture of Government of India (GOI) and a State Government "to plan, investigate, organise, execute, operate and maintain hydro electric power projects in river Satluj basin in the State and in any other place" and was registered under the Companies Act, 1956. The present paid-up share capital of the company is Rs. 4,109 crore. The equity contribution is shared between GOI and the State Government in the ratio of 3:1.

2. The 1500 MW 'X' Hydro Power Station (XHPS) (the largest underground hydroelectric power project in the country) was the first project undertaken by the company which has been

[1] Opinion finalised by the Committee on 02.12.2008

commissioned progressively between September 2003 to May 18, 2004. Another project, namely, 'Y' Hydro Electric Project (YHEP) of 412 MW is under construction and is scheduled for commissioning in the year 2012.

3. The querist has stated that the financial statements of the company are prepared according to historical cost convention on accrual basis in line with the generally accepted accounting principles in India and the provisions of the Companies Act, 1956.

4. As per the querist, the company has adopted an environmental, resettlement & rehabilitation policy which reiterates the company's commitment to sustainable development which is within the carrying capacity of the eco-system and which also promotes the improvement of quality of life. The accounting policy of the company with respect to accounting for the expenditure on above measures is as under:

(a) "Deposits/payments made/liabilities incurred provisionally and acceptable to the company towards award, compensation, rehabilitation, afforestation and other expenses relatable to land are treated as cost of land."

(b) "Expenditure incurred for compensatory afforestation, soil conservation and reforestation towards forest land is shown as "Lease hold land" and is amortised pro rata through depreciation over the period of likely use."

5. The 'Y' Project of the company was under construction during the financial year 2006-07. The total cost of the project as approved by the Board of Directors of the company is Rs. 2,047 crore. The approved cost includes Rs. 53.47 crore for rehabilitation and resettlement, the details of which are as below:

		(Rs. lakh)
(A)	Cost of Land	2,584.00
(B)	Resettlement Cost	136.95
(C)	Rehabilitation Cost	273.35
(D)	Estimated Cost of Area Development/ Community Development	2,353.00
	Total	**5,347.30**

(The querist has furnished copies of resettlement and rehabilitation scheme for the project affected families, cost estimate for catchment area treatment (CAT) plan and financial plan for resettlement and rehabilitation measures for the perusal of the Committee.)

The above is the estimated cost for the entire duration of the project which may change (plus or minus) based on actual requirement. Actual expenditure incurred / provided by the company up to the year 2006-07 against each of the above items is as under:

Item (A)	Rs. 17.68 crore incurred and booked as expenditure. The remaining portion of expenditure will be booked according to the accounting policy of the company, as and when the land is acquired.
Item (B) (C)& (D)	Rs. 4.89 crore has been incurred and accounted for, and accounting for further expenditure shall be made as and when the company's obligation (contractual/legal) shall arise.

The querist has also clarified that while no specific agreement was entered into with village panchayats, an amount of Rs. 1250 lakh would be spent on the infrastructure works of various villages/ panchayats on the basis of the plan approved and sent by different panchayats. This is included in the amount of Rs. 2,353 lakh for item (D) above.

6. The Government auditors, during the review of accounts of the company, had commented that 'Capital Work in Progress (CWIP) – Incidental Expenditure During Construction' and 'Current Liabilities & Provisions' were understated due to short provision of Rs 30.90 crore due to non-providing of balance amount of Rs. 30.90 crore being the difference between the rehabilitation and resettlement cost approved by the Board (Rs. 53.47 crore) and the expenditure accounted for up to 31.03.2007 amounting to Rs. 22.57 crore (Rs. 17.68 crore and Rs. 4.89 crore) in the books.

7. The company, in its reply to the auditors, had stated that the rehabilitation and resettlement cost approved by the Board was an estimated cost for the entire duration of the project which may

change ((+)/(-)) depending on the actual requirement. The expenditure incurred upto 31.03.2007 had already been accounted for. Further expenditure can be booked only after goods/services have been received by the company or the company, by virtue of contractual/legal obligation, is required to incur the expenditure and not merely based upon approved plans. The work of the project has just begun and no such event has occurred at the date of balance sheet which has resulted in company's obligation for rehabilitation and resettlement beyond what has been accounted for and no provision is required to be made for balance expenditure which is yet to be incurred. It was agreed with the auditors to refer the matter to the Expert Advisory Committee of the Institute of Chartered Accountants of India for opinion.

8. The querist has quoted the following paragraph of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets':

> ***"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."***

The querist has also referred to paragraph 17 of AS 29, which, inter alia, states that no provision is recognised for costs that need to be incurred to operate in the future and that the only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date. The querist has also referred to paragraph 18 of AS 29 which, inter alia, prescribes that it is only those obligations arising from past events existing independently of an enterprise's future actions (i.e., the future conduct of its business) that are recognised as provisions. Some examples are also given in Appendix C to AS 29 which illustrate the circumstances in which provisions are required to be made. As per the querist, these examples do not specifically cover the case of the company.

9. According to the querist, since no event has occurred which may result in a present obligation, no provision was required to be made at the balance sheet date (31.03.2007).

B. Query

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

(i) Whether the company is required to make a provision for the balance of planned rehabilitation and resettlement cost as explained above for which no contractual obligation has arisen on the balance sheet date.

(ii) If the answer to the above is in the affirmative,

(a) whether the amount should be booked through 'Incidental Expenditure During Construction (IEDC)' or directly to capital work-in-progress.

(b) whether it also requires a change in the accounting policy mentioned in paragraph 4(a) above.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to the need for provision towards balance of planned rehabilitation and resettlement cost. 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, correctness of accounting policy of the company as reproduced by the querist in paragraph 4(a) above in general, or appropriateness of capitalisation of various expenses, e.g., those related to afforestation, as part of cost of land, etc. The Committee has also not examined the accounting policy of the company as reproduced in paragraph 4(b) above, as that issue has not been raised by the querist.

12. The Committee notes, from the copy of Resettlement and Rehabilitation Scheme (R & R Scheme) for the project affected families of 'Y' Hydro Electric Project furnished by the querist, that the same has been made by the State Government and the company pursuant to Rule 8-A of the HP Nautor Land Rules, 1968. Hence, in the view of the Committee, the obligations created under the scheme are legal in nature.

13. The Committee notes paragraph 14 of AS 29 quoted by the querist in paragraph 8 above and the following paragraphs from AS 29:

> ***"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***10.2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***
>
> ***10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation."***
>
> ***"10.6 Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."***
>
> "11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."
>
> "16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.
>
> 17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its

possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large."

14. From the above, the Committee is of the view that a provision cannot be recognised simply because there is an approved cost or there is a legal or contractual obligation. A provision should be made only if it fits within the parameters discussed in paragraph 13 above, apart from meeting the recognition criteria prescribed in paragraph 14 of AS 29, reproduced by the querist in paragraph 8 above. In particular, provision should not be recognised before the obligating event arises under the provisions of law or the terms of contract.

15. As stated by the querist in paragraph 5 above, the approved cost for rehabilitation and resettlement consists of cost of land,

resettlement cost, rehabilitation cost and cost of area development/ community development. The Committee notes that the financial plan furnished by the querist contains detailed list of various expenses. As examples, likely obligating events for some items are given below:

(i) So far as cost of land is concerned, the Committee is of the view that acquisition of land is the obligating event. Hence, if the land owner is yet to fulfill his obligation of transferring the property in the land to the company, the company has no present obligation to pay compensation to the land owner. The Committee is, therefore, of the view that until land is acquired, no provision should be created in respect of the cost of land.

(ii) A published environmental policy of the company by itself, does not create a legal or contractual obligation. From the Facts of the Case and copies of documents furnished by the querist, it is not clear as to whether there is any legal or contractual obligation for afforestation, compensatory afforestation, soil conservation and reforestation towards forest land. In case there is any legal or contractual obligation for compensatory afforestation, felling of existing trees or even acquisition of land could be the obligating event depending on the provisions of law or the terms of the contract.

(iii) Acquisition of land is the obligating event triggering the provision for resettlement grant payable to the concerned project affected family.

The Committee is of the view that the obligating events for other items should similarly be identified before recognising any provision.

16. On the basis of the above, the Committee is of the view that provision should be made as soon as the obligating event arises provided it also meets the other recognition criteria stated in paragraph 14 of AS 29. The amount of the provision would depend on the extent of the obligation arising from the obligating event rather than being made for the entire difference between the

approved cost and actual expenditure incurred. The approved cost could be used as the basis for estimating the extent of the obligation arising from the obligating event, i.e., the amount for which the provision is to be recognised. As regards the company's approach, it is not clear as to whether the underlying obligating events were identified and the recognition criteria were met in respect of provisions recognised based on contractual/legal obligations and whether all the provisions to be recognised on that basis have been recognised for amounts as discussed above.

17. As regards capitalisation of the relevant items, the Committee is of the view that it is to be decided based on the applicable Accounting Standards, such as, Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. Thus, simply because an expenditure is incurred during construction, it does not necessarily mean that the said expenditure is eligible for capitalisation. If an expenditure is not eligible for capitalisation, it should be expensed, unless another accounting standard requires or permits a different treatment.

18. A project may consist of several fixed and intangible assets. The Committee is of the view that if an expenditure is eligible for capitalisation, it should be accorded the following treatment:

(i) If the expenditure results in the acquisition of an asset, it should be directly capitalised as part of the cost of that asset. For example, cost of land should be directly capitalised as 'Land'. Similarly, resettlement grant payable to the project affected families should be capitalised as part of cost of land, since the land cannot be acquired without incurring that expenditure.

(ii) If the expenditure is directly related to, or benefits, a particular asset under construction, it should be booked to 'Capital Work in Progress' and identified with the relevant asset under construction. In establishing whether the expenditure directly benefits or is related to an asset, a nexus between the expenditure and the benefit/relationship with the asset should be established technologically. For example, compensation for damage to private property due to blasting during construction should be booked to 'Capital Work in Progress', if the blasting is done for the purpose of construction of a particular asset.

(iii) If the expenditure is related to, or benefits, more than one asset under construction, it should be booked to 'Incidental Expenditure During Construction' and capitalised as part of the cost of the relevant assets appropriately at the time of completing the exercise of capitalisation. For example, compensation for damage to private property due to blasting during construction should be booked to 'Incidental Expenditure During Construction', if the blasting is done for the purpose of construction of more than one asset.

Thus, capitalisation of the relevant expenditure should be done on the basis of the principles stated above when the expenditure is incurred/provision is made in accordance with paragraph 16 above.

19. As regards the company's accounting policy mentioned by the querist in paragraph 4(a) above, the Committee is of the view that subject to the considerations stated in paragraph 11 above, the said policy of the company may require a change on the basis of considerations discussed in paragraphs 17 and 18 above. Further, while applying the accounting policy, the provision should be recognised immediately when and to the extent the obligating event takes place, and when the other recognition criteria for provision are met.

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) The company is not required to make a provision for the balance of planned rehabilitation and resettlement cost until in respect of the individual items of expenses, the obligating event arises and the recognition criteria are met.

(ii) (a) For treatment of expenditure, see paragraphs 17 and 18 above.

(b) As regards need for change in the company's accounting policy mentioned in paragraph 4(a) above, see paragraph 19 above.

Query No. 27

Subject: Treatment of expenditure on repairs, renovations, renewal, maintenance, etc. of fixed assets.[1]

A. Facts of the Case

1. An unlisted State Government undertaking deals in transportation of passengers by trams and buses in the city of Kolkata. The company was incorporated at London in the year 1880. Later, the company was taken over by the State Government in the year 1976 and the new company was incorporated on 15th October, 1982. Apart from regular audit by the Office of the Principal Accountant General, the company is audited by statutory auditors appointed by the Comptroller and Auditor General of India (C&AG), New Delhi. During the financial year 2006-07, a new auditor has been appointed to audit the accounts of the company. An issue has been raised by the statutory auditors during the course of their audit. The background of the issue is contained in the following paragraphs.

2. The querist has stated that the company spends money every year out of the fund provided by the State Government for repair and renovation of operable assets (e.g., tram cars, tram tracks, buses, bus facilities at depots, workshops and roads along tram track). The detailed scheme of repairs for the year is approved by the Board of Directors in the Board meeting and sent to the Government for release of funds on quarterly basis. During the year 2006-07, the State Government provided funds amounting to Rs. 1628 lakh for the purpose of renovations, repairs, renewal and proper maintenance of various operable assets so that vehicles can run smoothly on road. No technological improvements are

[1] Opinion finalised by the Committee on 02.12.2008

made as the buses have branded chasses and trams are designed vehicles which are more than 22 to 50 years old. Each tram is repaired on preventive maintenance basis every year on the existing chassis of the tramcar. Similarly, buses are repaired if they are found defective and complaints are lodged by drivers and technicians to repair and make them road-worthy. The overhead cables are replaced if these tear and snap or expire their usability due to normal wear and tear. Usually, spare parts of equipment for electrical items are also changed if they lose their utility due to functional failure. The company also repairs tram track, changes rails and repairs adjoining roads when the roads are broken. Rails and overhead traction wires are required to be changed on urgent basis, in small stretches of road due to normal wear and tear of rail and roads, by contractors / in-house staff of the company. The above repair is done only for smooth running of tram and other vehicles. The repairs are always a temporary measure. The repairs and maintenance are done only on parts of the assets and not on the assets as a whole, keeping the original infrastructure intact.

3. The querist has stated that the management is of the following opinion:

(i) The repair and maintenance activity does not result in increased future benefits from the existing assets beyond its previously assessed standard of performance in terms of passenger capacity (load factor), revenue earning and life of asset. The management believes that such test is applicable as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets', when the company proposes to capitalise such expenditure.

(ii) The treatment of the expenditure as repair and maintenance is being followed by the company consistently year after year and properly disclosed in the "notes to accounts". The statutory auditors appointed by C&AG, Principal Accountant General (of the State) and Income-tax Department themselves in the past confirmed the treatment.

(iii) The management of the company does not propose to capitalise any of the expenditure in the current year accounts as it does not fulfill the parameter set by paragraph 12.1 of AS 10.

(iv) The company has mentioned in notes to accounts regarding its policy to treat such expenditure as revenue expenditure since the repair is routine / preventive in nature which does not increase the future benefits beyond its previously assessed standard of performance. The existing capacity of the vehicles does not increase as a result of such repair work.

(v) The querist has also submitted the opinion of a technical expert on the subject for the perusal of the Committee.

4. The querist has also informed that the statutory auditors opined during the course of audit that they need such expenditure of repairs asset-wise along with the details of past expenditure since the inception of the company on the same assets to judge whether the nature of expenditure is capital or revenue. The auditor's opinion is reproduced below:

> "Plan loan amounting to Rs. 1628 lakh has been released during the year by the State Government against budget of Rs. 2000 lakh. Budgeted expenses include repairs, renewal, renovation and improvement of tramcars, tram tracks, buses, and bus facilities at depot and overhead systems. Such expenses have been treated as revenue expenditure. As per Accounting Standard 10, subsequent expenses on any fixed assets should be capitalised only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance. In the absence of relevant information to verify whether there has been increase in the future benefits from the existing assets beyond its previously assessed standard of performance, we are unable to comment on the treatment of expenses as revenue by the company. However, we have been informed by the management that due to these expenses, there is no change in the assessed standard of performance."

5. The management's view is that although the Companies Act, 1956 does not prescribe to maintain 'expenditure' head asset-

wise, it is the company's prudent accounting policy to maintain all the expenses on repair / maintenance asset-wise under the head 'Repair & Maintenance' in the profit and loss account (schedule 18 and sub-schedule 18/1). The current year's expenditure on repair and maintenance is Rs. 37.81 crore, which includes expenditure incurred out of fund received on account of Plan Scheme. For all practical purposes, it is not possible to match the funds received with such expenses because it is a continuous process. Funds received in the last month of a financial year may be spent in the first quarter of the next financial year. The expenditure is booked under the head 'Repair & Maintenance' as and when it is incurred. The company's perception on the basis of its 125 years of experience is that such a job is not capital in nature. In view of the above-mentioned qualification by the auditor, the management of the company as well as the querist are of the opinion that such a qualification, if not correct, will have far reaching effects in future.

