COMPENDIUM OF OPINIONS

Volume XXXI

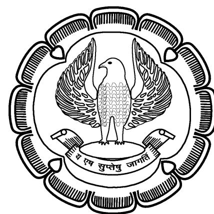
Expert Advisory Committee
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Compendium of Opinions

(Volume XXXI)

of the

Expert Advisory Committee



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

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Foreword

In times of economic growth, where complex and intricate business transactions are taking place on a routine basis, the accountants often feel the need of interpreting the General Accepted Accounting Principles (GAAPs) including Accounting Standards, Ind ASs, Guidance Notes, other Authoritative Pronouncements of the Institute of Chartered Accountants of India, etc. for applying and implementing them in the intricate situations. To address this need of the professionals, the Council of the Institute had constituted the Expert Advisory Committee for answering the queries received from the members of the Institute on accounting and/or auditing issues under specific situations in accordance with the Advisory Service Rules.

Over the years, the role of the Expert Advisory Committee has been well recognised for its independent and objective opinion not only by the members in industry and practice, but also by the Regulatory and Government authorities, such as Comptroller and Auditor General of India (C&AG), Ministry of Corporate Affairs, etc.

I am happy to share that in its continuous endeavour of serving the members of the Institute, the Expert Advisory Committee has brought out this thirty-first volume of the Compendium of Opinions, containing opinions finalised by the Committee during the Council Year 2011-12.

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

New Delhi
February 11, 2012

CA. G. Ramaswamy
President

Preface

I am pleased to present the thirty-first volume of the Compendium of Opinions containing opinions finalised by the Expert Advisory Committee during the period February 12, 2011 to February 11, 2012. The opinions contained in this volume pertain to diverse subjects, such as, accounting for sales tax exemption benefit under Ind AS, ESOP accounting, disclosure requirements for defined benefit plans in case of group administration plans, accounting for provident fund contribution in case of provident fund trust run by the holding company, depreciation on freehold land having mineral reserves and the internal roads, accounting for sales returns, recognition of provision for warranty under construction contract, etc.

Keeping in view the significance of information technology and the requirements of the users, this volume also contains a Compact Disk (CD), which incorporates all the opinions published not only in this volume but also published in all earlier volumes of the Compendium of Opinions (viz., Volume I to Volume XXXI). The CD with its user friendly features would enable the user to find opinions on a chosen subject in a matter of seconds. This CD would be immensely useful to all accounting professionals in industry as well as in the auditing profession.

I would like to inform the readers that the opinions of the Expert Advisory Committee are the opinions or views of the members of the Committee and are not necessarily the opinions of the Council of the Institute. The opinions are based on the facts and circumstances as supplied by the querist, the applicable accounting/auditing principles and the relevant laws and regulations prevailing on the date, the Committee finalises the particular opinion. The date of finalisation of the opinion is indicated along with every opinion. The opinions must be read and applied in the light of any subsequent developments and /or amendments in the applicable legal position and accounting/auditing principles that might affect the opinions.

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

I take this opportunity to thank all the members of the Committee, including co-opted members and special invitees, namely, CA. J. Venkateswarlu (Vice-Chairman), CA. G. Ramaswamy (President), CA. Jaydeep N. Shah (Vice-President), CA. Bhavna Doshi, CA. Charanjot Singh Nanda, CA. Dhinal Ashvinbhai Shah, CA. Nilesh S. Vikamsey, CA. Pankaj I. Jain, CA. Sanjay K. Agarwal, CA. Sanjeev K. Maheshwari, Shri Ashutosh Dikshit, Shri Prithvi Haldea, Shri Sidharth K. Birla, Ms. Usha Sankar, Ms. Naina A. Kumar (Nominee of Ms. Usha Sankar), Shri Rajesh Kumar Bhoot (Nominee of Shri Ashutosh Dikshit), CA. Sanjeev Rajendra Pandit, CA. Nalin Shah, CA. Sita Ram Pareek, CA. N. Ramesh Natarajan , CA. L. Ravi Sankar, CA. Manoj Fadnis , CA. Jigar Parikh and CA. Vikas Thapar for their invaluable support and contribution in finalisation of the opinions. The view of the Committee on complex technical issues can be arrived at only through the diverse perspectives and experience that these members bring to the deliberations of the Committee through their active participation and total involvement in the work of the Committee. I would also like to thank Dr. Avinash Chander, Technical Director, Dr. Rashmi Goel, Secretary, Expert Advisory Committee and CA. Parul Gupta, Assistant Secretary and other officers of the Secretariat for their sincere efforts, support and contribution made throughout the year.

I firmly believe that this volume of the Compendium like earlier volumes would be of immense use to the members and others concerned.

New Delhi
February 11, 2012

CA. Jayant Gokhale
Chairman
Expert Advisory Committee

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Query No. 1

Subject: Capitalisation of interest during pre-operative period in Cable and Telecommunication Industry.[1]

A. Facts of the Case

1. A closely held public limited company is engaged in the business of providing cable TV (both analog and digital services) and broad band internet service in the State of Orissa and its neighbouring states, like West Bengal, Andhra Pradesh and Chhattisgarh. The company is registered under the Companies Act, 1956. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956. The company plans to expand its operations to different states of India in near future.

2. The company has a three-tier organisation structure consisting of stations, regional headquarters and corporate office. The stations are grouped under different regions and report to the corporate office through the regional headquarters. The regional headquarters provide various services to the projects under construction and the operating stations under their jurisdiction.

3. The company is undertaking the following process for a location in project stage:

(a) Make selection of potential sites where the company operations are to be taken up. Bring approval of right of way from the local authority to lay cable in that locality. Then the company sets up an office and installs the network operating centre from where the services are to be provided to its customers.

(b) Immediate arrangement is made to have full contents from different broadcasters on payment to provide the services to the customers. Arrangement of intercity connectivity from available sources is also made for providing the broadband services from the company's control room. Once the facilities are available, company starts laying the cables and creates new passing which enable the company to provide cable and data connection to its customers. It also deploys necessary manpower to run the operations and provide services to its customers. All the above arrangements have an initial cost for the new location.

[1] Opinion finalised by the Committee on 16.3.2011.

4. According to the querist, passings are created in phases in different areas one after another depending upon the market demand and also the environmental situation. Normally, there is a time lag between the availability of the first pay channel and connecting the first customer. It is not practically possible to arrange for all the pay channels at a specific time. Irrespective of whether the customer is connected or not, the pay channel liability starts from the day the company gets the decoder box to receive the signals. A customer will also not be interested to avail a connection when all the channels are not available in the network.

5. The querist has stated that there are also initial operational hurdles in new locations and the business moves very slowly and considering its nature of activities, it takes time to consolidate the business. Getting a sizeable number of customers takes a pretty long time. This time period varies from 6 months to 2 years depending upon the market where the operations have been started by the company.

6. The company, as per its business plan, mixed the funding requirement of both equity and debt to meet the capital expenditure including the pre-operational expenses at new locations and expansion and up-gradation in its existing locations. The nature of the activities is such that the same materials are used both for capital expenditure and the repair and maintenance activities. It is also difficult to bifurcate the loan and equity amount that is spent to purchase fixed assets for different locations. The total assets requirement of all locations is pooled and then loan is arranged for the entire lot. The querist has stated that it is difficult to identify direct relationship between the loan and the capital item purchased as per paragraph 8 of Accounting Standard (AS) 16, 'Borrowing Costs'.

7. The querist has further stated that based on the provisions of paragraph 8 of AS 16, the interest cost on debt taken for new locations and up-gradation of the existing operations is being charged to the profit and loss account from the day one the interest liability arises in view of no proper calculation/allocation of interest being done asset/location wise.

8. *The company is now of the view that since borrowings are mainly for acquisition of new fixed assets for new locations and expansion of its activities in present locations, the interest cost for the period during which the test run is continuing and a sizeable number of customer base is not created at the relevant locations ought to be capitalised as per paragraph 9 read with*

paragraph 4(a) of AS 16 and not charged off fully to the profit and loss account (emphasis supplied by the querist).

9. As per the querist, if the debt cost from the day one is charged to the profit and loss account, there would be serious bottom line problem and the company would never be able to make bottom line positive with such huge interest cost burden during its initial period of expansion.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee that considering the nature of the business and assets of the company, whether (i) the company ought to capitalise borrowing cost for the period as stated in paragraph 5 above when commercial operation is not feasible for certain period initially, and (ii) charging off fully the interest to the profit and loss account will not be proper in view of applicability of AS 16.

C. Points considered by the Committee

11. The Committee while expressing its views has examined only the issues raised in paragraph 10 above and has not examined any other issue arising from the Facts of the Case, such as, treatment of other expenses during the pre-operative period, allocation of general borrowing costs, capitalisation in parts/phases and bifurcation of loan and equity components, etc. At the outset, the Committee also wishes to point out that from the Facts of the Case, the nature of the assets, which are being constructed or coming into existence as a result of construction activity is not clear. In other words, what is the 'qualifying asset(s)' in the extant case is not clear. Accordingly, in the following paragraphs, the Committee is laying down the broad principles to be kept in mind while capitalising the borrowing costs.

12. The Committee notes from the Facts of the Case that the company is entering into new locations and is also expanding in its existing locations, and for this, it is incurring borrowing costs. The Committee is of the view that broadly, such borrowing costs can be classified into two categories, viz., (i) those borrowing costs that are directly attributable to construction/ creation of an asset and (ii) those borrowing costs that are not directly attributable to such construction/creation.

13. For the sake of convenience, at first, the Committee deals with the second type of borrowing costs, i.e., those which are not directly attributable to construction of an asset. In this regard, the Committee notes paragraph 6

of AS 16, notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, which provides 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."***

From the above, the Committee is of the view that the borrowing costs that are not directly attributable to construction/creation of an asset (e.g., borrowing costs related to repair charges of an already existing centre or for expenses relating to deployment of manpower) should be expensed in the period in which these are incurred.

14. As regards the first type of borrowing costs, i.e., which are directly attributable to construction of an asset, the Committee notes the definition of the term 'qualifying asset' and paragraph 5 of AS 16 which are 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*." (Emphasis supplied by the Committee.)

From the above, the Committee notes that only those assets that necessarily take a substantial period of time to get ready for their intended use or sale can be considered as qualifying assets in the context of capitalisation of borrowing costs as per AS 16. The assets which are ready to use when acquired 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. The Committee further notes the Explanation to the definition of

the term 'qualifying asset' and paragraphs 14, 16 and 20 to 22 of AS 16, notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, which provide 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. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

(b) borrowing costs are being incurred; and

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

"16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place..."

"20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

> ***21. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.***
>
> 22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill."

15. On the basis of the above, the Committee is of the view that the company should evaluate what constitutes a substantial period of time considering the peculiarities of the facts and circumstances of its case, such as, nature of the asset being constructed. In this regard, time which is taken by an asset, technologically and commercially to get ready for its intended use or sale should be considered. The Committee notes from the Facts of the Case that the time taken to prepare the assets in question for its intended use is not clear. However, the querist has stated that there is a time lag to arrange for the pay channels and that the customer would not be interested to avail the facility unless all the channels are available. The Committee is of the view that once the asset is technologically ready, evaluation of optimum number of channels for commercial feasibility (i.e., commercial exploitation) of the asset should be done based on facts and circumstances of the case. In the view of the Committee, when a facility is technologically and commercially ready for distribution to the end-customers, the subsequent activities do not add value to the asset and therefore, the borrowing costs incurred thereafter should not be capitalised. The Committee is also of the view that the querist's argument on business feasibility, viz., consolidation of business and getting sizeable number of customers is not a criterion for determining the commercial readiness to estimate the substantial period of time. The Committee is of the view that commercial readiness should be determined on the basis of the assets providing output which can be commercially exploited in the market, not necessarily at profit. In this context, the Committee also wishes to point out that when a group of assets

is being constructed and if an asset of that group can be individually used, the borrowing costs incurred in respect of it should cease to be capitalised as and when that asset is ready for its intended use, as discussed above.

D. Opinion

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

(i) No, the time taken in getting a sizeable number of customers, as being argued by the querist in paragraph 5 above, should not be a consideration for determining “substantial period of time”. Accordingly, borrowing costs incurred during that period should not be capitalised. Capitalisation of borrowing cost would depend on whether the constructed asset meets the definition of ‘qualifying asset’ and other provisions of AS 16, as discussed above.