B. Query

6. The querist has been advised to seek expert opinion on the auditor's qualification from the Expert Advisory Committee of the Institute of Chartered Accountants of India. Accordingly, the querist has sought the opinion of the Expert Advisory Committee as to whether considering the overall facts, the accounting treatment of such expenditure by the company is incorrect when the company, based upon the generally accepted accounting principles, does not propose to capitalise any of such routine type of repair expenditure.

C. Points considered by the Committee

7. The Committee while answering the query has examined only the issue raised in paragraph 6 above and has not touched upon any other issue arising from the Facts of the Case, such as, accounting for the funds received from the State Government for the purpose of repairs, renovations, etc. of the operable assets. The Committee notes that the basic issue raised in the Facts of the Case relates to various types of expenditures, namely, repairs, renovations, renewals, maintenance, improvements, etc. incurred by the company in the context of various operable assets. Further,

sometimes replacements and changes are also made, such as, that of rails, overhead cables, etc.

8. The Committee notes paragraph 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which reads as follows:

> ***"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. The Committee is of the view that expenditure on fixed assets subsequent to their installation may broadly be categorised into (i) repairs, and (ii) improvements or betterments. Repairs, in the Committee's view, implies the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated service life or capacity. The term often includes maintenance primarily 'preventive' in character. It frequently involves replacement of parts. Expenditure on repairs and maintenance, including replacement cost necessary to maintain the previously estimated standard of performance, is expensed in the same period. On the other hand, in the view of the Committee, expenditures on improvements or betterments are expenditures that add new fixed asset unit, or that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs. Such expenditures are capitalised.

10. The Committee notes that it has been stated by the querist in the Facts of the Case that the repairs and maintenance are done only on parts of the assets and not on the assets as a whole keeping the original structure intact. It has also been stated in the Facts of the Case that no technological improvements are made and that these expenditures are routine/preventive in nature which do not increase the future benefits beyond the assets' previously assessed standard of performance in terms of passenger capacity, revenue earning and life of the assets. In the absence of any information to the contrary, the Committee presumes that the nature of the expenditure is as stated by the querist in the facts of the

case. From this, it appears to the Committee that the expenditures in the present case are of the nature of repairs and, therefore, should be expensed.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that the accounting treatment of the expenditure incurred in the context of various fixed assets as repairs and maintenance is correct, as such expenditure does not result in increase in future benefits from previously assessed standard of performance, i.e., a substantial increase in the life of the assets or the quality of services / capacity or revenue earning / substantial reduction in operating costs as per the presumption contained in paragraph 10 above.

Query No. 28

Subject: (i) Treatment of vend fee in the valuation of inventory and inclusion thereof in the valuation of goods in transit.

(ii) Treatment of transportation cost (including loading and unloading cost) in the valuation of inventory.

(iii) Recognition of 'goods in transit' in accounts.[1]

A. Facts of the Case

1. A company is a State Government undertaking registered under the Companies Act, 1956. It has exclusive privilege of supplying by wholesale and retail, Indian Manufactured Foreign Sprit [IMFS] and beer items throughout the State. It has about 6700 retail vending shops, 41 IMFS depots, 33 district managers'

[1] Opinion finalised by the Committee on 02.12.2008

offices, and 5 senior regional managers' offices throughout the State.

2. The company procures IMFS from 6 major suppliers and beer from 3 suppliers. Purchase orders are placed with the manufacturers/suppliers on the first of every month taking into account the average sales of previous three months and goods-in-transit at the end of previous month. Further indents are issued *daily* to the manufacturers/suppliers taking into account the stock position at retail vending shops, depots and other seasonal requirements (emphasis supplied by the querist).

3. The querist has stated that on receipt of indents, the manufacturers/suppliers will pay State excise duty to the credit of Government and then desptach the IMFS and beer products from their factory/godown to the depots of the company as instructed/directed. The invoice of the manufacturers/suppliers contains the basic price, excise duty, trade discount on basic price and sales tax on the net basic price and excise duty.

Vend Fee

4. The querist has informed that while issuing the indents, the company also pays vend fee @ Rs.142 per case for IMFS and Rs. 36 per case for beer. This payment is due by virtue of Tamil Nadu IMFS [Supply by Whole Sale] Rules, 1983. The relevant charging rule, Rule 15(1A) as amended by Government Order G.O. Ms. No. 323 dated 10.9.2004 is reproduced hereunder:

> " In addition to the excise duty or countervailing duty, as the case may be, paid in accordance with the provisions of sub-rule (1) above, a vend fee at the rates specified below shall also be collected from the licensee on the stock of Indian Made Foreign Spirit received from the manufacturing units inside the State or outside the State or removed from the bonded warehouse licensed under the Tamil Nadu Indian Made Foreign Spirit [Storage in Bond] Rules, 1981".

The querist has stated that in the present case, the licensee is the company. Further, in the Rules, anywhere, no time-limit has been prescribed for the payment of vend fee. By virtue of the said Rule

15(1A), since this has to be paid *on the receipt of stock from the manufacturing units*, the company has adopted the system of making payment of vend fee at the time of raising the indents. This practice has been adhered to due to the receipt of goods by 41 depots scattered all over the State and further the centralised office, which places indents, is unable to control *the time of the receipt of goods at various locations of the depots*. Inspite of raising inward documents, viz., Goods Receipt Acknowledgement by the receiving depots, due to its diversification and being scattered all over the State and further non-computerisation and non-integration of these documents coupled with the volume and frequency of placing indents (almost daily indents are placed to the manufacturers for supply and also daily receipt of goods takes place), the company has been adhering to the system of making the payment of vend fee on the same day of raising the indents. Further, it is to be noted that the vend fee is not considered for fixing selling price to consumers. This fee is paid out of the margin of the company (emphasis supplied by the querist).

Transport Charges and Transit Insurance

5. The cost of transport including loading charges at the suppliers end and the unloading charges at the end of the depots of the company are borne by the suppliers through transport contractors (the basic price paid to the manufacturers includes transport charges). However, the transit insurance, i.e., the charges of insurance for the movement of stock of IMFS and beer from the factory/godown of the manufacturers/suppliers' point to 41 IMFS depots located throughout the State are borne by the company. The company avails trade discount from suppliers to meet the cost of transit insurance. The querist has also informed that as per the condition no.10 of terms and conditions for the supply of IMFS by local manufacturers for purchase of IMFS and beer, the stocks received in good and perfect condition shall only be accepted and payment made for. Stocks which are defective either in packing or in quality or any other aspect during visual examination at the time of delivery shall be rejected straightaway and such stock shall be disposed off as per the rules in force. Similar conditions are included in the case of supply of beer by local manufacturers (vide condition

No.9 (a)), and import of IMFS from outside the State (vide condition No.17). Hence, according to the querist, it may be noted that the title over the goods passes on to the company only on receipt of goods in good condition.

Fixation of Selling Price

6. The mode of fixation of selling price for IMFS and beer has been supplied by the querist for the perusal of the Committee, wherein, as per the querist, it is clear that the vend fee has not figured as an element of cost in that fixation. It is paid by the company out of its margin.

Transport of Goods to Retail Shops

7. The goods received at depots are transferred to retail vending shops, which are managed by the company [as branches]. The transport charges for these internal transfers to retail vending shops are borne by the company. Further, stocks lying at depots and retail vending shops are insured (for fire, flood, burglary, etc.) by the company along with other risks, viz., cash in safe, money-in-transit, fire, fidelity, etc.

Valuation of Stock at Depots and Retail Vending Shops

8. As per the querist, the company has been valuing the closing stock at lower of cost or market price and also based on the principles laid down in Accounting Standard (AS) 2, 'Valuation of Inventories'. The inventory as on 31.03.2007 was at Rs. 264.23 crore as detailed hereunder:

Sl.No.	Location – Closing Stock	Rs. in crore
a.	IMFL & beer - At Depots	85.07
b.	IMFL & beer- Retail Vending Shops	144.88
c.	IMFL & beer - Goods-in-Transit	34.26
d.	Excise labels	0.02
	Total	264.23

Vend fee included in the 'goods in transit' is Rs. 2.84 crore and vend fee included in the closing stock at depots and at retail vending shops is Rs. 19.06 crore.

9. The cost elements considered for valuation of inventory are:

   (i) Basic price paid to manufacturer (net of trade discount) which also includes transport charges.

   (ii) Excise duty paid by the manufacturer.

   (iii) Sales tax paid by the manufacturer on above.

   (iv) Amount incurred on transit insurance by the company.

These elements of cost are applied for valuation of inventory lying in retail vending shops also.

Treatment of Vend Fee in the accounts

10. The company is paying vend fee on IMFS @ Rs. 142 per case and on beer @ Rs. 36 per case at the time of issue of indents as stated in earlier paragraphs. The said vend fee has been charged to the profit and loss account as and when the same has been incurred. However, at the end of the financial year [say 31st March of every year], vend fee paid on the goods-in-transit has been treated in the accounts as 'prepaid expenses' on the stand that the liability for payment of vend fee shall arise only on the receipt of goods.

Recognition of goods-in-transit in books of account

11. The company has been recognising 'goods-in-transit' in the books of account at the year-end on receipt of invoice.

B. Query

12. The querist has sought the opinion of the Expert Advisory Committee on the following issues, considering paragraph 6 of AS 2, dealing with cost of inventories:

   (a) Whether the vend fee (which is paid out of the profit) and the transport cost [including loading and unloading] incurred by the company for moving the goods from depots to retail vending shops can be included in the term ‘cost of purchase’ or ‘other costs incurred in bringing the inventories to their present location and condition’ and be taken as an element of cost for the purpose of valuation of closing stock both at depots and retail shops. In case of inclusion of the vend fee as an element of cost in valuing the closing stock, what would be the accounting treatment in the year in which it is implemented [i.e., measurement and impact of such cost on the opening stock]?

(b) For the year 2006-07, the Accountant General during the supplementary audit of accounts under section 619(4) of the Companies Act, 1956 objected to the treatment of ‘prepaid expenses’ for the vend fee incurred on the goods-in-transit and the company has revised its accounts by charging these expenses to profit and loss account disclosing the fact and also with a specific mention that this will be referred to the Institute of Chartered Accountants of India (ICAI) for expert opinion. What would be the correct treatment in accounts with regard to recognition of ‘goods-in-transit’, and the vend fee paid on such goods-in-transit?

C. Points considered by the Committee

13. The Committee while answering the query has addressed only the issues raised in paragraph 12 above and has not touched upon any other issue arising from the Facts of the Case, such as, appropriateness of the accounting policy of the company with respect to valuation of closing stock at lower of cost or market price, etc.

14. The Committee notes the following paragraphs from AS 2:

“6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods…"

"11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."

"13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

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

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

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

(d) selling and distribution costs."

15. From the above, the Committee notes that as per AS 2, the cost of inventories would include costs, apart from the cost of purchase and cost of conversion, that are incurred in bringing the inventories to their present location and condition. The Committee is of the view that the test for determining whether or not the cost of carrying out a particular activity should be included in the cost of inventories is whether the activity contributes to bringing the inventories to their present location and condition; the nomenclature of the activity or the place where the activity is carried out is not relevant.

16. The Committee is of the view that the term 'distribution costs' referred to in paragraph 13(d) of AS 2 reproduced above read with paragraph 6 of AS 2, should be construed as distribution costs which are incurred by the seller in making the goods available to the buyer from the point of sale. In other words, distribution costs used in the expression 'selling and distribution costs' would include only those costs which are incurred for moving the goods from the premises of the seller, whether from the branches or depots or retail outlets to the premises of the buyer. Thus, the costs incurred in moving the goods from the manufacturers'/ suppliers' factory to depots or from depots to seller's retail outlets before sale, should be construed as the costs incurred in bringing the inventories to their present location and condition and, therefore, should be included as part of the cost of inventories. The Committee is further of the view that the expenditure incurred towards loading and unloading of the material prior to effecting the sale is also incurred to bring the inventories to their present location and condition and, therefore, should be considered as element of cost of inventory. However, to the extent the transportation and loading and unloading costs are incurred in relation to despatch to retail vending shops, such costs should not be considered in arriving at the cost of inventories held at depots which are meant for despatch to retail shops. Instead, such expenditure should be considered in arriving at the cost of inventories held at retail shops as required by paragraph 11 read with paragraph 6 of AS 2 since this expenditure is incurred in changing the location of the merchandise, i.e., bringing the inventories to the intended point of sale, i.e., the retail vending shops.

17. As far as accounting treatment of vend fee is concerned, the Committee is of the view that the same depends on the point of time at which vend fee is considered to be levied on the goods as that determines the nature of the expense. In this regard, the Committee notes section 17-D of the Tamil Nadu Prohibition Act, 1937, which provides as follows:

> "**17-D. Payment of a sum in consideration of the grant of any exclusive or other privilege or fee on licences for manufacture or sale. –** The State Government may, by rules, levy a sum or fee or both in consideration of the grant of any exclusive or other privilege under section 17-C and also a fee on licences granted under section 17-C."

(Section 17-C deals with the grant of exclusive privilege of manufacturing, or selling by retail, or supplying by wholesale of IMFS)

The Committee further notes that Rule 15(3) of Tamil Nadu Indian Made Foreign Spirit (Supply by Wholesale) Rules, 1983, inter alia, states as follows:

> "An additional vend fee at the rates specified below shall also be paid by the licensee on the quantities of IMFS and Beer sold…"

The Committee also notes from the Facts of the Case that the vend fee is payable on the receipt of IMFS (refer paragraph 4 above) as it is required to be 'collected' at that stage. From the above, the Committee is of the view that the timing of levy of vend fee is not clear, e.g., whether it is levied on receipt or at the point of sale. The Committee further notes that at what point the vend fee is levied is a legal issue. Accordingly, the same is not being addressed as the Committee is prohibited to answer issues involving pure interpretation of the relevant enactments under Rule 2 of its Advisory Service Rules. Accordingly, first, it should be determined from the legal point of view as to the point of time, the vend fee is considered to arise. The Committee is of the view that if levy of vend fee arises on receipt of the goods, it should be treated as part of cost of inventories. However, if levy of vend fee arises on sale of goods, the same should not be included as part of cost of inventories, in view of the same being a selling and distribution cost as per paragraph 13 of AS 2.

18. As far as the treatment of goods-in-transit is concerned, the Committee notes that paragraphs 9.14 and 9.16 of the Statement on the Amendments to Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, states as below, although in the context of disclosure of the value of imports of raw-materials etc., to fulfill the requirements under clause 4(D)(a)of Part II of Schedule VI:

> "9.14 The value of imports should include goods which are in transit on the balance sheet date, provided that the property in those goods has already passed to the purchasing company. For the purpose of determining whether or not the property has passed, reference may be made to the terms of the import contract, and recognised legal principles, relating to this matter..."

> "9.16 Since the requirement is to disclose the value of imports during the accounting year, it may be necessary to determine when the title to the goods has passed from the overseas exporter to the Indian importer. The question as to when the title to the goods has passed should be determined in accordance with the well recognised legal principles relating to this matter. The disclosure should be restricted to imports where the title has passed within the accounting year irrespective of whether or not payment has been made during the year and irrespective of whether or not the goods have been physically received during the year."

19. The Committee further notes that in the context of recognition of revenue from sale of goods, it has been well established from the accounting point of view that in case there has been a transfer of significant risks and rewards of ownership in the goods, revenue can be recognised even though transfer of property in goods has not taken place. In this regard, the Committee notes paragraph 6.1 of Accounting Standard (AS) 9, 'Revenue Recognition', as below:

> "6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. *However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.* Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes." (Emphasis supplied by the Committee.)

20. The Committee is of the view that the abovementioned requirements recognise the primacy of substance over form which should also be applied in case of purchases. Thus, the company should recognise only those goods-in-transit in respect of which significant risks and rewards of ownership have passed to the company. The Committee is of the view that the question when the transfer of significant risks and rewards of ownership takes place depends on particular facts and circumstances of the case, including the terms of the contract, express and/or implied, and the conduct of the parties. In this regard, the Committee notes that the querist has stated in the Facts of the Case that the cost of transit insurance is borne by the company and that the stocks received in good and perfect condition shall only be accepted and payment made for. The Committee is of the view that apart from these two factors, various other factors should also be considered for ascertaining the timing of passing of significant risks and rewards of ownership. For example, factors, like whether the company can sell the goods to another party or pledge the same while these are in transit, etc. will have to be taken into account in determining the timing of transfer of significant risks and rewards of ownership.

21. As far as accounting treatment of vend fee paid on the goods-in-transit is concerned, keeping in view the recommendations contained in paragraph 17 above, it would not be considered as a 'prepaid expense' if the risks and rewards of ownership are passed on to the company when the goods are in transit since it would be considered as 'constructive receipt' if the point of levy of vend fee is at the point of receipt of goods. However, if the levy of vend fee is at the point of sale, it should be considered as prepaid expense.

D. Opinion

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

(a) The transport cost (including loading and unloading cost) incurred by the company form part of 'other costs incurred in bringing the inventories to their present location and condition' and should be taken as an element of cost of inventory. However, to the extent transportation and loading and unloading costs are incurred in relation to despatch to retail vending shops, such costs should not be considered in arriving at the cost of inventories held at depots which are meant for despatch to retail shops. Instead, such cost should be considered in arriving at the cost of inventories held at retail shops as discussed in paragraph 16 above. The vend fee should be included in the cost of inventories only when the levy of the fee is considered to arise at the point of receipt of goods as discussed in paragraph 17 above. In such a case, the vend fee not included in the opening stock should be considered as a 'prior period item' under Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' and treated accordingly.

(b) The goods-in-transit would be recognised as the inventories of the company depending on whether the significant risks and rewards of ownership of these goods have been transferred to the company considering the factors discussed in paragraph 20 above. As far as vend fee paid on such goods-in-transit is concerned, it should be included as a part of cost of inventory only when the liability in respect thereof arises as discussed in paragraph 21 above.

Query No. 29

Subject: Accounting for expenditure incurred on development of corporate portal.[1]

A. Facts of the Case

1. A company was incorporated on 27th September, 1999 under the Companies Act, 1956 as a Government company as a part of Indian Railways' wider organisational reform and to strengthen its marketing and service capabilities in the areas of rail catering, tourism, and passenger amenities. The company obtained the certificate for commencement of business on 2nd December, 1999. The authorised share capital of the company is Rs. 50 crore and paid up share capital is Rs. 20 crore. The total paid up capital is subscribed by the Ministry of Railways.

2. The main activities of the company are as under:

- On-board catering services and static catering units on the Indian Railways network.
- Selling of railway tickets by way of e-tickets and i-tickets through the company's web portal.
- Managing and operating all India Railway Enquiry Call Centre.
- Setting up of food plazas with private partnerships at railway stations on Indian Railways network.

[1] Opinion finalised by the Committee on 02.12.2008

- Running of special train charters, special coach charter and promotion of rail tour packages and value added tours.

- Manufacturing packaged drinking water for Indian Railways passengers.

- Managing the departmental catering units, taken over from the Indian Railways.

- Establishment of budget hotels / management of existing Rail Yatri Niwas / budget hotel.

- Organising special train charters on hill railways.

3. During the year 2005-06, the company had awarded a contract for design and development of the corporate portal of the company to M/s XYZ Ltd. at Rs. 32.20 lakh. The corporate portal is leveraging the web/internet technologies/tools for dissemination of information and allow a familiar, easy to use web. The portal is being accessed through internet and/or intranet. The portal is facilitating the users throughout the enterprise to access a wide variety of information, e.g., company's announcements, tender calendar, etc. Also employees of the company can view human resource details. Portal is also helping in the speedy and efficient dissemination of information.

4. The querist has stated that an amount of Rs. 32.20 lakh was incurred on development of web portal. As per the accounting policy adopted by the company, the amount incurred on development of web portal was capitalised along with the computer/ server. A disclosure in this regard was given in the notes to the accounts.

5. During the course of supplementary audit of the accounts of the company under section 619 of the Companies Act, 1956 by the Audit Party of Comptroller and Auditor General (C&AG) of India, it was observed that :

> " 'Fixed Assets – Computers' includes a sum of Rs. 32.20 lakh incurred on web portal of the company. It is a software and is an intangible asset and as stated under Accounting

Standard (AS) 26, 'Intangible Assets', besides disclosing method and rate of amortisation the following disclosures are also to be made:

(i) Whether it is an internally generated intangible asset or not.

(ii) A distinction has to be made between internally generated assets and other intangible assets.

(iii) The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.

(iv) A reconciliation of the carrying amount at the beginning and end of the period showing (a) additions, indicating separately those from internal development and through amalgamation; (b) retirements and disposals; (c) impairment losses recognised in the statement of profit and loss during the period (if any); (d) impairment losses reversed in the statement of profit and loss during the period (if any); (e) amortisation recognised during the period; and (f) other changes in the carrying amount during the period.

Thus, requisite disclosures in terms of mandatory AS 26 pertaining to an intangible asset have not been made."

6. The querist has stated that as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets', a fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. As per paragraph 10 of Accounting Standard (AS) 26, 'Intangible Assets', "an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Standard, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a

computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.”

7. The querist has further stated that hardware and software platform for the said corporate portal was advised by M/s. XYZ Ltd. As per the requirements given, the said developed software would operate through web and application server and data server. The said computer machines were not supposed to be operated as stand-alone machines. In the view of the company, the application software developed by M/s XYZ Ltd. is an integral part of the web application server and data based server. Accordingly, the company has decided to capitalise the cost of Rs. 32.20 lakh incurred on designing of web portal of the company, along with computers, as per the accounting policy followed by it. A disclosure in this regard has been made as per note no. 20 of the notes to accounts. In view of the above, according to the querist, the amount of Rs. 32.20 lakh incurred on web designing of web portal has been correctly accounted for.

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India as to whether the accounting policy followed by the company with regard to capitalisation of software along with computers is correct or the same is needed to be rectified, as pointed out by the Audit Party of the C&AG of India.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that the company has incurred an expenditure of Rs. 32.20 lakh on designing and development of the corporate portal of the company. The Committee notes that the basic issue raised in the query relates to whether the accounting policy of the company of capitalising such development costs related to portal to ‘Fixed Assets – Computers’ is proper or not. Accordingly, the Committee has answered this particular issue and has not touched upon any other issue arising from the Facts of the Case, such as, whether or not such expenditure has properly been classified as being related to the development phase of the generation of an internally

generated asset, viz., portal, as per the provisions of AS 26. The Committee has presumed that the entire expenditure in respect of which the query has been raised relates to the development phase of the portal.

10. The Committee notes paragraph 10 of AS 26, which provides as follows:

> "10. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Standard, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset."

From the above, the Committee notes that from purely accounting point of view, there are broadly two types of computer software, viz., (a) computer software which is an integral part of the computer and without which that computer cannot operate, such as, an operating system, which is a foundation software of a machine that controls the operation of a computer and allows users to enter and run their software packages; and (b) other software. The Committee is of the view that the basic difference between the two is that the first type of software helps the computer machine to run and forms a platform for running other computer software. Therefore, the Committee is of the view that it is only the first type of computer software that should be capitalised along with the related hardware.

11. The Committee notes from the Facts of the Case that the company has capitalised the application software internally developed by the company along with the web application server and data based server for which the reason is stated to be that the application software is an integral part of the web application server and data based server and that the said computer machines were

not supposed to be operated as stand-alone machines. In this regard, the Committee notes that application software is a software program running on the top of the operating system that has been created to perform a specific task for a user. The said computer machines can still be run through the operating system without the application software, though not for the desired tasks. Thus, the Committee is of the view that the application software cannot be treated as an integral part of the related machines and cannot be capitalised alongwith the said computer machines. Accordingly, in the view of the Committee, the computer software under consideration should be treated as separate internally developed intangible asset provided it meets the requirements of AS 26.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the accounting policy followed by the company with regard to capitalisation of software along with computers is not correct and the same needs to be rectified on the lines of paragraph 11 above.

Query No. 30

Subject: Accounting treatment of parts of a fixed asset replaced by insurance/capital spares and kept in store after repair for further use.[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 either with the mother plant or subsequently. According to the querist, all such spares are capitalised in line with the accounting

[1] Opinion finalised by the Committee on 02.12.2008

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', and Accounting Standards Interpretation (ASI) 2, 'Accounting for Machinery Spares (Re. AS 2 and AS 10)'[2] read with an earlier opinion on 'accounting treatment of insurance spares' given by the Expert Advisory Committee of the Institute of Chartered Accountants of India [published as Query No. 40 in the Compendium of Opinions – Volume XXI]. The said accounting policy of the company is as follows:

> "3.1(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 the 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.
>
> 3.1(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 the revenue in that year itself.
>
> 3.1(c) When the useful life of the related fixed asset expires and the asset is retired from active use, such spares are valued at net book value or net realisable value whichever is lower. However, in case the retired asset is not replaced, WDV of the related spares less disposable value is written off.
>
> 3.2 Other spares are treated as 'stores and spares' forming part of the inventory and expensed when issued."

2. The querist has stated that WDV of the capital spares consumed is charged to the revenue. However, on the replacement of old capital spares with the new ones, it happens that some of the capital spares, which are retrieved, are suitable for reuse after

[2] ASI 2 has subsequently been withdrawn by the ICAI.

some repairs. Accordingly, such retrieved spares are got repaired depending upon the economically serviceable condition and are kept in stock for their subsequent use. Cost of repair of such spares is expensed and a memoranda quantitative account is kept for such spares. This policy is being followed consistently.

3. The querist has informed that during the audit of accounts of the company for the year 2007-08, the government auditor has raised an observation regarding the practice being followed by the company regarding the accounting for retrieved spares. The contention of the auditor is that re-usable capital spares retrieved from the generating units and lying in stock at the end of the year should be valued on the basis of engineering estimates and recognised in the accounts. The audit observation was not pressed further on the assurance that the management shall study the implication next year.

4. The querist has further stated that as regards the observation of the auditor, management is of the opinion that re-capitalisation of such repaired capital spares on assessed value may not be appropriate owing to the following reasons:

(i) Expenditure on repair of the retrieved capital spares already stands charged to revenue;

(ii) In hydro-power industry, life of the spare part of the power generating plant usually depends on the quantum of silt in the water. Moreover, quantum of the silt content is also not uniform at all times. In a particular season, silt content may be more than usual thereby causing early replacement of spare parts and vice-versa. Therefore, it is quite difficult to ascertain the life of the retrieved spares, rate at which it is to be depreciated in case of re-capitalisation of such retrieved (repaired) spares;

(iii) At times, engineering estimate may be more than the cost of repair, in that case, re-capitalisation would tantamount to recognition of notional income to the extent of difference between the engineering estimate and cost of repair, which does not seem to be prudent.

5. The querist has stated that to address the issue of taking such spares in the accounts in addition to keeping memoranda quantitative record, the company is of the view, particularly in view of the reasons given in paragraph 4 above, that the appropriate accounting treatment would be to capitalise such retrieved (repaired) spares at a notional value of Re.1 instead of capitalising it at the value as per engineering estimate. This process of capitalising the retrieved (repaired) capital spares @ Re.1 would keep on revolving every time when a capital spare is consumed and the retrieved one is got repaired for its re-use.

B. Query

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

(a) Whether the accounting treatment as suggested in paragraph 5 above would be appropriate.

(b) Other alternative treatment, if any, in lieu of the aforesaid alternative.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of parts of a fixed asset replaced by insurance/capital spares and kept for reuse after some repairs. Therefore, the Committee restricts itself to the specific issue raised by the querist and has not touched upon any other issue that may be contained in the Facts of the Case, such as, appropriateness of rest of the accounting policy of the company related to spares as mentioned in paragraph 1 above, identification of the spares as capital spares, viz., machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular, etc.

8. The Committee notes paragraph 25 of AS 10, which provides as below:

> ***"25. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal."***

9. From the above, the Committee is of the view that if any item of fixed asset is having no expected future benefit from its use or disposal, it should be eliminated from the financial statements. However, if it has a future economic benefit, it should continue to be recognised in the books of account.

10. The Committee is of the view that ordinarily, when a part of the fixed asset gets worn out and is physically replaced by its capital spare, the part taken out from the fixed asset is of no further use and is discarded. However, from accounting point of view, the cost of the part thus removed from the fixed asset continues to be a part of the cost of the whole fixed asset which keeps getting depreciated. The capital spare, which now replaces the original part in the fixed asset loses its separate identity and becomes a part of the fixed asset. Accordingly, the written down value of the capital spare is written off in the profit and loss account. From the Facts of the Case, the Committee notes that in the case of the company under consideration, sometimes the original part removed from the fixed asset can be used again after repair. The original part thus continues to have an economic value as it can later replace the capital spare which was used to replace the original part, when that capital spare gets worn out. In such a situation, when the capital spare replaces the original part in the fixed asset and that original part can be used again after repair, the written down value of that capital spare should not be charged off to the profit and loss account. Instead, only the repair charges should be charged off to the profit and loss account. The depreciation should continue to be charged on the value of the capital spare over the remaining useful life of the fixed asset. This is so because though physically, original part and the capital spare get exchanged, they both continue to be of further use to the enterprise.

D. Opinion

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

(a) The accounting treatment suggested by the querist in paragraph 5 above is not appropriate under the circumstances of the company.

(b) The correct treatment would be to continue to recognise the written down value of the capital spare in the books of account. Please refer paragraph 10 above.

Query No. 31

Subject: Provision towards resettlement and rehabilitation schemes.[1]

A. Facts of the Case

1. A company is a Government of India undertaking incorporated in the year 1975 under the Companies Act, 1956. One of the objectives of the company is to set up power plants at various geographical locations in the country and to supply bulk power to various State Electricity Boards.

2. The company is registered under the Companies Act, 1956 and being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. As per the querist, since the Government has not prescribed any format for the statement of accounts for the central undertakings engaged in generation of electricity, the company is preparing its accounts in the format prescribed as per Schedule VI to the Companies Act, 1956. The company is also listed with the Bombay Stock Exchange and National Stock Exchange.

3. The company has ambitious expansion and diversification plans for the future and aims to be a 75,000 MW company by the year 2017. Further, it intends to diversify by way of providing backward and forward integration. As a part of its diversification plans, it has entered the hydro sector, coal mining, and oil and gas exploration sectors. For this purpose, large tracts of land are required. The land is acquired from the State Governments and/or the private

[1] Opinion finalised by the Committee on 09.01.2009

land owners through the concerned State Government. The land acquired from the State Governments is normally on long term lease basis while the land acquired from the private land owners is on freehold basis. The estimated amounts payable towards acquisition of land including the estimated amount payable to the project affected persons (PAPs) under resettlement and rehabilitation (R&R) schemes are indicated in the Feasibility Report (FR) or Detailed Project Report and approved by the company before taking up the project work.

4. *Land Acquisition for the Power Projects*

A. Land acquired from the State Government:

The amount paid to the State Government towards transfer of land or diversion of forest land, e.g. land premium, compensatory afforestation, cost of trees, catchment area treatment and rim plantation, etc. is treated as cost of land / 'capital work-in-progress – expenditure pending allocation – diversion of forest land', as the case may be.

B. Land acquired from private parties:

In case of private land, a survey is conducted for obtaining the details of the extent of land, persons affected and the number of land owners. Based on the survey, a requisition is made to the District Collector (authority nominated by the Government under the Land Acquisition Act, 1894) for acquisition of the identified land. The District Collector designates a Tehsildar to take appropriate steps for acquisition of the required land. The Tehsildar on behalf of the Government publishes a notice under the Survey and Boundaries Act, 1961. A gazette notification is also issued identifying the land for public purpose. Thereafter, notices are issued to the land owners and a hearing is conducted. In the meantime, the Tehsildar fixes the value of the land after assessing the local prevailing market rate. Buildings are valued based on the schedule of rates of the Public Works Department and the trees are valued based on the norms fixed by the State Forest Department. The District Collector or the State Government, as the case may be, approves the value fixed by the Tehsildar. Thereafter, a Gazette declaration regarding the acquisition of land for public purpose is issued. The Tehsildar issues a notice intimating the company to remit the money in respect of land to be acquired by the company to the Government Treasury for distribution to the land owners. On receipt of the money, the possession of the land is handed over to the company by the Tehsildar. The amount paid to the Tehsildar by the company is accounted for as cost of land on physical possession of land.