(ii) In case the interest incurred is not directly attributable to construction/creation of an asset, it should be fully expensed in the period in which it is incurred. However, if the interest incurred is directly attributable to construction/creation of a ‘qualifying asset’ as per the provisions of AS 16, as discussed in paragraphs 14 and 15 above, charging it off to the profit and loss account will not be proper in view of AS 16.

Query No. 2

Subject: Accounting treatment of Minimum Alternative Tax (MAT) Credit in case of carried forward losses.[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 the 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. The company's shares are not listed with any stock exchange. The turnover of the company for the year ending on 31/03/2010 is Rs. 1,02,213 lakh.

2. The querist has stated that the company is paying Minimum Alternative Tax (MAT) as per the Income-tax Act, 1961 due to carried forward losses of Rs. 92,048 lakh till 31st March, 2009 and the same is expected to be at Rs. 52,049.30 lakh approximately as on 31st March, 2010. During the year 2009-10, the company has provided MAT liability of Rs. 48,03.18 lakh. The Comptroller and Auditor General of India (C&AG) during the course of audit of the accounts of the company pertaining to the year 2009-10 has raised query on MAT credit as mentioned below:

> "Section 115JAA provides that credit in respect of MAT (minimum alternative tax) shall be allowed to the company which shall be carried forward and set off not beyond the fifth assessment year immediately succeeding assessment year in which tax credit becomes allowable.
>
> The tax credit shall be allowed to be set off in a year when tax becomes payable on the total income computed in accordance with any other provisions other than section 115JA or 115JB of the Income-tax Act.
>
> An amount of Rs. 4,803.18 lakh has been provided for in the accounts of the company for the financial year 2009-10 towards MAT in accordance with section 115JA of the Income-tax Act, 1961 calculated @ 16.995% of the book profit.

[1] Opinion finalised by the Committee on 16.3.2011.

As MAT is in the nature of advance tax, which is adjustable from tax payable in future (within 5th assessment year), the amount should have been shown as recoverable on account of MAT. Non-compliance of this has resulted in understatement of profit after tax as well as reserve and surplus by Rs. 4,803.18 lakh with corresponding under-statement of loans and advances."

3. The company has given reply in the following manner:

According to paragraph 6 of Accounting Standards Interpretation (ASI) 6[2], 'Accounting for Taxes on income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India (ICAI), MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes *eligible to be recognised as an asset*, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein (emphasis supplied by the querist).

As per the Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under the Income-tax Act, 1961, issued by the ICAI, the MAT credit receivable can be recognised as an asset by crediting profit and loss account, and debiting MAT Credit Receivable A/c, if and only if, there exists a *virtual certainty* that the company will have to pay taxes as per normal rates within the specified period. MAT credit is an asset as it has expected future economic benefits in the form of its adjustment against the discharge of the normal income tax liability if the same arises during the specified period. But, it (asset) has to be recognised in the balance sheet only when it is probable that the future economic benefit associated with it will flow to the enterprise. At this point of time, according to the querist, the company cannot predict with any degree of certainty that profit subject to normal income tax will accrue during the remaining years of specified period provided in section 115JA of the Income-tax Act, 1961. In fact, for the purpose

[2] The ASI has been withdrawn by the Council of the Institute of Chartered Accountants of India and the consensus portion thereof has been added as 'Explanation' to the paragraph 21 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income'.

of consideration of probability of expected future economic benefits in respect of MAT credit, the fact that the company is paying MAT and not the normal income tax, provides a prima facie evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view of this, MAT credit should be recognised as an asset only when and to the extent there is *convincing evidence* that the company will earn sufficient profits in the near future, so that it is able to pay taxes as per the normal provisions of Income-tax Act, 1961, and not as per MAT regime. (Emphasis supplied by the querist.)

Since, the company is having unabsorbed carried forward losses of Rs. 92,048 lakh, there is very much an element of uncertainty that the company will be paying normal tax in near future within the specified period. Moreover, the uncertainty is further compounded with the impending implementation of IFRS and the Direct Tax Code with effect from 01/04/2011. Besides, there would be an impact of the revised tariff which is to be decided by the Central Electricity Regulatory Commission (CERC) for the tariff period 2009-14. Hence, in the view of the querist, it is not necessary to provide MAT credit during the year 2009-10.

4. The querist has stated that the company shall create MAT credit in the year when it will be able to pay normal tax as per the provisions of the Income-tax Act, 1961. Till then, the company shall be reviewing on each balance sheet date as to whether to create MAT credit as an asset or not.

B. Query

5. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether recognition of MAT credit entitlement is necessary in the year 2009-10 even with the presence of huge carried forward losses of Rs. 92,048 lakh at the beginning of the year and uncertainty in profitability due to upcoming events, like implementation of IFRS and Direct Tax Code from 1st April, 2011 or whether the company should create MAT credit as an asset in the year when there is virtual certainty that computation of income tax as per normal provisions of Income-tax Act, 1961 shall arise or earlier to that.

C. Points considered by the Committee

6. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 5 above and has not examined any other issue

that may arise from the Facts of the Case, such as, computation of MAT liability and credit receivable in respect thereof, etc. Further, the opinion of the Committee, expressed hereinafter is only from accounting point of view and not from the angle of interpreting of any legal provisions of statute, such as, Income-tax Act, 1961.

7. The Committee notes paragraphs 7 to 12 of the Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under the Income-tax Act, 1961, issued by the Institute of Chartered Accountants of India, as follows:

> "7. The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term 'asset' 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."
>
> 8. MAT paid in a year in respect of which the credit is allowed during the specified period under the Act is a resource controlled by the company as a result of past event, namely, the payment of MAT. MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, MAT credit is an 'asset'.
>
> 9. According to the Framework, once an item meets the definition of the term 'asset', it has to meet the criteria for recognition of an asset so that it may be recognised as such in the financial statements. Paragraph 88 of the Framework provides the following criteria for recognition of an asset:
>
> > "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."
>
> 10. In order to decide when it is 'probable' that the future economic benefits associated with the asset will flow to the enterprise, paragraph 84 of the Framework, *inter alia*, provides as below:

> "84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared."