5. In addition to the above, the company also takes measures for resettlement and rehabilitation (R&R) of the project affected persons (PAPs) with the objective that the PAPs will improve or at least regain their previous standard of living. As per the Rehabilitation Action Plan (RAP), the PAPs are entitled for the following rehabilitation packages apart from the land compensation amount already received from the Tehsildar:

I. Land for Land Option

Under 'Land for Land' option, the following sums will be payable:

(a) Rehabilitation amounts calculated @ Rs…..per acre of land actually acquired; from this, the basic land compensation amount (excluding solatium and interest) paid under the Land Acquisition Act, 1894 shall be deducted.

(b) Additional rehabilitation grant as ex-gratia, calculated per acre of land actually acquired on purchase of land.

(c) Land development charges calculated @ Rs… per acre of land actually acquired; and

(d) Land registration amount towards purchase of land shall be paid by the company. However, the registration charges shall be restricted on the rehabilitation amount agreed to be paid in (a) above.

For payment under the 'Land for Land' option, the following mechanism shall be adopted:

(i) The project affected person (PAP) shall open a joint account in the bank. This account shall be in the name of husband and wife. In case the PAP is unmarried or widow/widower then he or she shall open the account in his/her own name. In case the land ownership is in the joint name of more than one person, and the same has been acquired from them, the bank account shall have to be opened in the name of all the joint land owners.

(ii) After opening the bank account, the PAP shall enter into an agreement with the company giving his/her acceptance to the rehabilitation option.

(iii) On finalisation of the agreement, the company shall deposit the entitled amount due on purchase of land alongwith the ex-gratia amount in the bank account of PAP.

(iv) For making the option effective, the company shall constitute a Task Force. This shall comprise two persons nominated by the Village Development Area Committee (VDAC), one person each nominated by the company and District Administration. The representative of District Administration shall not be below the rank of Deputy Collector. Apart from this, the company shall endeavor to seek the assistance of any retired Deputy Collector.

(v) Further, the PAP shall submit to the Task Force, the consent letter from the seller from whom he intends to purchase the land.

(vi) After scrutiny of the consent letter by the Task Force, the PAP shall be eligible to draw from his bank account towards purchase of land and the ex-gratia amount.

(vii) The option shall be time bound and purchase of land within one year from the commencement of implementation shall be compulsory.

(viii) In case land is not acquired within one year period, the Task Force shall review the implementation status of the option.

II. Rehabilitation/resettlement grants

In case the land oustees do not opt for 'land for land' option, they can opt for 'One Time Rehabilitation Grant'. The one time rehabilitation grant will be paid on signing an agreement with the company giving his acceptance and thereafter, the company will deposit the amount in the joint names of the land oustees which can be withdrawn on fulfilling the relevant conditions mentioned at (i) to (viii) above. The rehabilitation grant will be calculated based on the minimum agricultural wage multiplied by the applicable number of days in the concerned State prevailing at the time of notification under section 4 of the Land Acquisition Act, 1894.

III. Subsistence/self-resettlement grant

Keeping in view the time required for stabilising the resettlement process, each PAP shall normally get a monthly subsistence allowance equivalent to 20 days minimum agricultural wages per month for a period of one year and financial assistance will be given generally @ five times of the basic compensation payable for house excluding solatium and interest under the Land Acquisition Act. These grants will be payable on opening of the bank account in joint names of his/her spouse etc.

IV. Infrastructural facilities

In addition to the payments towards cost of land and other benefits indicated above, certain infrastructural facilities are also provided to the group of PAPs to improve their standard of living or to put them close to their previous standard of living. The amounts towards such facilities are provided in the feasibility report. These infrastructural facilities will vary depending upon the local requirements and may include the following:

- Construction of the resettlement colonies
- Internal and approach roads with proper drainage
- Safe drinking water through hand pumps

- Community halls/Panchayat Ghar
- Primary educational facilities
- Primary health facilities
- Street lighting in resettlement colonies
- Public cremation ground/burial ground, etc.

In respect of the above-mentioned infrastructural facilities, the company awards various contracts for execution in the resettlement colonies of the PAPs.

6. During review of accounts for the financial year 2006-07, the Government auditor observed that "provisions do not include an obligatory expenditure towards rehabilitation and resettlement to be discharged by the company in respect of its projects under construction/expansion. By not making the above provision, the company has violated the provisions of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets'."

7. According to the querist, the related provisions with regard to recognition of provision or disclosure of contingent liability in Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute of Chartered Accountant of India, are as under:

Recognition of Provision:

"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."

Contingent Liability:

"26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14)."

8. The querist has explained the accounting treatment being followed by the company as follows:

(i) Amounts payable to the PAPs in respect of R&R benefits indicated at paragraph 5 I to 5 III above:

(a) The amount payable to the PAPs is neither provided as liability nor disclosed as contingent liability since in many cases, the PAPs do not fulfill the above-mentioned conditions making them eligible to receive such payments and do not meet the above-mentioned conditions of paragraphs 14, 27 and 28 of AS 29 for recognition of provisions/disclosure of contingent liability.

(b) On fulfillment of the conditions mentioned in the respective rehabilitation package, the amount payable is ascertained and accounted for as liability.

(ii) In respect of infrastructural facilities indicated at paragraph 5 IV above to be executed by the company:

(a) The amount paid to the contractors on execution of such works is debited to the cost of land. At the balance sheet date, liabilities are provided in case such works have been executed and not paid.

(b) Balance amount of such contracts remaining to be executed are disclosed as 'Estimated amount of contracts remaining to be executed on capital account' in the 'Notes to Accounts' forming part of annual accounts.

(c) Pending award of contracts/execution of such works, the company is neither providing liability nor disclosing contingent liability even though these works are included in the Feasibility Report (FR) or Detailed Project Report (DPR) of the company, since inclusion of the above works in the FR or DPR does not create present obligation on the company as a result of a past event or meets the requirement for disclosure of contingent liability in terms of AS 29 mentioned above.

B. Query

9. Considering the applicable provisions of AS 29 and the present practice being followed by the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the existing practice being followed by the company indicated at paragraphs 8 (i) and 8 (ii) above is in order.

(ii) In case answer to (i) is in the negative, whether the company should provide for liability

(a) in respect of the estimated amount payable to the land oustees in respect of 'Land for Land', rehabilitation/resettlement grants, subsistence grant/ self-resettlement grant indicated at paragraphs 5 I (a) to (d), 5 II and 5 III above, even though the land oustees have not complied with mechanism for implementation of these schemes indicated at paragraph 5 I (i) to (viii) above or the attached conditions making them eligible to receive such amounts/grants as per the resettlement and rehabilitation scheme of the company.

(b) in respect of infrastructural measures, mentioned at paragraph 5 IV above, agreed to be executed by the company for which award letters will be issued in future and also the works will be executed only after the award in respect thereof.

(iii) In case no liability in respect of rehabilitation and resettlement schemes indicated at paragraphs 5 I (a) to (d), 5 II, 5 III and 5 IV above is to be provided because the land oustees have not complied with implementation mechanism or the attached conditions making them eligible to receive such amounts/grants as per the resettlement and rehabilitation scheme of the company, whether the same is to be disclosed as contingent liability.

(iv) In case no liability in respect of works mentioned at paragraph 5 I to IV above is to be provided, whether any disclosure of this fact is to be made in the 'Notes to Accounts' forming part of annual accounts.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist primarily relates to need for creating provision or contingent liability towards various rehabilitation/resettlement measures discussed in paragraph 5 above. 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, appropriateness of capitalisation of some expenses, e.g., those related to afforestation, as part of cost of land/capital work-in-progress, etc.

11. The Committee notes paragraph 14 and paragraphs 26 to 28 of AS 29 as reproduced by the querist in paragraph 7 above. In addition, the Committee notes the following paragraphs from AS 29:

> ***"A provision is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to***

result in an outflow from the enterprise of resources embodying economic benefits.

An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

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."***

"Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation – an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."

"11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

"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).

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

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In

> contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.
>
> 19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large."

12. The Committee notes from the above that a provision cannot be recognised simply because there is a published environmental policy of the company or the cost has been included in the FR/DPR or there is a legal or contractual obligation, until an event takes place which triggers creation of an obligation for an entity that leaves no realistic alternative to an enterprise apart from settling that obligation, and other conditions as mentioned in the above-reproduced paragraph 14 of AS 29 are also met. Thus, a provision should not be recognised before the obligating event arises under the provisions of law or the terms of the contract. A contingent liability should be disclosed when either there is a possible obligation arising from the past events, the existence of which will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise or there is a present obligation but is not recognised because the outflow of resources embodying economic benefits required to settle the obligation is not probable or a reliable estimate cannot be made of the amount of the obligation.

13. In the present case, as far as the obligating event for the rehabilitation/resettlement measures, such as those mentioned in paragraph 5I, 5II, and 5III are concerned, it appears to the Committee that the obligating event for the same arises as soon as the land is acquired from the project affected persons. This is so, even if the PAPs may not have fulfilled the necessary conditions for becoming individually entitled to receive the money, because, as far as the company is concerned, upon acquisition of land from

the PAPs it becomes liable to pay to the PAPs collectively. Accordingly, a provision in respect thereof, on the basis of best estimate of the expenditure required to settle the obligation, should be made on the acquisition of land from the project affected persons irrespective of fulfillment of various conditions by PAPs. With respect to the infrastructural facilities mentioned in paragraph 5 IV also, the point of time at which the provision should be made in the books of account would depend on the obligating event, which in the view of the Committee, is the acquisition of land by the company. The event of acquisition of land from the PAPs makes the company liable to provide the infrastructural facilities even though the contracts may not have been awarded for execution of those works. Accordingly, the accounting treatment being followed by the company in the present case as enumerated in paragraph 8 above is not correct and the same should be modified on the lines as discussed above.

D. Opinion

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

(i) The existing accounting practice being followed by the company is not in order. Please refer to paragraph 13 above.

(ii) (a) In respect of the estimated amount payable to the land oustees in respect of 'Land for Land', rehabilitation/ resettlement grants, subsistence grant/self-resettlement grant, a provision, on the basis of best estimate of the expenditure required to settle the obligation, should be made on the acquisition of land from the project affected persons as discussed in paragraph 13 above.

(b) In respect of infrastructural measures, a provision on the basis of best estimate of the expenditure required to settle the obligation, should be made on the acquisition of land from the project affected persons.

(iii) & (iv) Please refer to (ii) above.

Query No. 32

Subject: Provision towards environmental aspects – Thermal/ Gas Power Stations.[1]

A. Facts of the Case

1. A company is a Government of India undertaking incorporated in the year 1975 under the Companies Act, 1956. One of the objectives of the company is to set up power plants at various geographical locations in the country and to supply bulk power to various State Electricity Boards.

2. The company, being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. As per the querist, since the Government has not prescribed any format for statement of accounts for the central undertakings engaged in generation of electricity, the company is preparing its accounts in the format prescribed as per Schedule VI to the Companies Act, 1956. The company is also listed with the Bombay Stock Exchange and the National Stock Exchange.

3. The company has ambitious expansion and diversification plans for the future and aims to be a 75,000 MW company by the year 2017. Further, it intends to diversify by way of backward and forward integration. As a part of its diversification plans, it has entered into the hydro sector, coal mining and oil and gas exploration sectors. Before setting up the projects, the company prepares the feasibility report comprising demand analysis and justification, feasibility studies, layout systems, plant systems & works, environmental aspects, technical data, cost estimate and financial analysis, schedule of project implementation, manpower training and placement and operation and maintenance philosophy, etc.

4. The querist has stated that as per 'Mega Power Projects Policy' of the Government of India, all mega power projects require 'First Stage Site Clearance' from the Ministry of Environment and Forest (MOEF), Government of India. Further, no objection certificate is to be obtained from the State Pollution Control Board

[1] Opinion finalised by the Committee on 09.01.2009

as well as MOEF. Accordingly, for setting up thermal/gas power projects, the company obtains environment clearance from the Ministry of Environment & Forest of the Government of India and from the State Pollution Control Board. To minimise the pollution from power projects, various measures are undertaken by the company. These include installation of various plants and machinery in the various areas as indicated below. For execution of these works, separate award letters/contracts are issued by the company alongwith other contracts for the project. These works include construction/ installation/setting up of plant and machinery etc. in the power station, for example:

(i) Electrostatic precipitator for reducing ash emissions through smoke in the environment;

(ii) Chimneys;

(iii) Cooling towers;

(iv) Ash handling plant;

(v) Effluent treatment plant;

(vi) Dust extraction and supercession system;

(vii) Fire protection and explosion hazards;

(viii) De-mineralised water treatment systems;

(ix) Sewerage collection, treatment and disposal systems;

(x) Environmental lab equipments; and

(xi) Afforestation and green belt development

5. The querist has further stated that during the review of accounts for the year 2006-07, Government auditor observed that "Provisions do not include an obligatory expenditure towards environmental liabilities to be discharged by the company in respect of its projects under construction/expansion. By not making above provision, the company has violated the provisions of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets'."

6. According to the querist, the related provisions with regard to recognition of provision for a liability in AS 29 are as under:

Recognition of Provision:

"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."

Contingent Liability:

"26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14)."

7. The querist has explained the existing accounting treatment being followed by the company as under:

(i) Pending award of contracts for such works, the company is neither providing liability nor disclosing the same as contingent liability even though these works are included in the Feasibility Report (FR) or Detailed Project Report (DPR) of the company, since inclusion of the above works in the FR or DPR does not create present obligation for the company as a result of a past event or meet the requirement for disclosure of contingent liability in terms of provisions of AS 29 mentioned above.

(ii) On award of such works, the balance amounts of such contacts remaining to be executed are disclosed as 'Estimated amount of contracts remaining to be executed on Capital Account' in the 'Notes to Accounts' forming part of annual accounts.

(iii) On execution of such works, the amount paid to the contractors is debited to the 'Capital work-in-progress – Plant & Machinery' and liabilities for works executed and not paid as at the balance sheet date are provided for.

B. Query

8. Considering the applicable provisions of AS 29 and the present practice followed by the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the existing practice followed by the company indicated in paragraph 7(i) to 7(iii) is in order.

(ii) In case answer to (i) above is in the negative, whether the company should provide liability in respect of contracts mentioned above for which award letters will be issued in future and also the works will be executed only after award of such contracts.

(iii) In case no liability is to be provided in respect of the above works, whether any disclosure of this fact is to be made in the 'Notes to Accounts' forming part of annual accounts.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to timing of creation of

provision / disclosure of contingent liability towards various environmental measures undertaken by the company in the setting up of thermal/gas power stations as enumerated in paragraph 4 above. The Committee has, therefore, considered only this issue and has not touched upon any other issue arising from the Facts of the Case.

10. As far as recognition of provisions and disclosure of contingent liabilities are concerned, the Committee notes paragraph 14 and paragraphs 26 to 28 of AS 29 (as reproduced in paragraph 6 above), and the following definitions and paragraphs from AS 29, which provide as follows:

> ***"A provision is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***
>
> ***An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.***
>
> ***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."***

"Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation – an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."

"11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

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

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for

example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed —– indeed the obligation may be to the public at large."

11. The Committee notes from the above that a provision cannot be recognised simply because there is an approved cost or there is a legal or contractual obligation until an event takes place which triggers creation of an obligation for an entity that leaves no realistic alternative to an enterprise apart from settling that obligation, and other conditions as mentioned in the above-reproduced paragraph 14 of AS 29 are also met. Thus, a provision should not be recognised before the obligating event arises under the provisions of law or the terms of the contract. A contingent liability should be disclosed when either there is a possible obligation arising from the past events, the existence of which will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise or there is a present obligation but is not recognised because the outflow of resources embodying economic benefits required to settle the obligation is not probable or a reliable estimate cannot be made of the amount of the obligation. The Committee is of the view that simply existence of legal requirements to undertake various environmental measures or mere inclusion of various works in the Feasibility Report or Detailed Project Report does not create an obligation on the company, for undertaking these measures unless an obligating event has occurred.

12. As far as obligating events in respect of various measures enumerated in paragraph 4 above are concerned, the Committee is of the view that the obligating event in respect of afforestation and greenbelt development (mentioned in paragraph 4(xi) above) could arise either on the acquisition of land or at the start of the site preparation for setting up the power plants by way of cutting

trees, deforestation etc. or when the demand is raised by the concerned authorities for these works keeping in view the requirements of relevant law/terms of cotnract. As far as the obligating event in respect of construction/installation/setting up of various plant and machinery etc. as mentioned in paragraph 4(i) to 4(x) above is concerned, the Committee is of the view that the obligating event in this case should also be determined keeping in view the relevant legal/contractual requirements, for instance, the obligating event could be the performance of work by the concerned contractors, wholly or in part, as per the terms of the contract, rather than merely the award of the contract. Further, on commencement of execution of such works, the capital work-in-progress of the related asset should be debited to the extent of work executed. As far as disclosure of estimated amount of contracts remaining to be executed on capital account made by the company is concerned, the same is in accordance with the requirements of Schedule VI to the Companies Act, 1956 relating to the matters to be shown separately as a footnote to the balance sheet, as provided under the head 'Current Liabilities and Provisions' of Part I 'Form of Balance Sheet' of the Schedule VI.

D. Opinion

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

(i) Subject to paragraphs 11 and 12 above, the accounting treatment followed by the company as indicated in paragraph 7 above appears to be correct with respect to items of plant and machinery mentioned in paragraph 4(i) to 4(x) above. For afforestation and greenbelt development mentioned in paragraph 4(xi) above, please refer to paragraphs 11 & 12 above.

(ii) and (iii) With respect to the construction/installation/setting up of various items of plant and machinery mentioned in paragraph 4(i) to 4(x) above, no provision or contingent liability needs to be created or disclosed respectively in respect of contracts for which the award letters will be issued in future unless an obligating event in respect thereof has arisen as discussed in paragraphs 11 and

12 above. For afforestation and green belt development mentioned in paragraph 4(xi) above, please refer to paragraphs 11 & 12 above.

Query No. 33

Subject: Provision towards environmental aspects – Hydro Power Stations.[1]

A. Facts of the Case

1. A company is a Government of India undertaking incorporated in the year 1975 under the Companies Act, 1956. One of the objectives of the company is to set up power plants at various geographical locations in the country and to supply bulk power to various State Electricity Boards.

2. The company, being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. As per the querist, since the Government has not prescribed any format for statement of accounts for the central undertakings engaged in generation of electricity, the company is preparing its accounts in the format prescribed as per Schedule VI to the Companies Act, 1956. The company is also listed with the Bombay Stock Exchange and the National Stock Exchange.

3. The company has ambitious expansion and diversification plans for the future and aims to be a 75,000 MW company by the year 2017. Further, it intends to diversify by way of providing backward and forward integration. As a part of its diversification plans, it has entered into the hydro sector, coal mining, and oil and gas exploration sectors.

4. The querist has stated that before setting up the projects,

[1] Opinion finalised by the Committee on 09.01.2009

the company prepares the feasibility report comprising demand analysis and justification, feasibility studies, layout systems, plant systems and works, environmental aspects, technical data, cost estimate and financial analysis, schedule of project implementation, manpower training and placement, and operation and maintenance philosophy, etc.

5. The querist has also informed that as per Mega Power Projects Policy of the Government of India, all mega power projects require 'First Stage Site Clearance' from the Ministry of Environment and Forest (MOEF), Government of India. Further, no objection certificate is to be obtained from the State Pollution Control Board as well as the MOEF. Accordingly, for setting up Hydel Power Projects, the company obtains environment clearance from the Ministry of Environment and Forest of the Government of India/ concerned State and also clearance from the State Pollution Control Board. To minimise the pollution from hydel power projects, various measures are undertaken by the company. These include:

(a) Compensatory afforestation;

(b) Greenbelt development around the perimeters of the project;

(c) Catchment area treatment;

(d) Installation of following plant and machinery to reduce noise and water pollution:

   (i) Effluent treatment plant;

   (ii) Fire protection and explosion hazards;

   (iii) De-mineralised water treatment systems;

   (iv) Sewerage collection, treatment and disposal systems; and

   (v) Environmental lab equipments.

6. According to the querist, in respect of compensatory afforestation, greenbelt development around the perimeters of the project and the catchment area treatment, amounts are paid to the

concerned State Governments for carrying out the works. For execution of the works mentioned at paragraph 5(d) above, separate award letters/contracts are issued by the company alongwith other contracts for the project. These works include construction/ installation/setting up of plant and machinery, etc. in the power station.

7. During review of accounts for the financial year 2006-07, the Government auditor observed that "Provisions do not include an obligatory expenditure towards environmental liabilities to be discharged by the company in respect of its projects under construction/expansion. By not making above provision, the company has violated the provisions of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets'."

8. According to the querist, the related requirements with regard to recognition of provision for a liability in AS 29, issued by the Institute of Chartered Accountants of India, are as under:

Recognition of Provision:

"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."

Contingent Liability:

"26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14)."

9. The querist has stated that the existing accounting treatment being followed by the company is as follows:

(i) The company is neither providing liability nor disclosing the same as contingent liability in respect of works mentioned at paragraph 5 above which are only included in the approved Feasibility Report (FR) or Detailed Project Report (DPR) of the company, since mere inclusion of the above works in the FR or DPR does not create present obligation for the company as a result of a past event or meet the requirement for disclosure of contingent liability in terms of AS 29 mentioned above.

(ii) The amounts agreed to be paid by the company to the State Government towards compensatory afforestation, greenbelt development around the perimeters of the project and the catchment area treatment are disclosed as 'Estimated amount of contracts remaining to be executed on Capital Account' in the 'Notes to Accounts' forming part of annual accounts.

(iii) The amounts paid by the company to the State Government on receipt of demand for carrying out compensatory afforestation, greenbelt development and the catchment area treatment are accounted as 'Capital work-in-progress – incidental expenditure towards diversion of forest land'.

(iv) On award of contracts indicated at paragraph 5(d) above, the amounts of such contracts remaining to be executed are disclosed as 'Estimated amount of contracts remaining to be executed on Capital Account' in the 'Notes to Accounts' forming part of annual accounts.

(v) On execution of such works, the amount paid to the contractors is debited to the 'Capital Work-in-progress – Plant & Machinery' and liabilities for works executed and not paid as at the balance sheet date are provided for.

B. Query

10. Considering the applicable provisions of AS 29 and the present practice followed by the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the existing accounting treatment followed by the company indicated at paragraph 9(i) to (v) above is in order.

(ii) In case the answer to (i) above is in the negative, whether the company should provide liability in respect of contracts mentioned at paragraph 5 above for which agreements/award letters will be signed/issued in future and also the works will be executed only after award of such contracts.

(iii) In case no liability is to be provided for in respect of the above works, whether any disclosure is required to be made in the 'Notes to Accounts' forming part of annual accounts.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised in the query primarily relates to timing of creation of provision and disclosure of contingent liability in relation to various environmental measures undertaken by the company for setting up of power plant projects. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, accounting for the expenditure involved in preparation of feasibility and detailed project reports, etc.

12. As far as recognition of provisions and disclosure of contingent liabilities are concerned, the Committee notes paragraph 14 and paragraphs 26 to 28 of AS 29 (as reproduced in paragraph 8

above), and the following definitions and paragraphs from AS 29, which provide as follows:

> ***"A provision is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***
>
> ***An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.***
>
> ***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."***
>
> ***"Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.***
>
> ***Possible obligation – an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."***

"11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

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

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the

identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large.”

13. The Committee notes from the above that a provision cannot be recognised simply because there is an approved cost or there is a legal or contractual obligation until an event takes place which triggers creation of an obligation for an entity that leaves no realistic alternative to an enterprise apart from settling that obligation, and other conditions as mentioned in the above-reproduced paragraph 14 of AS 29 are also met. Thus, a provision should not be recognised before the obligating event arises under the provisions of law or the terms of contract. A contingent liability should be disclosed when either there is a possible obligation arising from the past events, the existence of which will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise or there is a present obligation but is not recognised because the outflow of resources embodying economic benefits required to settle the obligation is not probable or a reliable estimate cannot be made of the amount of the obligation. The Committee is of the view that simply existence of legal requirements to undertake various environmental measures does not create an obligation on the company for undertaking these measures unless an obligating event has occurred.

14. On the basis of the above, the Committee is of the view that the obligating event in respect of compensatory afforestation, greenbelt development and catchment area treatment (mentioned in paragraphs 5(a) to (c) above) could arise either on the acquisition of land or at the start of the site preparation for setting up the power plants by way of cutting trees, deforestation etc. or when the demand is raised by the State Governments for these works, keeping in view the requirements of relevant law/terms of contract rather than inclusion of these items in the Feasibility Report or Detailed Project Report. As far as the obligating event in respect of works to be executed under paragraph 5(d) above is concerned, the Committee is of the view that the obligating event in this case should also be determined keeping in view the relevant legal/contractual requirements, for instance, the obligating event could be the performance of work by the concerned contractors, wholly

or in part, as per the terms of contract, rather than merely the award of the contract. With regard to disclosure as contingent liability also, the Committee is of the view that a possible obligation does not arise merely on inclusion of various works in the Feasibility Report or Detailed Project Report. The disclosure of estimated amount of contracts remaining to be executed on capital account made by the company is in accordance with the requirements of Schedule VI to the Companies Act, 1956 relating to the matters to be shown separately as a footnote to the balance sheet, as provided under the head 'Current Liabilities and Provisions' of Part I 'Form of Balance Sheet' of Schedule VI .

D. Opinion

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

(i) It is not appropriate to create a provision or to make a disclosure as contingent liability in respect of works mentioned at paragraph 5 above merely on inclusion thereof in the approved Feasibility Report or Detailed Project Report. A provision is required to be made in case the agreement on the part of the company to pay amounts to the State Government creates an obligation for the company. The treatment mentioned in sub-paragraphs (iii), (iv) and (v) of paragraph 9 above appears to be correct in respect of the stages mentioned in the sub-paragraphs. However, creation of provision or disclosure of contingent liability needs to be made in respect of the relevant expenditures at the time the obligating event takes place as discussed in paragraphs 13 and 14 above.

(ii) & (iii) Please see (i) above.

Query No. 34

Subject **Reopening and revision of accounts/qualification on opening balances by the auditor.[1]**

A. Facts of the Case

1. An unlisted State Government undertaking deals in transportation of passengers by trams and buses in the city of Kolkata. The company was incorporated at London in the year 1880. Later, the company was taken over by the State Government in the year 1976 and the new company was incorporated on 15th October, 1982. Apart from regular audit by the Office of the Principal Accountant General (the State), the company is audited by statutory auditors appointed by the Comptroller and Auditor General of India (C&AG), New Delhi. During the financial year 2006-07, a new auditor has been appointed to audit the accounts of the company. An issue has been raised by the statutory auditors during the course of their audit. The background of the issue is contained in the following paragraphs.

2. The company had outstanding dues to another company, XYZ Ltd. in the form of fuel surcharge on account of high tension electricity (amounting to Rs. 20,59,22,169) and delayed payment surcharge (Rs. 25,35,37,643). The querist has stated that the State Government sanctioned an amount of Rs. 45,94,59,812 in the financial year 2001-02 in the form of capital grant towards settlement of the said outstanding dues to XYZ Ltd. by book adjustment against some receivables from XYZ Ltd. by the State Government. A copy of Order No. 2907-F.B. dated 5.11.2001 of the State Government has been supplied by the querist for the perusal of the Committee. The company running the trams had been unable to pay to XYZ Ltd. the electricity charges since a long time. The delayed payment surcharge (Rs. 25.36 crore) was disclosed as a contingent liability by the company. The company was unable to pay the debt to XYZ Ltd. as it was beyond its means due to its capital having been totally eroded due to continuous losses year after year. The State Government came to a settlement with XYZ Ltd. with regard to the dues for the energy bills of the company, which is wholly owned by the State Government. In the said

[1] Opinion finalised by the Committee on 09.01.2009

settlement, the Director of the Electricity Board, State Government, adjusted the unpaid electricity consumption bills of the company along with other local/public bodies against the sum which XYZ Ltd. owed to the State Government by way of electricity duty. Thus, the adjustment of the company's accumulated debt and delayed payment surcharge to XYZ Ltd. was by book entry. There was contra-debiting the debt of the company to the head, '3055 Road Transport-00-800-other expenses-Non-plan-005-grant to the company for adjustment of energy bill of XYZ Ltd. (TR) 31-grant-IN-Plan-02-Other grant'. As per the querist, the communication dated 5.11.2001 of the State Government in this connection bears out the facts stated. Thus, as per the querist, it is clear from the nature of the grant by the State Government that the entire grant *was for the purpose of stemming the erosion of the capital of the company, which is owned by the State Government* (emphasis supplied by the querist). According to the querist, it is an SOS act of the State Government to improve the liquidity position of its own undertaking and keep it going in the larger public interest. The adjustment with XYZ Ltd. was only a mode as the State Government had to receive its dues from XYZ Ltd.

3. According to the querist, the accounting narration of the State Government, as indicated above, clearly shows that the intention of the State Government was to save the sub-stratum of the company, its own undertaking, which was on a high funds crisis. The Government came forward to help its own undertaking and thus, ensure its survival. The State Government found this necessary in the interest of maintaining the mass conveyance of public transport system in the city in which the wholly owned company of the State Government has been playing a major role for a century and a quarter. The grant is an imperative step for strengthening its capital base.

4. The querist has stated that the Deputy Secretary to the State Government vide letter no. 2578-WT/TR/P/7T-7/2005 dated 08th June, 2005 had clarified that the grant is provided to its wholly owned company to assist in overcoming the shortage of capital and thus, it is a capital contribution. As per the querist, the letter in this connection bears out the facts stated above.

5. The querist has further stated that in the assessment procedure of Assessment Year 2002-03, the fact was raised by the A.C.I.T. and he declined to accept it as a capital grant. The company contended the views of the assessing officer and approached the higher authority. The C.I.T. (A) and then I.T.A.T. (Kol.) rejected the views of A.C.I.T. and upheld the company's view supported by the documents received from its 100% owner, the State Government.

6. A similar situation arose in the financial year 2005-06, when the State Government vide its order no. 103-WT(F)/TR/N/7T-9/2003 dated 6th July, 2005, sanctioned a grant of Rs. 2 crore for adjustment against electricity dues to XYZ Ltd. upto March 2005. A copy of the said order has been supplied by the querist for the perusal of the Committee. As per the querist, it is the government's policy to adjust the dues against government fuel surcharge dues from XYZ Ltd. by book adjustments. As experienced from previous years and as a prudent matter, the company treated the same as capital receipt and showed under capital reserve as evidenced from the balance sheet. The statutory auditors sought explanation to the transaction and after scrutinising all the papers, they admitted that the transaction was rightly treated in the accounts. The matter was also taken up by the Resident Audit Officer, C.A.G., vide their query no. AQ/1/CTC/Annual A/cs/2005-06 dated 03.11.2006 relating to audit query of financial year 2005-06. The company replied the matter as stated above and the statutory auditors also agreed with the management's reply. After being satisfied with the reply, the Principal Accountant General (Audit), the State, served his report with "no comments" for the financial year 2005-06.