11. The concept of probability as contemplated in paragraph 84 of the Framework relates to both items of assets and liabilities and, therefore, the degree of uncertainty for recognition of assets and liabilities may vary keeping in view the consideration of 'prudence'. Accordingly, while for recognition of a liability the degree of uncertainty to be considered 'probable' can be 'more likely than not' (as in paragraph 22 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets') for recognition of an asset, in appropriate conditions, the degree may have to be higher than that. Thus, for the purpose of consideration of the probability of expected future economic benefits in respect of MAT credit, the fact that a company is paying MAT and not the normal income tax, provides a *prima facie* evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view of this, MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. Such evidence may exist, for example, where a company has, in the current year, a deferred tax liability because its depreciation for the income-tax purposes is higher than the depreciation for accounting purposes, but from the next year onwards, the depreciation for accounting purposes would be higher than the depreciation for income-tax purposes, thereby resulting in the reversal of the deferred tax liability to an extent that the company becomes liable to pay normal income tax.

12. Where MAT credit is recognised as an asset in accordance with paragraph 11 above, the same should be reviewed at each balance sheet date. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period."

8. From the above, the Committee is of the view that the MAT Credit receivable should be recognised in the books of the company only when and to the extent that there is convincing evidence that the company will be able to avail the future economic benefits arising therefrom during the specified period in which tax credit is allowable. The Committee notes that the requirement regarding 'virtual certainty' does not exist in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax, issued by the Institute of Chartered Accountants of India, as erroneously mentioned by the querist in paragraph 3 above. The Committee also notes from the Facts of the Case that as on 31st March, 2009, carried forward losses were Rs. 92,048 lakh, and are expected to be at Rs. 52,049.30 lakh as on 31st March, 2010, thus, indicating that to the extent of difference (which is approximately Rs. 39,998.70 lakh), the losses will be set off during the financial year 2009-10. The Committee is of the view that this set-off of losses may be an indication that the company may be able to pay normal income taxes during the specified period. However, in the view of the Committee, considering the principle of 'prudence' and the provisions of the Guidance Note, the mere existence of such indication is not sufficient. For recognising the MAT credit, there has to be a convincing evidence that the company would be able to avail future economic benefits arising from the MAT credit during the specified period, which the company should determine keeping in view the facts and circumstances of the company. While determining this, in the view of the Committee, reversals of deferred tax liabilities, if any, arising during the specified period should also be taken into account.

D. Opinion

9. On the basis of the above, the Committee is of the opinion that MAT Credit entitlement should be recognised in the books of the company if there exists convincing evidence that the company would be able to avail the future economic benefits arising therefrom during the specified period, as discussed in paragraph 8 above.

Query No. 3

Subject: ESOP accounting on account of revision of the exercise price.[1]

A. Facts of the Case

1. A company is a listed company in the manufacturing sector having various businesses (a conglomerate). The company had granted stock options to its employees ('ESOP') in August, 2007 (Year Zero).

2. Total number of options granted originally was 10,000 to be vested over a period of 4 years i.e., 25% each year. Market price of shares of the company on the date of ESOP grant was Rs. 2,800/- per share and exercise price was Rs. 2,000/- per share.

3. On account of attritions / non-fulfillment of eligibility conditions, the number of options has been reduced to 9,000 in year two (2009).

4. The company has followed intrinsic value method for ESOP accounting as provided by the 'Guidance Note on Accounting for Employee Share-based Payments' issued by the Institute of Chartered Accountants of India.

5. The company decides to revise the exercise price as Rs. 1,800/- per share in year two on account of reduction in market price of company's shares. Current market price in year two is Rs. 2,000/- per share.

6. The querist has stated that actual figures have been substituted by rounded-off figures for the sake of simplicity.

B. Query

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

(i) Whether any additional charge is to be taken to the profit and loss account under employee cost on revision of exercise price in year two (2009) as mentioned in paragraph 5 above. If yes, what will be the amount and basis thereof? What would be the amount to be charged as employee cost on revision of the exercise price from year two onwards?

[1] Opinion finalised by the Committee on 3.5.2011.

(ii) Whether the extra charge in year one (2008) will be adjustable in subsequent charge to the profit and loss account in the remaining vesting period, consequent upon reduction in the number of ESOPs eligible for exercise in year two.

(iii) What will be the treatment of the amount credited to the ESOP Outstanding Account against original grant, i.e., Rs. 800 per share (Rs. 2,800 less Rs. 2,000) at the time of exercise of options?

C. Points considered by the Committee

8. The Committee notes that the employee stock option plan mentioned by the querist is a graded vesting plan since the options vest in tranches over a period of 4 years i.e., 25% for each year. The Committee, however, notes that the basic issues raised by the querist are related to accounting for the effects of revision of the exercise price of the stock options, reduction in the number of ESOPs and treatment of amount credited to ESOP Outstanding Account against the original grant. 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, accounting for the original plan, detailed aspects of accounting for graded vesting plan etc. Incidentally, the Committee notes that while reduction in the number of options due to attritions/non-fulfillment of eligibility conditions as well as revision of the exercise price took place in year two (2009), the querist has referred to 'extra charge in year one (2008)' in the query raised in paragraph 7(ii) above. It appears that in respect of the extra charge, year referenced should be 'year two (2009)'. Further, the Committee presumes that there is no change in any vesting condition at the time of revision of the exercise price.

9. The Committee notes that while the Institute of Chartered Accountants of India has issued a 'Guidance Note on Accounting for Employee Share-based Payments', (hereinafter referred to as the 'ICAI Guidance Note'), the Securities and Exchange Board of India (SEBI) has issued the 'Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999' (hereinafter referred to as the 'SEBI Guidelines'). Schedule I to the SEBI Guidelines contain accounting aspects of Employee Stock Option Schemes. The Committee has referred to both the ICAI Guidance Note and the SEBI Guidelines for their appropriate application in the extant case.

10. The Committee notes that both fair value method and intrinsic value method are permitted in ICAI Guidance Note and Schedule I to the SEBI Guidelines. The Committee notes that while fair value method is explained in detail in ICAI Guidance Note, application of intrinsic value method simply involves substitution of the term 'intrinsic value' in place of 'fair value'. In this regard, the Committee notes that the last sentence of paragraph 40 of the ICAI Guidance Note reads as below:

> "For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39."