7. During the audit for the financial year 2006-07, the statutory auditors for that year again raised the question over the transaction and the company narrated the matter as above though the transaction did not pertain to the year under audit. It was purely a previous year's transaction, which occurred and transacted in the same year itself. The company also submitted to the auditors all the papers relating to the financial year 2001-02 and 2005-06 as evidence and tried to explain that the matter is well settled. However, they suggested the company to ignore all the facts that happened earlier and make changes in the current year's accounts, to which

the company denied. The auditors accordingly qualified the accounts vide qualification no. 4.6(ii)(a), which reads as below:

> “(a) The sanction of payment in the previous year by the State Government of Rs. 200 lakh as a subsidy to clear off “outstanding electricity charges upto March 2005” has been treated as capital grant awarded by the State Government “to rescue out the company from capital erosion” instead of treating the same as revenue subsidy in terms of Accounting Standard (AS) 12, ‘Accounting for Government Grants’ like other revenue subsidies received and accounted for. This has resulted in overstating the carrying amount of loss and capital reserve by Rs. 200 lakh. Further, the nomenclature, “capital grant awarded by the State Government (Promoter) to rescue out the company from capital erosion” in the capital reserve as disclosed by the company is not as per documents available. However, we have been informed by the management that the C&AG and the previous auditor of the company have supported the accounting treatment as well as disclosure made by the company.”

8. The situation being peculiar and unforeseen by the company, the querist desires to know whether an auditor can ignore the views of previous auditors appointed by the C&AG and cleared by the C&AG itself. If so, in the view of the querist, the sanctity of the auditors’ report upon which one relies is questionable. As per the querist, the matter was not overlooked by anybody but discussed at length by every authority. Further, if it is appropriate for the auditor to raise the issue again, then infinite number of financial statements of previous years can be reconstructed and there would not be any final structure of financial statements in any year though it is created by adopting proper accounting norms and duly audited by appropriate authority.

B. Query

9. The querist has been advised to seek the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issues:

(i) The subject matter of auditors’ qualification no. 4.6(ii)(a), relates to the financial year 2005-06. Whether the statutory auditors can re-open and recommend changes of the duly audited accounts of prior years in the current year, on the plea that they are not in agreement with the treatment of past year transactions, even if past statutory auditors appointed by the C&AG, Principal Accountant General (of the State) and the Income-tax Department [C.I.T. (A) and Tribunal] have approved the treatment in the accounts in that year.

(ii) Whether the current year's auditors can recommend changes in past years' audited financial statements or qualify the statements only because they dispute the accounting treatment of an item of opening balance which was duly audited and certified by a fellow member of the Institute.

C. Points considered by the Committee

10. The Committee, while answering the query has considered only the issues raised in paragraph 9 above and has not touched upon any other issue(s) arising from the Facts of the Case, such as, the propriety of accounting for the grant received from the State Government in the context of which the current auditors have qualified the financial statements vide their qualification no. 4.6(ii)(a), etc.

11. The Committee notes the following paragraphs of Standard on Auditing (SA) 510 (AAS 22), 'Initial Engagements – Opening Balances', issued by the Institute of Chartered Accountants of India (ICAI):

> "1. The purpose of this Standard on Auditing (SA) is to establish standards regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. This Standard would also be considered by the auditor so that he may become aware of contingencies and commitments existing at the beginning of the current period."
>
> **"3. For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:**

(a) the closing balances of the preceding period have been correctly brought forward to the current period;

(b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(c) appropriate accounting policies are consistently applied."

"6. The auditor will need to consider whether the accounting policies followed in the preceding period, as per which the opening balances have been arrived at, were appropriate and that those policies are consistently applied in the financial statements for the current period and where such accounting policies are inappropriate, the same have been changed in the current period and adequately disclosed.

7. When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated."

"12. If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate."

12. From the above, the Committee notes that even though the opening balances reflect the effect of the preceding periods, these form an integral part of the financial statements for the current period. If the opening balances are not correct, the financial statements for the period will not portray a true and fair view. Accordingly, it is the duty of every auditor to ensure that the opening balances have been arrived at using appropriate accounting policies. For this, the auditor will need to consider the

appropriateness of the accounting policies followed in the preceding period by examining the records underlying the opening balances. If based upon above procedures, the auditor concludes that the accounting policies are inappropriate, the auditor needs to consider whether the same have been changed in the current period and adequately disclosed in accordance with the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' and other pronouncements of the ICAI. In other words, the auditor needs to consider whether the same have been rectified through rectification entries in the current year. In case the effect of the incorrect opening balances is not properly accounted for and adequately disclosed in the accounts for the current year, the auditor should express a qualified or an adverse opinion, as appropriate. The Committee also notes paragraph 3.5 of the Preface to the Statements of Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) which states that the responsibility for the preparation of financial statements and for adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements. Thus, the Committee is of the view that the auditor cannot on his own re-open the duly audited accounts of prior years in the current year and recommend changes therein. He can only express his opinion on the accounts for the year under audit. Accordingly, in case of incorrect opening balances, the rectification of the same will have to be carried out in the current year's accounts through appropriate entries.

13. From the above, the Committee is of the view that under the given circumstances of the company under consideration, the auditor on his own cannot reopen the duly audited accounts of the prior years and recommend changes therein. However, since the opening balances are an integral part of the financial statements for the current period, if in the opinion of the auditor, the opening balances are not based on appropriate accounting policies and the effect thereof is not properly accounted for (i.e., rectified) and adequately disclosed in the accounts for the current year, the auditor should qualify his audit report on the accounts of the current year or give an adverse report, as deemed appropriate by him.

D. Opinion

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

(i) The auditors cannot on their own reopen the duly audited and adopted accounts of prior years and recommend changes therein in the current year on the plea that they are not in agreement with the treatment of past year transactions. The auditors can only express their opinion on the accounts for the year under audit.

(ii) The auditors cannot recommend changes in the past year's audited financial statements. However, since the opening balances are an integral part of the financial statements for the current period, if in the opinion of the auditor, the opening balances are not based on appropriate accounting policies and the effect thereof is not properly accounted for (i.e., rectified) and adequately disclosed in the accounts for the current year, the auditor should qualify his audit report on the accounts of the current year or give an adverse report, as deemed appropriate by him.

Query No. 35

Subject: Treatment of expenditure during construction period.[1]

A. Facts of the Case

1. A company was incorporated in the year 2003. Its registered office is located in Tamil Nadu (TN). It has its project office and is constructing its first power project within the State. As on date, the

[1] Opinion finalised by the Committee on 09.01.2009

company has no other branch/ unit and is a single project company. Further projects will be taken-up after another 2-3 years only. Construction activity will go on till the financial year 2010-11, when the commissioning activity will start. The commissioning activity/ stabilisation may take 6-8 months' time and, hence, commercial operations are likely to start in the financial year 2011-12 only. Accordingly, as on date, there is no other operation and maintenance (O&M)/ revenue activity. The company, however, earns certain interest on bank deposits from time to time.

2. According to the querist, for such a long duration project, at times, there is a need to adopt more than one option/approach for a particular construction activity. Ultimately, it will be any one of those options which will finally be adopted and the rest may have to be abandoned in between due to circumstances, on which, some costs might have been incurred or the company may have to pay foreclosure costs.

3. The company has recruited certain manpower, traditionally called as O&M manpower. During construction phase, some of them have been sent on training for O&M. The O&M training is a long term activity and goes on for about a year. Even thereafter, they will be placed on 'on the job activities' in some operating unit or on some simulator. There being no watertight segregation, a few of the O&M appointees may be involved in the construction activities going on at present. The O&M staff needs to be qualified and licensed before commissioning activities are undertaken. It is then only that the regulators will give permission for commissioning activities to start. At that time, they all will be placed on activities related to commissioning and, thereafter, for O&M in due course. Without trained, qualified and licensed man power in place by the time of commissioning (which is routinely called/ known as O&M man power), commissioning is just not possible as regulatory clearances will not be forthcoming.

4. For such a long duration project, the company feels that it needs to have a conducive atmosphere within and around the project, because any disruption due to unrest from within or in the surroundings can cause delay in completion of the project, thereby causing more completion/ capital costs on the project. Removal of

local fears and winning over confidence and support of locals are, therefore, prerequisites for timely completion of the project. With this objective and due approvals, the company plans to spend about Rs. 25 lakh every year for 'Neighborhood Development'. This is used for construction of small infrastructure items in nearby villages, helping them for their education and health related activities. From the company's view point, though the project is at the construction stage and has no revenue generating activities, this type of expenditure is unavoidable and has a long term advantage for the company.

5. Cost of the project in hand is about Rs. 3,500 crore. Whereas outlay during the financial year 2007-08 was Rs. 390 crore, the amount involved in the three points given in paragraph 6 below was Rs. 50.24 lakh, Rs. 36.79 lakh and Rs. 12.46 lakh, respectively. (So, according to the querist, materiality, perhaps, may not be there.)

6. The querist has stated that the auditor has raised a point as below:

> "…Statement of Expenditure during construction, pending allocation…includes Rs. 99.49 lakh in respect of the following items which are not represented by an asset in physical form :

		Rs. in Lakh
(i)	Amount paid towards compensation for foreclosure of work order of shifting an equipment, using 'strand jack system'.	50.24
(ii)	Amount incurred on construction of community hall, compound wall of a school	36.79
(iii)	Stipend paid to trainees.	12.46
	Total	99.49

> As the expenditure cannot be allocated to any asset, it should have been treated as 'Miscellaneous Expenditure', to be written off as 'deferred revenue expenditure' as and when the project

is put into commercial operations and not as 'Expenditure during construction , pending allocation'.

Thus miscellaneous expenditure is understated with overstatement of 'Expenditure during construction, pending allocation' by Rs. 99.49 lakh."

7. The company's view for each of the item is as given below:

Nature of Expenditure and Audit's point	**Company's view**
(i) Amount paid towards compensation for foreclosure of work order of shifting an equipment, using 'strand jack system'	
Rs. 50.24 lakh was paid towards compensation for the foreclosure of a work order, which was issued for shifting and erection of project components, using a lifting/ movement system called 'strand jack system'. (Audit viewed that this should be accounted for under miscellaneous expenditure to be written off to revenue once commercial activities start.)	Company's view is that use of heavy duty cranes for erection of various over dimensional components in any major industry is a common methodology. At the same time, it is also very common to use strand jack systems for such activities. (In strand jack system, items like girders and handling structures are used.) To save time for erection of a large sized component in the absence of cranes, it was planned to use strand jack system. Since regulatory clearance was a must for such activities, option for crane hiring/purchase was also pursued in parallel. However, the regulatory clearance for installation by strand jack system was taking more time. Hence, it was decided to go for heavy duty crawler crane - leaving the other option mid way.

	The company, therefore, viewed that since the expense is incurred for a technical option, which is very much relevant to the erection of a project component, this expense on foreclosure, though will not form part as direct cost to the asset, needs to be treated as 'expenditure during construction' ('EDC') and hence, shown correctly as an indirect cost for completion of the project.
(ii) Amount incurred on construction of community hall, compound wall of a school	
A sum of Rs. 36.79 lakh was spent on construction of community hall and compound wall in schools in nearby villages. (Audit viewed that this should be accounted for under miscellaneous expenditure to be written off to revenue once commercial activities start.)	Company's view is that before starting of any mega project of this magnitude, a lot of clearances are required to be undertaken and it involves public hearing as well. During such public hearings (before the State/Central Government gave clearance for construction of this mega project), the neighbouring villagers had made a lot of demands asking for certain basic needs and improvements/ developments in the neighbouring villages. Though there is no revenue earning during construction phase for the company, yet the expenditure is being incurred by the company to keep up those

	assurances only. Hence, for this type of mega project, this sort of expenditure is practically an essential expenditure during construction. The company further viewed that though it is a fact that it is spending when there is no revenue income, but this being a sort of prerequisite for the project, the expenditure is a necessity, so as to see that the project implementation is without any hindrance, which otherwise can cause delay in construction/completion of the project, and thus indirectly can surely increase the capital costs for the project, and such additional costs for completion of project will have to be treated as EDC only. Keeping in view the above, the company is of the view that since the expense has an indirect contribution towards completion of the project, this is certainly an incidental item to the capital expenditure only and should be treated as EDC and not as 'miscellaneous expenditure', to be written off to revenue after start of commercial activities.
(iii) Payment of stipend to trainees	
Stipend amount paid to trainees – Rs. 12.46 lakh.	The company viewed that though this expenditure

Salaries and wages include a sum of Rs. 12.46 lakh being the stipend amount paid to trainees. These trainees, tradesmen and scientific assistants are recruited and are being trained for their deployment in operation and maintenance activities after construction is completed. (Audit viewed that this should be accounted for under miscellaneous expenditure to be written off to revenue once commercial activities start as per paragraph 6.2 of the Guidance Note on Treatment of Expenditure during Construction Period).	pertains to the scientific/ technical employees recruited for ultimate objective - operations and maintenance (O&M) of the plant once commercial operations start, and are traditionally being called as 'O&M manpower' but before operational phase, commissioning phase is a must to enable the plant to start commercial activities. It is with this staff only that the required commissioning phase will be completed, without which entering into revenue phase is just not possible – as it required qualification/licensing and clearances from regulators. It was further viewed that for the type of industry in which the company is in, 'appropriate training' is a prerequisite, before anyone is put on the commissioning, operations and maintenance of the power plant. The nature of operations are such that no chance/ risk can be taken in this regard. It was further viewed that for an organisation which has operations and construction activities at the same time, people are given such exposure during operations in the operating station – in a pooled manner. But being a single

project company as of now and there being no other operating plant as on date, in order to have a qualified man power on the date of commissioning, people are required to be recruited well before start of commissioning activities and are required to be given the operations and maintenance related training. It may be appreciated that it is *not* a general training of sales or other auxiliary staff but it is to enable the plant to start commissioning operations (emphasis supplied by the querist).

Therefore, such expenses are essential and are to be incurred much before the plant commences its commercial operations and hence, need to be treated as a part of expenses to enable an asset to perform once commercial operations start.

Not only this, it is with this trained manpower only, that commissioning activities can start and authorisation to commission the plant will be given by the regulators. Commissioning activities take about 6-8 months time. It is thereafter only, the plant can go to commercial stage.

	Therefore, this trained man power is a must during construction and without this, the construction just cannot be completed. The company's view, therefore, is that the training cost cannot be treated as a normal training given to other auxiliary/ administrative staff. Since this training is very much a prerequisite before commissioning activities start, the expenditure incurred thereon, therefore, needs to be treated as indirect expenditure, incidental and related to construction as without this, the plant, even if it is ready, just cannot start functioning. The expenditure, therefore, is not of deferred revenue in nature in the view of the company and needed to be treated as incidental to construction only, i.e., EDC.

8. According to the querist, the company took into consideration the following:

(i) Nature of its present activities – as stated in paragraphs 1 to 5 above.

(ii) Guidance Note issued by the Institute of Chartered Accountants of India on Treatment of Expenditure during Construction Period, which also suggests that sometimes circumstances force a project to incur a capital expenditure which is not represented by any specific or any tangible asset and that in such cases, the expenditure so incurred would have to be treated in the books of account as capital expenditure and not as revenue expenditure.

(iii) Accounting Standard (AS) 26, 'Intangible Assets', issued by the Institute of Chartered Accountants of India which, as per the querist, requires that deferred revenue expenditure incurred on or after 1st April, 2003, should be written off as current year expenses only.

9. As per the querist, keeping in view the points mentioned in paragraph 8 above, it was viewed by his professional colleagues that the three types of expenses (stated and detailed in paragraph 7 above) should be treated as 'expenditure during construction' and not as deferred revenue expenditure to be written off as and when the project is put into commercial operations. The company has accordingly treated the three types of expenses in its annual financial statements.

B. Query

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

(i) Whether the expenses stated and detailed in paragraph 7 above can be treated as 'miscellaneous expenditure', to be written off as 'deferred revenue expenditure' as and when the project is put into commercial operations.

(ii) Whether it is correct/ fair to treat these expenses as 'expenditure during construction, pending allocation'.

(iii) Whether there is any other treatment and if so, it may be elaborated.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the specific three types of expenses incurred during the construction period. Therefore, the Committee has examined only this issue and has not considered any other issue that may be contained in the Facts of the Case.