11. The Committee notes that while accounting for modification of terms of stock options is not addressed in SEBI Guidelines, the same is addressed in ICAI Guidance Note. Relevant portions of the ICAI Guidance Note are reproduced below:

> **"Modifications to the terms and conditions on which shares or stock options were granted, including cancellations and settlements**
>
> 23. An enterprise might modify the terms and conditions on which the shares or stock options were granted. For example, it might reduce the exercise price of options granted to employees (i.e., reprice the options), which increases the fair value of those options.
>
> 24. The enterprise should recognise, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock options do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of (a) any modifications to the terms and conditions on which the shares or stock options were granted, or (b) a cancellation or settlement of that grant of shares or stock options. In addition, the enterprise should recognise the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.
>
> 25. The requirements of paragraph 24 should be applied as follows:
>
> (a) If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price),

measured immediately before and after the modification, the enterprise should include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the shares or stock options granted. The incremental fair value granted is the difference between the fair value of the modified shares or stock options and that of the original shares or stock options, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified shares or stock options vest, in addition to the amount based on the grant date fair value of the original shares or stock options, which is recognised over the remainder of the original vesting period. If the modification occurs after the vesting date, the incremental fair value granted is recognised immediately, or over the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified shares or stock options.

…"

12. From paragraph 40 of ICAI Guidance Note, the Committee is of the view that the intrinsic value may be used, *mutatis mutandis*, in place of the fair value mentioned in the treatment for reduction of the exercise price explained in paragraph 11 above. In the querist's case, intrinsic value of the ESOP on the grant date was Rs. 800 (=Rs. 2,800 – Rs. 2,000) per option. Subsequently, in year 2009, immediately before revision of the exercise price, market price of the shares dropped to Rs. 2,000 per share and, consequently, the revision of the exercise price to Rs. 1,800 results in a benefit of Rs. 200 (=Rs. 2,000–Rs. 1,800) to the option holders. Hence, the incremental cost of Rs. 200 per option should be accounted for by the company. The Committee is of the view that incremental cost should be accounted for by the company even though the intrinsic value of the option immediately after the revision of the exercise price *viz.* Rs. 200 per option is less than the intrinsic value of the option on the date of the grant *viz*. Rs. 800 per option. This is because as per paragraph 24, no exception has

been provided in the Guidance Note from recognition of incremental cost under any situation.

13. As regards the issue relating to amount to be charged from year 2 (2009) onwards to the profit and loss account on account of revision of the exercise price, the Committee is of the view that it should be the sum of the amount chargeable as per original plan plus the relevant portion of the incremental cost to be expensed. As explained in paragraph 11 read with paragraph 10 above, to the extent that the options have already vested, the incremental cost should be expensed immediately. To the extent that the options have not yet vested, the incremental cost should be expensed from the date of revision of the exercise price until the date when the modified stock options vest. The basis of amortisation of the incremental cost to periods subsequent to the revision of the exercise price should be the same as prescribed in SEBI Guidelines for the amortisation of the original cost. Thus, while period of amortisation for original cost and incremental cost differ, the basis of amortisation for both is same. For example, for a plan where all the options vest at the end of the 4th year, if there is a modification of the award at the beginning of the third year resulting in incremental cost, the original cost will continue to be charged on a straight-line basis till the end of the 4th year, while the incremental cost will be charged on a straight-line basis to years 3 and 4. While this is the general principle to be followed, the Committee notes that in the extant case, the employee stock opinion plan is a graded vesting plan with uniform vesting pattern spread over a period of 4 years. The Committee is of the view that depending on the method adopted for charging the original cost of the graded vesting plan, the incremental cost of unvested options should be attributed to different tranches with different vesting periods or considered as a whole with a single vesting period of the last tranche for applying the principles explained above. As stated in paragraph 8 above, the Committee has not examined the detailed aspects of accounting for graded vesting plan and applicability of the optional treatment to the querist. In particular, the Committee has not examined the issue of allocation of incremental cost in the context of a graded vesting plan where the pattern of vesting is not uniform.

While applying the above principles, while initial recognition of the incremental cost in the balance sheet should be made in the manner as illustrated in SEBI Guidelines for the initial recognition of the original cost, however, the Committee also notes that in the instant case, there appears to be the lapse of some options before the revision of the exercise price. If so, the Committee

is of the view that first, such lapses should be accounted for and thereafter, the incremental cost of the outstanding options should be accounted for as explained above. Accounting for lapses is explained in paragraph 14 below.

14. In respect of reduction in number of ESOPs eligible for exercise in year 2 due to attritions / non-fulfillment of eligibility conditions, the Committee notes that there can be several situations resulting in lapse of either vested options or unvested options or a combination of vested and unvested options. For example, non-fulfillment of eligibility conditions even before the end of the first year will result in lapse of the unvested options only. It is also possible that after partial vesting of some percentage of options (i.e., 25% at the end of year zero), the employee may leave the employment but foregoes his/her right to exercise the vested options either before or after the expiry of the exercise period. This is a case of combination of lapse of vested and unvested options. The Committee notes that clauses (a), (b) and (c) of Schedule I to the SEBI Guidelines prescribe accounting treatment for granted options while clauses (d) and (e) thereof deal with accounting for lapses of unvested and vested options respectively. Clauses (d) and (e) of Schedule I to the SEBI Guidelines are reproduced below:

> "(d) When an unvested option lapses by virtue of the employee not conforming to the vesting conditions after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortised portion of the accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortised portion."
>
> "(e) When a vested option lapses on expiry of the exercise period, after the fair value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense."

The Committee is of the view that though clause (e) quoted above refers to 'fair value', the treatment specified therein is equally applicable for intrinsic value method with the modification that in place of term 'fair value', 'intrinsic value' should be used. This is because clause (b) of Schedule I to the SEBI guidelines permits both fair value and intrinsic value method. Further, the Committee is of the view that the accounting treatment mentioned in clause

(e) is equally applicable to a case where an employee foregoes his/her right to exercise the option even before the expiry of the exercise period.