12. At the outset, the Committee wishes to point out that recommendations of a Guidance Note would be applicable only to the extent that they are not contrary to an Accounting Standard. Hence, the recommendations of the 'Guidance Note on Treatment of Expenditure during Construction Period'[2] may be considered, only if they are not contrary to an Accounting Standard. In particular, the Committee notes that for the accounting year under consideration viz. 2007-08, Accounting Standard (AS) 26, 'Intangible Assets', notified by the Central Government under the Companies (Accounting Standards) Rules, 2006 (the 'Rules') is applicable. Further, the Committee notes that a project may consist of several fixed tangible and intangible assets. The Committee is of the view that if an expenditure is eligible for capitalisation based on the applicable Accounting Standard, such as, Accounting Standard (AS) 10, 'Accounting for Fixed Assets', it should be accorded the following treatment:

(i) If the expenditure results in the acquisition of an asset, it should be directly capitalised as part of cost of that asset.

(ii) If the expenditure is directly related to, or benefits, a particular asset under construction, it should be booked to capital work in progress and identified with the relevant asset under construction. In establishing whether the expenditure directly benefits or is related to an asset, a nexus between the expenditure and the benefit/ relationship with the asset can be established technologically.

(iii) If the expenditure is related to, or benefits, more than one asset under construction, it should be booked to 'expenditure during construction' and capitalised as part of cost of the relevant assets appropriately at the time of completing the exercise of capitalisation.

Further, the Committee is of the view that if an expenditure is not eligible for capitalisation, it should be expensed, unless another

[2] The Guidance Note on Treatment of Expenditure during Construction Period has been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision at its 280th meeting held on August 7-9, 2008.

Accounting Standard requires or permits a different treatment.

Amount paid towards compensation for foreclosure of work order of shifting an equipment, using 'strand jack system'

13. The Committee notes from the Facts of the Case that strand jack system was initially contemplated to save erection time in the absence of cranes. At the same time, since it requires regulatory approval, option for crane hiring/purchase was also pursued in parallel. Since the regulatory approval was taking time, it was decided to go for heavy duty crawler crane, leaving the option of strand jack system midway. In this connection, the Committee notes the following paragraphs from AS 10 notified under the 'Rules':

> "9.1 The cost of an item of fixed asset comprises ...any directly attributable cost of bringing the asset to its working condition for its intended use…
>
> 9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.
>
> 9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost…"
>
> "10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5[3]. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

[3] To be read as 9.4.

> ***"20. The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.***
>
> ***21. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset."***

14. The Committee is of the view that compensation for foreclosure of the option of strand jack system is an expenditure incurred in stopping a particular course of action and is not directly attributable to bringing an asset (or the relevant assets) to its (their) working condition. On the basis of the principles of AS 10 quoted in paragraph 13 above in conjunction with the principles mentioned in paragraph 12 above, the Committee is of the view that such compensation is not eligible for capitalisation and the same should be expensed, since, a different accounting treatment is not required or permitted in any other Accounting Standard.

Amount incurred on construction of community hall, compound wall of a school

15. As regards the expenditure incurred on construction of community hall and compound wall to school, though the said expenditure might have avoided possible delay in construction/ completion of the project and possible cost overrun as stated by the company in paragraph 7 above, the said expenditure was not incurred for the purpose of construction of any asset(s) and/or for bringing the asset to its working condition for its intended use. The Committee notes that the main purpose of the expenditure is removal of local fears and winning over confidence and support of locals. As stated by the querist in paragraph 4 above, this has long term advantage for the company. The Committee is of the view that this is akin to expenditure incurred on internally generated goodwill. Relevant paragraphs of AS 26 are reproduced below:

> "***35. Internally generated goodwill should not be recognised as an asset.***

36. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost."

"55. Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

> ***(a) it forms part of the cost of an intangible asset that meets the recognition criteria…; or***
>
> ***..."***

16. From the above, the Committee is of the view that expenditure incurred on construction of community hall and compound wall to school should be expensed, since a different accounting treatment is not required or permitted in any other Accounting Standard for such expenditure.

Payment of stipend to trainees

17. As regards the stipend to trainees (O & M staff), the Committee notes from the Facts of the Case that a few of them may be involved in the construction activities going on at present. The Committee is of the view that to the extent the trainees are involved in construction activities, the stipend should form part of capital work in progress, if those activities are identifiable with a specific fixed asset, or 'expenditure during construction, pending allocation' if those activities are identifiable with more than one fixed asset, as the case may be. To the extent the trainees are not involved in construction during the period, the project is under construction, the stipend should be expensed, since, a different accounting treatment is not required or permitted in any other Accounting Standard for that expenditure. In particular, the Committee notes the following portion of paragraph 56 of AS 26 (read in conjunction with paragraph 55 of AS 26 quoted in paragraph 15 above).

> "56. …Examples of other expenditure that is recognised as an expense when it is incurred include:
>
> (a) …
>
> (b) expenditure on training activities;
>
> (c) …
>
> (d) …"

The Committee is of the view that the above paragraph 56 of AS 26 is applicable for all types of training and not restricted to general training of sales or other auxiliary/administrative staff. Though training may be necessary to get authorisation to commission the plant and to enable the plant to start commissioning operations, the training expenditure is not incurred for construction of any asset(s) and/or bringing the asset to its working condition for its intended use.

D. Opinion

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

(i) The expenses stated and detailed in paragraph 7 above cannot be treated as 'miscellaneous expenditure', to be written off as 'deferred revenue expenditure' as and when the project is put into commercial operations.

(ii) It is not correct/fair to treat these expenses as 'expenditure during construction, pending allocation', except for stipend paid to trainees involved in construction activities when those activities are identifiable with more than one fixed asset.

(iii) Compensation for foreclosure of work order for strand jack system, expenditure incurred on construction of community hall, etc. and stipend paid to trainees not involved in construction activities should be expensed. Stipend to trainees involved in construction activities should form part of capital work in progress, if those activities are identifiable with a specific fixed asset, or 'expenditure during construction period, pending allocation' if those activities are identifiable with more than one fixed asset.

Query No. 36

Subject: Provision for LTC benefits provided to employees.[1]

A. Facts of the Case

1. A company was incorporated in the year 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 company has adopted the following accounting policy for leave travel concession (LTC) benefit provided to the employees:

> "Expenditure on leave travel concession to employees is recognised in the year of availment due to uncertainties in accrual."

3. LTC is admissible to employees and members of their families once in a block of two years. In a block period, an employee has the following options:

(i) Visit to home town

(ii) Visit to any place in India (Bharat Darshan)

[1] Opinion finalised by the Committee on 09.01.2009

(iii) Visit to any place in lieu of home town subject to the maximum of distance as per his/her entitlement (which varies from grade to grade)

(iv) Encashment of value of fare entitled in lieu of home town LTC subject to the maximum of distance as per his/her entitlement (which varies from grade to grade)

(v) Payment of cash assistance in case of actual journey, which varies from grade to grade.

(vi) Entitlement of LTC to children of the employees from their place of study (if different from place of posting) to place of posting of the employee once in a calendar year.

Besides, as per LTC rules of the company, an employee is allowed to carry forward the non-availment of LTC in a block period to the next block of two years.

4. As per the querist, the above policy with respect to LTC has been adopted since it is

(i) difficult to assess the frequency of LTC availment,

(ii) difficult to assess the option that would be exercised by an employee,

(iii) difficult to provide for liability for a particular year as the employee has the option to carry forward the non-availment to future block, and

(iv) uncertainty prevails over encashment/availment of LTC.

The querist has stated that the company is of the view that considering the above options available to employees, it is difficult to make a fair assessment of the liability in terms of Accounting Standard (AS) 15, ‘Employee Benefits (revised 2005)’. As per the querist, even if the company makes the valuation as per AS 15 (revised 2005), the provision will be far from reality.

B. Query

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

(i) Whether the accounting policy adopted by the company is in compliance with the existing Accounting Standard and in line with the standard accounting principles.

(ii) Whether it is mandatory to create provision for LTC in the books of account after taking into account the actuarial valuation as per AS 15 (revised).

C. Points considered by the Committee

6. 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 (revised 2005) are based on the aforesaid principle. AS 15 recognises that the liability towards employee benefits should be provided as and when the services are rendered.

7. The Committee notes the following definition of 'other long-term employee benefits' as contained in AS 15 (revised 2005):

> ***"Other long-term employee benefits 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."***

The Committee is of the view that the LTC benefits provided by the company to its employees fall in the category of 'other long-term employee benefits' as reproduced above, since the LTC benefit can be availed in a block period of 2 years. 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.

8. The Committee is of the view that actuarial basis of valuation takes into account various uncertainties and therefore the various difficulties mentioned by the querist in paragraph 4 above would be factored into the actuarial valuation of the amount of provision required. Accordingly, the LTC benefits provided to the employees should be provided for on the basis of actuarial valuation.

D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

(i) No, the accounting policy adopted by the company is not in compliance with the existing Accounting Standard and the standard accounting principles.

(ii) Yes, it is mandatory to create provision for LTC benefits in the books of account after taking into account the actuarial valuation as per AS 15 (revised 2005).

Query No. 37

Subject: Treatment of advance paid in foreign currency for acquisition of fixed assets.[1]

A. Facts of the Case

1. A company, incorporated under the Companies Act, 1956, is a 50:50 Joint Venture of company 'N' Ltd. and the State Electricity Board. The company is establishing a coal based thermal power project of 1,500 MW comprising 3 x 500 MW Units in the State. The company, being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. As per the querist, since the Government has not prescribed any statement of accounts

[1] Opinion finalised by the Committee on 09.01.2009

for the central undertakings engaged in generation of electricity, the company is preparing its accounts in the format prescribed as per Schedule VI to the Companies Act, 1956.

2. The company awarded two contracts to M/s A Ltd. for supply and erection of steam generators with electrostatic precipitator and turbine generator. The contract value has components in US Dollars, Euro and Indian Rupees. The break-up of the contract price is as under:

Steam Generator Package

Supply of Plant & Equipment	USD	49,035,900
	Euro	22,799,250
	INR	7,025,450,120
Supply of Mandatory Spares	INR	453,151,152
Type Test Charges	INR	16,339,535
Total	**USD**	**49,035,900**
	Euro	**22,799,250**
	INR	**7,494,940,807**

Turbine Generator Package

Supply of Plant & Equipment	USD	19,646,260
	Euro	38,516,440
	INR	4,105,081,301
Supply of Mandatory Spares	INR	297,251,399
Type Test Charges	INR	11,574,027
Total	**USD**	**19,646,260**
	Euro	**38,516,440**
	INR	**4,413,906,727**

3. The terms of payment for the supply of the equipment are as under:

1. Initial advance 15% of contract value

2.	On despatch	55% of the contract value
3.	On receipt	20% of the contract value
4.	On trial operation	05% of contract value
5.	On performance test	10% of contract value

M/s A Ltd. will supply the equipments over a period of two to three years. During the year 2007-08, the company has paid 15% of the contract value as initial advance to M/s A Ltd. as per the terms of the contract on 18th October, 2007:

Particulars	**Amount in Foreign Currency**	**Ex Rate as on 18.10.07**	**Converted Value – In Indian Rupees**
SG Package			
Euro	3419888	56.1875	192154957
US Dollars	7355385	39.6085	291335767
Indian Rupee			1053817518
		(A)	**1537308242**
TG Package			
Euro	5777466	56.1875	324621371
US Dollars	2946939	39.6085	116723833
Indian Rupee			615762195
		(B)	**1057107399**
		A+B	**2594415641**

4. The above-mentioned amount of advance was accounted for as 'Advance for Capital Expenditure' and grouped under the head 'Fixed Assets – Construction Stores & Advances' in the annual accounts of the company for the financial year 2007-08. The company did not restate the amount of advances at the rates of

exchange ruling as at the balance sheet date, i.e., 31st March, 2008.

5. During supplementary audit of accounts u/s 619(3) of the Companies Act, 1956 by the Comptroller & Auditor General of India, it was observed by them that the advances paid for capital expenditure in foreign currency are monetary items as per Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', and should have been reported at the exchange rates prevailing as on 31.03.2008 (reporting date), i.e., US Dollars = Rs. 39.49 and Euro = Rs. 62.34 and the corresponding exchange gain of Rs. 5.54 crore should have been credited to the profit and loss account/'Incidental Expenditure During Construction' account.

6. During discussions with the Government Auditors, the statutory auditors of the company were of the view that advance for capital expenditure in foreign currency is to be treated as a non-monetary item considering the following:

(i) As per the definition given in AS 11, monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivables and payables.

(ii) As per International Accounting Standard (IAS) 21, The Effects of Changes in Foreign Exchange Rates, the essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency.

(iii) In the instant case, the capital advance is not to be received back in cash; rather, only a capital asset will be received against the same. Hence, it is a non-monetary item as per the definition of AS 11.

(iv) The intention of AS 11 is to recognise that portion of gain/loss of the change in foreign currency rates arising on subsequent payments/receipts, which pertains to the relevant accounting period (i.e., the monetary assets/liabilities are restated at year-end rates to recognise the gain/loss which has arisen in that accounting period). Since no gain/loss is going to arise on receipt of the asset at a later date, there is no question of recognising the portion of gain/loss which has arisen up to the year-end date. Any gain/loss on change in foreign currency rates would arise only when the advance is received back in cash whereas the financial statements are prepared with the assumption that only an asset would be received against the capital advance. Hence, restating the capital advance at the year-end rates would only lead to a notional entry which would be required to be reversed in the subsequent period.

After deliberations, Government Auditors observed that the observation regarding treatment of advances for capital expenditure lacks clarity and should be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India for opinion.

B. Query

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

(i) Whether advance paid to M/s A Ltd. for acquisition of fixed assets is a monetary item.

(ii) If answer to (i) above is in the affirmative, whether the advances paid to a party for acquisition of fixed assets are to be restated by using the closing rate of exchange at each balance sheet date.

(iii) In case answer to (ii) above is in the affirmative, whether these exchange differences can be adjusted in the cost of related assets, considering the provisions of paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', i.e., directly attributable cost of bringing the asset to its working condition for its intended use.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to treatment of advance paid in foreign currency. 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. Further, the Committee notes that the foreign currency advance was paid on 18.10.2007 (i.e., during the accounting year 2007-08). Hence, Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', notified under the Companies (Accounting Standards) Rules, 2006 (the 'Rules') is applicable for the Facts of the Case. Incidentally, the Committee notes that the total of payments payable at different stages mentioned in paragraph 3 above exceeds 100% of contract price. However, this does not affect the issue involved.

9. The Committee notes the following paragraphs from AS 11 notified under the 'Rules':

> ***"7.11 Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money."***
>
> ***"7.14 Non-monetary items are assets and liabilities other than monetary items."***
>
> "12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. …"

10. From the above, the Committee is of the view that the words 'received or paid' in the definition of the term 'monetary items' do not necessarily envisage receipt or payment in cash. What is of the essence of the definition of monetary items is that the value of the asset or liability should be fixed or determinable in monetary terms. Accordingly, where the advance is related to a fixed price contract for the receipt of a specified quantity of goods, it will be a non-monetary asset since it represents a claim to receive a specified quantity of goods and not a right to receive money. From the Facts of the Case, the quantity of the fixed assets to be received is specified and the price expressed in multi-currency is also fixed.

It is a case of fixed price contract for the receipt of a specified quantity of fixed assets. Hence, the Committee is of the view that, in the present case, foreign currency component of advance paid which is related to the fixed assets to be received is a non-monetary item.

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) No. Advance paid to M/s A Ltd. for acquisition of fixed assets is not a monetary item. It is a non-monetary item.

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

(iii) In view of (ii) above, this question does not arise.

Query No. 38

Subject: Accounting treatment of catalyst used in processing plants.[1]

A. Facts of the Case

1. A public sector company is manufacturing industrial chemicals and fertilizers. In the manufacture of the same, it uses many inputs as well as catalysts. As per design, catalysts are directly used in the production process to facilitate reaction. As these catalysts do not participate in the reaction these are classified as process chemicals and consumables rather than raw material inputs. Catalysts are of high value. Such catalysts are replaced when their charge gets over or does not support the performance

[1] Opinion finalised by the Committee on 31.01.2009

as desired. The company uses various catalysts in its production which is product/plant specific. The charge of some of the catalysts, normally called as the life of the catalyst, may be over in one year whereas sometimes it gets extended up to 5-7 years. The first charge of the catalyst is capitalised along with the plant.