15. From the above, the Committee is of the view that reduction in number of ESOPs eligible for exercise in year 2 due to attritions / non-fulfillment of eligibility conditions will result in reduced employee compensation expense in the period of attritions / non-fulfillment of eligibility conditions or in that period as well as future periods till the end of the vesting period or even after the expiry of the exercise period. Depending on the method of accounting adopted for graded vesting plan and retention of right to exercise the vested options, lapse of unvested options may also result in reduced employee compensation expense for future periods only. Thus, while the impact of incremental cost expensed may be in one period or spread over more than one period (see paragraph 13 above) till the end of the vesting period, the reduction in employee compensation expense may be either in one period or more than one period till the end of the vesting period or even after the expiry of the exercise period. While the impact of lapses of vested and/or unvested options reduce the impact of incremental cost expensed, such offsetting effect may or may not be in the same period(s). Since it is the net result of accounting for lapses and accounting for incremental cost expensed, the question of making any separate adjustment mentioned by the querist in the query raised in paragraph 7(ii) above does not arise at all.

16. As regards the treatment of ESOP Outstanding Account on exercise of the option, the Committee notes paragraph 22 of the ICAI Guidance Note, relevant portion of which is reproduced below:

> "22. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). ..."

Thus, at the time of exercise of the option, amount in ESOP Outstanding Account, to the extent that it is related to the options exercised, should be debited along with the consideration received against them (viz., cash/bank account), while Share Capital and Share Premium account should be credited. This is also illustrated in the ICAI Guidance Note as well as in clause (f) of Schedule I to the SEBI Guidelines.

The Committee is of the view that the above treatment applies not only to the amount of Rs. 800 per option credited to the ESOP Outstanding Account against original grant but also to the incremental amount credited to the said account consequent upon the reduction of the exercise price.

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) Yes, incremental cost on account of revision of exercise price is required to be accounted for in respect of outstanding options on the basis of difference between the exercise price measured immediately before and after the revision. As regards the amount to be charged from year 2 (2009) onwards as employee cost on account of revision of the exercise price, it should be the sum of the amount chargeable as per original plan plus the relevant portion of the incremental cost to be expensed. The basis of amortisation of the incremental cost should be same as adopted for amortisation of the original cost as per SEBI Guidelines. See paragraphs 12 and 13 above.

(ii) Extra charge in year 2 (2009) will be the net result of accounting for lapses and accounting for incremental cost expensed as explained in paragraph 15 above.

(iii) At the time of exercise of the option, amount in ESOP Outstanding Account, to the extent that it is related to the options exercised, should be debited along with the consideration received against them (viz., cash/bank account), while Share Capital and Share Premium account should be credited. See paragraph 16 above.

Query No. 4

Subject: Disclosure of assets and liabilities held under projects being executed on behalf of the Government of India.[1]

A. Facts of the Case

1. A company registered under the Companies Act, 1956 was incorporated in 1966. The company is a public sector enterprise, fully owned by the Government of India under the Ministry of Health and Family Welfare (MoHFW). The company was set up in the natural rubber rich state of Kerala, for the production of male contraceptive sheaths for the National Family Welfare Programme. As a part of diversification, the company has entered into health care sector in early nineties and today, it has grown into a multi-product/service, multi-unit organisation addressing various public health challenges facing humanity.

2. The service division of the company, inter alia, provides procurement consultancy services and infrastructure development consultancy for medical and allied infrastructure facilities to the Government of India, State Governments and other institutions. The Procurement and Consultancy Services Division (P&CD) provides consultancy services for procuring a range of healthcare and hospital products, equipments and services. It is designated as a National Procurement Support Agency (NPSA). The division undertakes consultancy assignments including bid process management, procurement of goods and stores, as well as project planning and monitoring. Procurement and Consultancy Services Division has ISO 9001 certification. The Infrastructure Development Division imparts consultancy services and undertakes turnkey projects for development of medical and allied infrastructure facilities. The company has been appointed by the MoHFW as in-house consultant for the upgradation of medical colleges. Medical infrastructure projects being executed by the company include the upgradation of medical colleges at different states and Aligarh under the Pradhana Mantri Swasthya Suraksha Yojana (PMSSY). Also, the company is upgrading the JIPMER Institute at Puducherry and is the in-house consultant to the Government of India for setting up six big Medical institutes in the states of Bihar, Orissa and Uttaranchal.

3. The company entered into consultancy agreement with the MoHFW. According to the querist, the salient features of the consultancy agreement

[1] Opinion finalised by the Committee on 3.5.2011.

with the Government of India for the infrastructure development (copy of agreement furnished by the querist for the perusal of the Committee) and procurement and consultancy (copy of agreement furnished by the querist for the perusal of the Committee) are as follows:

- The company, as in-house consultant of the MoHFW, will provide consultancy services for the construction of building and procurement of medical equipments for the upgradation of medical institutes.
- The agreement entered into by the company with the MoHFW will not be construed as establishing a relation of master and servant or that of principal and agent as between the client (i.e., MoHFW) and the consultant (i.e., the company). The consultant subject to the agreement shall have the complete charge of personnel performing the services and shall be fully responsible for the services performed by them or on their behalf.
- The MoHFW will pay the company, consultancy fee for rendering timely and satisfactory services. The fee is paid to the company based on the completion of milestones/stages stipulated in the agreement.
- The company's service involves preparation of concept plan, preparation of detailed project report, preparation of bid documents, short-listing of bid, preparation of detailed design and structural drawings for civil construction including building service, scrutinising and processing the bid for final selection of the contractor as per the procedure laid down by the MoHFW, providing contractual framework alongwith drafting and execution of legal documents including the contract between the company and selected party (third party), monitoring, control and review of projects, obtaining necessary approvals from statutory authorities on behalf of the MoHFW, etc.
- The company's service also includes settlement of contractual disputes with the contractor/supplier including arbitration (third party).
- The company's service also includes procurement, supply, installation, testing and commissioning of medical equipments based on the equipment specification provided by the MoHFW.

- The consultant (i.e., the company) shall keep accounts and records relating to the project for inspection and audit for 5 years.

- The consultant (i.e., the company) shall always act in respect of any matter relating to the contract or services as faithful advisers to the client (MoHFW) and shall, at all times, support and safeguard the client's legitimate interest in any dealings with the third parties.

- The company shall pay taxes, duties, fees, levies and other impositions levied under the applicable laws. The client shall reimburse these expenses.

- The company enters into agreement with construction agencies/ suppliers for executing the project. The tenders were invited on behalf of the MoHFW and the acceptance of offers sent to the construction agencies/suppliers indicates that the company accepted the same on behalf of the MoHFW. Thereafter, the work orders are issued by the company on behalf of the MoHFW. The payments to the agencies/suppliers are governed by the terms and conditions of the agreement made with them and are made out of the advance received from the MoHFW.

- The company shall be receiving funds/bank guarantees from the supplier towards security deposit/performance bank guarantee, etc.

- The company shall be opening Letters of Credit (L/Cs) and establishing bank guarantees in favour of suppliers towards committing payment against supplies.

- The company has to settle all contractual disputes with the contractor/supplier including arbitration. However, all legal awards resulting in financial liabilities shall be borne by the MoHFW.

- The MoHFW shall advance the company 10% of the estimated cost of the project for making payments to the contractors based on the progress of the project. For procurement activities, 100% advance is made by the MoHFW before releasing letter of award to suppliers.

- The company will submit the utilisation/account of advance fund received from the MoHFW. The MoHFW will, in turn, replenish the fund utilised.
- The company shall operate separate bank account for the fund received for each individual project covered in the agreement.
- As per the terms of agreement, any interest earned on the advance and maintained as short-term deposit shall be considered as the amount advanced by the MoHFW.
- The company shall be liable to the client (MoHFW) for performance of the services in accordance with the provisions of terms and conditions of the contract and for any loss suffered by the client as a result of a default of the consultant, limited to a maximum of 10% of the consultancy fee in such performance.
- The consultant shall indemnify the Government against all actions, suits, claims, and demands brought or made against it in respect of anything done or committed to be done by the consultant and its staff in the execution of or in connection with the services provided under this agreement and against any loss or damage to the Government in consequence to any action or suit being brought against the consultant for anything done or committed to be done in the course of the execution of this agreement including losses/damages liable or claimed for infringement of intellectual property rights of any third party. The consultant will abide by the job safety measures prevalent in India and will free the client from all the demands or responsibilities arising from accidents or loss of life, the cause of which is the consultant's negligence. The consultant will pay all indemnities arising from such incidents without any extra cost to the client and will not hold the client responsible or obligated. The Government may, at its discretion and entirely at the cost of the consultant, defend such suit either jointly with the consultant or singly in case the latter chooses not to defend the case. This obligation will survive the termination of the contract for one year.
- In the case of procurement and consultancy, the consultant (i.e., the company) will receive the Earnest Money Deposit (EMD)

and security deposit in the name of Pay and Accounts Officer (PAO), MoHFW, which will be passed on to the PAO on opening of the tenders and issue of notification of award. The PAO will release the deposit amount only on hearing from the company.

4. The querist has stated that the company operates separate bank account for each project for the funds received from the MoHFW as per the terms and conditions of the agreement and maintains separate set of books of account for each project. Further, the company does not have any title to the project assets. Hence, the assets and liabilities pertaining to the projects are disclosed under notes forming part of annual accounts of the company. Only the consultancy fee received/receivable from the MoHFW is the revenue/ turnover of the company and is accounted for in the books of the company.

5. The company keeps the funds of the projects in short-term fixed deposits on behalf of the MoHFW till the same is required for project payments. Such short-term deposits are also accounted for in the project's books of account. The interest received on such deposits is payable to the MoHFW, Government of India and hence, no income tax is paid/TDS is deducted by the bank on such interest.

6. On completion of the projects, the assets are taken over by the respective institutions. The surplus amount, if any, advanced by the Ministry will have to be returned to the Ministry (together with interest accrued and earned on advances) along with statement of accounts of the project. In the case of procurement consultancy, supplies are effected directly to the consignee (as designated by the MoHFW under the agreement) and settlement to the supplies is made based on the consignee receipts.

7. As per the agreement, the accounts shall be kept for a period of 5 years for inspection and audit by the MoHFW.

8. The company has been in the procurement and consultancy business since the financial year 1997-98 and infrastructure development consultancy services from the financial year 2006-07. In the initial years (upto the financial year 2004-2005), the company had been disclosing the assets and liabilities of the P&CD business as assets and liabilities held under trust (as per contra) in the balance sheet based on the suggestion by the then statutory auditors and Comptroller and Auditor General of India (C&AG). Based on the suggestion of the subsequent auditor, this has been changed to the present system of disclosure in which the assets and liabilities of the projects

are disclosed under notes forming part of accounts. Further, considering the nature of the agreement clauses, particularly the liability clause, the unexecuted part of the projects is not included in the contingent liabilities of the company.

9. However, in the financial year 2008-09, the statutory auditors have qualified the accounts stating that the assets and liabilities of the project (handled by the procurement and consultancy division and infrastructure development division of the company for and on behalf of the Government of India) are not incorporated in the balance sheet of the company. The company is keeping the unutilised amount of advance given by the Ministry in fixed deposits and interest received thereon is credited in the respective projects accounts as per the respective agreements. According to the statutory auditors, these assets and liabilities are to be incorporated in the financial statements of the company, because the company entered into commercial contract for the transaction relating to the respective projects and the funds are maintained with the bank in the name of the company.

10. The auditors' observations based on which the accounts have been qualified are given below:

(i) There is contractual obligation for the company.

(ii) Unutilised funds received for the projects are kept in the bank accounts opened in the name of the company and only the company can operate such accounts.

(iii) Utilisation of funds is at the discretion of the company for the purpose of the project as per the agreement.

(iv) The basis for the consultancy charges receivable is the utilisation of the funds, i.e., the revenue recognition is based on the utilisation of funds. Thus, the receipt and utilisation of funds are one of the normal business activities of the company. Hence, the assets and liabilities of the project must be disclosed in the financial statements of the company. Further, as per the generally accepted accounting practices, the entire transactions of the company must be reflected in the audited statements and the company has to ensure the completeness of the information furnished/disclosed in the financial statements.

B. Query

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

(i) Whether the present practice of the company disclosing the assets and liabilities of the project under notes forming part of the annual accounts is in order.