2. The company prepares annual cost statements based on absorption costing method for valuation of its stock of finished products. As the expected life/utility of catalyst exceeds over a year there is a scope for consideration of pro-rata cost of catalyst based on its expected life while arriving at the cost of production of the finished product. However, since inception, consistently the company charges off the entire cost of catalyst replaced in the year of its replacement. The reasons for the same are as under:

(i) The expected life is subject to innumerable and dynamic variables of continuously running plants and material conditions. Thus, there is no standard input-output relationship between expected life and the quantity of catalyst consumed.

(ii) The company has experienced erratic fluctuations in the actual life as compared to its estimated life in all cases.

(iii) Moreover, in every annual shutdown, the catalysts are reviewed and some of the catalysts are topped-up, i.e., part replacement is done to support performance. Hence, the company is also required to maintain inventory of such catalysts to meet operating requirements.

(iv) Catalysts are product/plant specific, thus forming part of direct cost of production.

(v) Once a catalyst has become completely useless, it is disposed off as scrap.

(vi) Pro-rata charging off the cost of catalyst requires bringing back to inventory, the quantity of catalysts already issued to process which is highly unascertainable and impractical.

3. The querist has informed that the company has adequately disclosed the fact in its accounting policy in this regard as follows:

> "cost of manufactured goods comprises of direct cost (including cost of catalyst replaced during the year), variable production overheads and fixed production overheads on absorption costing method".

The querist has also informed that the company's accounting policy also states that "the company does not value stocks in process at the close of the year as the same is not practicable".

4. During the year 2007-08, the Government auditors have queried that this practice is not as per paragraph 8 of Accounting Standard (AS) 2, 'Valuation of Inventories', since the company is charging off the entire cost of catalyst in the year in which it is incurred even though the life of the catalyst is four years. This is resulting in abnormal expense during the first year of replacement of catalyst. Paragraph 8 of AS 2 relates to treatment of cost of conversion. During the year 2007-08, the company incurred a cost of Rs. 24.71 crore for the replacement of catalyst in its ammonia plant and has charged off the same in the accounts of the year without spreading over the cost of catalyst for four years. This has resulted in overstatement of finished goods (urea) and material consumed to the extent of Rs. 1.75 crore and Rs. 18.53 crore respectively, and understatement of profit to the extent of Rs. 16.78 crore.

5. To the above observation of the Government auditors, the company replied that as the usage of the catalyst in production process is not systematic, the company has been charging off the cost of the catalyst in the year of replacement itself. The company also argued that the expected life of the catalyst as arrived at by the auditors is notional. Further, as explained in Annexure I by the querist, any other method followed would result in the same charge to the profit and loss account.

6. The Government auditors have cleared the accounts only on the assurance that an expert opinion on this accounting treatment would be obtained from the Institute of Chartered Accountants of India.

B. Query

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

(i) Whether the company is correct in its accounting treatment for catalysts.

(ii) Whether the current practice of the company is contrary to paragraph 8 of AS 2.

C. Points considered by the Committee

8. The Committee, while expressing its opinion, has restricted itself to the issues raised with regard to accounting for catalyst as stated in paragraph 7 above and has not considered any other issue that may raise from the Facts of the Case, such as, the accounting policy of the company regarding not valuing the stock-in-process at the close of the year.

9. The Committee notes from the Facts of the Case that the catalysts having high values are used in the production process. The catalysts have a life more than one year although the life may fluctuate considerably keeping in view the conditions in which the same is used. Further, a catalyst may be reused after recharging the same. Once a catalyst becomes completely useless it is disposed off as scrap.

10. The Committee notes that a catalyst meets the definition of an asset since it is a resource controlled by the enterprise from which its future economic benefits are expected to flow to the enterprise. Unless the amount of an asset is not material, it is necessary to determine the nature of the asset in order to determine its appropriate accounting. Keeping in view the nature of the catalyst, the Committee is of the view that the catalysts can either be inventories or fixed assets. In this context, the Committee notes the definition of 'fixed asset' given in paragraph 6.1 of Accounting Standard (AS) 10 'Accounting for Fixed Assets', as below:

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

The Committee also notes the definition of 'inventories' given in paragraph 3 of AS 2, 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.***

11. The Committee notes from the Facts of the Case that a catalyst only facilitates the process of production of a product. Without the catalyst plant and machinery can still operate and the product can still be produced. Accordingly, catalyst cannot be considered of the nature of plant and machinery, which converts raw materials into finished products. The catalyst is also not of the nature of an asset which is kept for administrative use. Accordingly, the Committee is of the view that the catalyst is not of the nature of a fixed asset as contemplated in AS 10. On the other hand, the Committee is of the view that the catalyst is used in the process of production and is of the nature of supply to be consumed in the production process. It should be considered of the nature of a consumable even though its life may be greater than one year. In other words, the Committee is of the view that a catalyst is covered by the definition of the term 'inventories' under AS 2. Accordingly, in the view of the Committee, the principles of AS 2 should be applied for the purpose of measurement and presentation of catalysts. Keeping in view the above considerations, the Committee is of the view that the first charge of the catalyst should not be capitalised along with the plant as being presently done by the company.

12. From the above, the Committee is of the view that catalysts should be valued at the lower of cost and net realisable value as prescribed in paragraph 5 of AS 2. At the end of the year, where the catalysts are still in use, the cost thereof to be charged under cost of conversion as per paragraph 8 of AS 2 should be only to the extent of catalysts consumed during the period. To the extent the catalyst is yet to be consumed, it should be treated as inventory,

for whose valuation purposes, the balance cost of the catalysts should be compared with the net realisable value thereof. With regard to determination of net realisable value, the Committee is of the view that paragraph 24 of AS 2 reproduced below should be applied:

> "24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisiable value."

Accordingly, the Committee is of the view that the accounting policy of the company in respect of catalyst would be correct if the net realisable value thereof, as determined above, is nil.

D. Opinion

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

(i) The company would be correct in its accounting treatment for catalysts if the net realisable value as determined in accordance with paragraph 12 above is nil.

(ii) The current practice of the company is contrary to paragraph 8 of AS 2.

Annexure

		YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
A	DR TO P/L	100	100	100	100	100	100	100	100	100	100
	AS PER THE										
	COMPANY'S POLICY	100	100	100	100	100	100	100	100	100	100
B	DR TO P/L	25	25	25	25						
	OVER 4 YEARS										
	ESTIMATED		25	25	25	25					
				25	25	25	25				
					25	25	25	25			
						25	25	25	25		
							25	25	25	25	
								25	25	25	25
									25	25	25
										25	25
											25
	DR TO P/L AS PER B ABOVE	25	50	75	100	100	100	100	100	100	100
	DR TO P/L AS PER A ABOVE	100	100	100	100	100	100	100	100	100	100

Query No. 39

Subject: Valuation of material-in-transit.[1]

A. Facts of the Case

1. A government company is incorporated under the Companies Act, 1956. The shares of the company are listed with recognised stock exchanges. The company is engaged in the business of refining and marketing of petroleum products. It has refineries for processing crude oil and Lube blending / Filling plants. The company also has depots, installation and LPG plants across India, besides having administrative offices at Delhi, Chennai, Kolkata, Mumbai and other major cities. The main raw material for processing in the refineries is crude oil which is both imported and indigenously procured. At any period end, a few shipments of crude oil are in transit. The company imports products which can also be in transit at period ends.

2. According to the querist, crude oil cargos are generally lifted from load port on FOB basis and consequently the ownership of the goods shipped vests with the company. The querist has stated that under normal circumstances, once a tanker is loaded from the port, liability for associated expenses like freight, insurance, customs duty, survey fees, wharfage and handling charges becomes part of the cost of purchase. The shipments subsequently reach the port where the refinery is situated within a few days' to a month's time.

3. As per the querist, at any period end, the company values the crude oil-in-transit inclusive of customs duty, survey fees, and wharfage and handling charges which are generally applicable as soon as the loading is completed and bill of lading (B/L) date is finalised (as the ownership vests with the company). The corresponding liabilities, such as, customs duty, wharfage, survey fees, etc., are provided. This is irrespective of whether the material-in-transit has entered the Indian territorial waters or not. This has been the consistent policy followed by the company.

4. The government auditors have expressed their views that the

[1] Opinion finalised by the Committee on 31.01.2009

above method of accounting results in overstatement of stock-in-transit and overstatement of liabilities to the extent of provisions made towards customs duty, wharfage, etc. They have also stated that provisioning made towards customs duty is not warranted as the tanker has not entered the territorial waters of India.

5. The querist has drawn attention to paragraphs 6 and 7 of Accounting Standard (AS) 2, 'Valuation of Inventories', which are reproduced below:

> ***"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.***
>
> **Costs of Purchase**
>
> 7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase."

As per the querist, the company has been consistently taking into account customs duty, survey fees, wharfage and handling charges which are generally applicable as soon as the loading is completed and B/L date is finalised (as the ownership vests with the company) by providing the corresponding liabilities. By the time the accounts of the company are finalised for any period end, these cargos generally reach the refinery ports and these expenses are incurred. Providing or not providing for these liabilities does not have any impact on the profit and loss account of the company.

B. Query

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

(a) Whether the accounting policy followed by the company in respect of materials-in-transit at period ends is in order.

(b) If not, then for each of the following, at what point of time the liability should be recognised in the books of account in respect of in-transit shipments as at the period end:

(i) Freight expenses.

(ii) Insurance expenses.

(iii) Survey fees paid at the load port and at the disport.

(iv) Handling expenses at the load port / disport.

(v) Customs duty on imported cargos. Whether provision should be made only when the cargos reach the Indian territorial waters as at the period end.

(vi) Wharfage. Whether provision should be made only when the cargos reach the port at the period end.

C. Points considered by the Committee

7. The Committee, while answering the query, has addressed 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 point of time when the significant risks and rewards of ownership of crude oil-in-transit vest with the company etc. The Committee presumes that the significant risks and rewards of ownership of the crude oil-in-transit vest with the company.

8. The Committee notes paragraphs 6 and 7 of AS 2 reproduced by the querist in paragraph 5 above. The Committee also notes the following paragraphs from AS 2:

> "11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."

> "13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:
>
> (a) abnormal amounts of wasted materials, labour, or other production costs;
>
> (b) storage costs, unless those costs are necessary in the production process prior to a further production stage;
>
> (c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
>
> (d) selling and distribution costs."

9. From the above, the Committee notes that as per AS 2, the cost of inventory would include costs, apart from the cost of purchase, that are incurred in bringing the inventories to their present location and condition. The Committee is of the view that the test for determining whether or not the cost of carrying out a particular activity should be included in the cost of inventory is whether the activity contributes to bringing the inventory to their present location and condition. Also, the Committee notes that the expenses of the nature of administrative overheads are not included in the cost of inventory and are expensed when incurred.

10. From the above, the Committee is of the view that with respect to each shipment of crude oil-in-tranist, the company will have to determine as to which expenses have been incurred for bringing the crude oil to its present location and condition. Accordingly, the expenditure which is yet to be incurred should not form part of the cost of such inventory. Thus, expenses like freight, handling expenses at load port, etc. may form part of the inventory of crude oil-in-transit if they have been incurred. The handling expenses yet to be incurred at the destination port cannot be included in the cost of inventory as such expenses have not been incurred as yet. With respect to customs duty and wharfage, the company will have to determine the point of time when these are levied and depending upon the location and condition of the crude oil-in-

transit, such expenses may/may not form part of the cost of inventory in transit. The Committee is further of the view that insurance expenses and survey expenses may form part of cost of inventory if these are of the nature of mandatory expenses, i.e., without which the inventory cannot be moved or transported.

D. Opinion

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

(a) The accounting followed by the company in respect of materials-in-transit at period ends is not in order.

(b) Only those expenses which contribute to bringing the inventory to their present location and condition can form part of the cost of inventory. Accordingly, the liability for the expenses mentioned at (i), (iv) (v) and (vi) of paragraph 6(b) above should be recognised in the books of account in respect of in-transit shipment only when those expenses are incurred/the liability in respect thereof has arisen (the payment for the same may have yet to be made). The insurance expenses and survey fees (mentioned at (ii) and (iii) of paragraph 6(b) above) may form part of the cost of inventory if these are mandatory in nature as discussed in paragraph 10 above.

Query No. 40

Subject: ***Classification of compulsorily convertible debentures in the balance sheet as equity – whether appropriate.***[1]

A. Facts of the Case

1. A private limited company is engaged in the business of construction and development of real estate. The company has,

[1] Opinion finalised by the Committee on 31.01.2009

during the year ended 31st March, 2008, issued '*Compulsorily*' Convertible Debentures to a large International Bank under a Foreign Direct Investment Regime under the Foreign Exchange Management Act, 1999. The key features of the debentures issued are as below (emphasis supplied by the querist):

(i) The debentures issued are compulsorily convertible into equity shares after a tenure of 39 months from the date of issue. The querist has emphasised that the debentures so issued are mandatorily convertible in order to be subscribed by an International Bank from foreign funds under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Amendment) Regulations, 2000, read with Press Note No. 2 of 2005 issued by the Ministry of Commerce & Industry, Government of India.

(ii) Till the date of conversion, interest is payable @ 13.65% on quarterly basis.

(iii) The debentures are unsecured.

2. The company has not yet adopted Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement', and Accounting Standard (AS) 31, 'Financial Instruments: Presentation' issued by the Institute of Chartered Accountants of India, and is debiting interest payable on such debentures to the profit and loss account.

3. The querist has stated that in the balance sheet of the company for the year ended 31st March, 2008, the amount received on issue of convertible debentures is classified under the head 'unsecured loans', as the auditors are of the view that till such a debenture is converted into equity, it continues to be a debt, and therefore, to be classified under 'Loan Funds'.

4. According to the querist, in the view of the management of the company, such amounts received are not repayable and are convertible into equity shares. In substance, it is capital of the company, and therefore, should be classified under the head 'share capital' under 'shareholders' fund'. In this regard, the querist has

drawn the attention of the Committee to the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. As per the querist, this Framework enunciates the underlying concepts in the preparation and presentation of financial statements. The Framework defines 'liability' as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. The Framework defines 'equity' as the residual interest in the assets of the enterprise after deducting all its liabilities. Based on the above, the management is of the view that since the result is not an outflow from the enterprise of resources, the compulsorily convertible debentures could not be a liability, and, therefore, could be classified as equity.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee on the correctness of the view held by the management of the company that the compulsorily convertible debentures should be classified as equity. If the answer is in the negative, whether it could be shown in any other way under 'shareholders' funds', i.e., as a separate item between shareholders' funds and loan funds as is being done in the case of share application money.

C. Points considered by the Committee

6. The Committee notes from the Facts of the Case that the debentures issued by the company carry an interest @ 13.65% on quarterly basis till the date of conversion. Accordingly, the Committee is of the view that till the date of conversion the debentures are of the nature of loans.

7. The Committee also notes that the company under consideration is a private limited company and, therefore, the provisions of Schedule VI to the Companies Act, 1956 would apply with respect to the form of balance sheet of the company. The Committee notes that Schedule VI to the Companies Act, 1956 requires debentures to be classified under the head 'secured loans' and that the disclosure is required to be made with respect to the terms of redemption or conversion (if any) of debentures issued to

be stated together with earliest date of redemption or conversion. The Committee further notes that the debentures issued by the company are unsecured. Accordingly, the Committee is of the view that the same should be classified under the head 'unsecured loans' in the balance sheet of the company.

D. Opinion

8. On the basis of the above, the Committee is of the opinion that the compulsorily convertible debentures cannot be classified as share capital/shareholders' funds/equity till the conversion thereof. Such debentures also cannot be shown as a separate item between shareholders' funds and loan funds. Such debentures should be classified under the head 'unsecured loans' with appropriate disclosures with respect to the term of conversion along with the earliest date of conversion in accordance with the requirements of Schedule VI to the Companies Act, 1956.

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. A copy of the query may 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, Post Box No. 7100, Indraprastha Marg, New Delhi- 110 002.