(ii) Whether Accounting Standard (AS) 7, 'Construction Contracts' and Accounting Standard (AS) 9, 'Revenue Recognition' shall be applicable to the company with respect to the transactions of Procurement and Consultancy Division and Infrastructure Development Division business.

(iii) Whether it is necessary to disclose the unexecuted part of the work of Procurement and Consultancy Division projects and Infrastructure Development Division projects under contingent liabilities.

C. Points considered by the Committee

12. The Committee notes that the basic issues raised by the querist are related to (i) disclosure of project assets and liabilities, (ii) applicability of AS 7 and AS 9, and (iii) need for disclosure of unexecuted part of work. Therefore, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of non-payment of income-tax/deduction of TDS on the interest on short-term deposits as per the provisions of Income-tax Act, 1961, or interpretation of the terms of the Agreements entered into with the MoHFW, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view.

13. As regards the first issue raised by the querist, the Committee notes that the terms 'Asset' and 'Liability' are defined in paragraphs 49(a) and 49(b) respectively of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India as follows:

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

"(b) A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

14. The Committee is of the view that so far as the company is concerned, the project assets and project liabilities do not meet the definition of 'Asset' and 'Liability' respectively (reproduced in paragraph 13 above). This is because the future economic benefits from the project assets are not expected to flow to the company. On completion of the projects, the assets are taken over by the respective (medical) institutions. The project assets are not funded by the company. In substance, they are funded by the MoHFW. Accordingly, the liabilities which arise during the transactions are those of the MoHFW and not that of the company. As such, the project assets and project liabilities should not be recognised by the company in its books of account.

15. As regards the second issue raised by the querist, the Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', which is reproduced below:

"b. Substance over Form

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

Thus, the transactions and events are accounted for and presented in accordance with their substance, i.e., the economic reality of events and transactions, and not merely in accordance with their legal from. In other words, it is the 'economic reality' that is important in accounting and not only the 'legal reality'.

16. The Committee notes from the Facts of the Case that the company is getting the construction done through other agencies/parties and procuring the equipments, etc., from other suppliers on behalf of the MoHFW. The Committee notes that the company is mainly providing consultancy services in relation to construction/procurement services for which it is receiving a fixed consultancy fee. Thus, all risks (financial liability, project liabilities, etc.) and rewards (control over project assets, etc.) shall rest with the Ministry. Accordingly, the Committee is of the view that keeping in view the

consideration of substance over form as explained above, the principle of revenue recognition for agency relationship as enunciated in the following definition of 'revenue' as per AS 9 notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') should be applied in the extant case:

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

The Committee, however, is of the view that though the principle of revenue recognition for agency relationship as stated above is applicable both for procurement and consultancy services and infrastructure development services, considering the nature of services involved, the applicable Standard for the two services will differ as explained in paragraph 17 below.

17. The Committee notes that there are two agreements, viz., (i) for procurement and consultancy services and (ii) for infrastructure development including consultancy services. As regards the procurement and consultancy services, the Committee notes that the company is providing only consultancy services in relation to procurement of medical equipments and products which does not seem to be related to construction activities. Accordingly, in substance, it seems to be covered by AS 9 and therefore, the consultancy fee received on this account should be recognised as revenue following the principles of AS 9.

As regards the infrastructure development related services, stated by the querist in respect of turnkey projects for development of medical and allied infrastructure facilities, the Committee is of the view that the company is rendering services directly related to the construction as in case of project managers and accordingly, the principles of AS 7 should be applied while recognising revenue (viz., consultancy fee) from such services. In this connection, the Committee notes paragraph 4 of AS 7, notified under the 'Rules', which is reproduced below:

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

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

(b) ..."

18. As regards the money received by the company from the MoHFW, the Committee is of the view that this seems to be of the nature of 'asset held in trust' and accordingly, the asset and liability in respect thereof should be recognised in the books of account of the company. This will be so whether the money received is kept in bank account or in short-term fixed deposits. As and when the expenditure is incurred, the 'asset held in trust' should be credited with corresponding debit to the related liability. In case the adjustment is to be done at a later date, the expenditure should be debited to receivable account. In case amount receivable by the company for the services is also adjusted against the money received from MoHFW, in addition to the entry for revenue recognition, two more entries are required to the extent the adjustment is made, *viz.,* (i)debiting liability with corresponding credit to receivable (for the services) and (ii)debiting company's bank account with corresponding credit to 'asset held in trust'.

19. The Committee is also of the view that considering the fiduciary nature of the company's responsibility, the company may, if it desires, disclose in the notes forming part of accounts, project assets and project liabilities with disclosure of their nature.

20. As regards the third issue, the Committee notes that Schedule VI[2] to the Companies Act, 1956 requires disclosure of 'Estimated amount of contracts remaining to be executed on capital account and not provided for' as part of 'contingent liabilities'. The projects are not capital in nature for the company. Only for the MoHFW, the projects may have elements which are capital in nature. The Committee is, therefore, of the view that the question of making the aforesaid disclosure by the company does not arise at all.

[2] Schedule VI has been revised. Revised Schedule VI came into force for the Balance Sheet and Profit and Loss Account for the financial year commencing on or after 01.04.2011.

D. Opinion

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

(i) The present practice of the company disclosing the assets and liabilities of the project under notes forming part of accounts is in order only if it is supplemented with the disclosure of their nature.

(ii) For consultancy services of the Procurement and Consultancy Division, AS 9 is applicable. For infrastructure development related services of the Infrastructure Development Division, AS 7 is applicable. As regards the money received by the company from the MoHFW, see paragraph 18 above.

(iii) The unexecuted part of the work of Procurement and Consultancy Division projects and Infrastructure Development Division projects should not be disclosed under 'contingent liabilities'.

Query No. 5

Subject: Depreciation on freehold land having mineral reserves and the internal roads constructed in the premises of the company.[1]

A. Facts of the Case

1. A State Government enterprise is engaged in mining and marketing of four major minerals, namely, Rock Phosphate, Gypsum, Lignite and Limestone. The company is also engaged in the business of generating and selling of wind energy.

[1] Opinion finalised by the Committee on 3.5.2011.

2. The querist has stated that the company was granted a mining lease for excavation of lignite for a period of 20 years and accordingly, the company has purchased/acquired a 1063.35 hectare of freehold land having estimated mineable lignite reserves to the tune of 172.90 lakh MT for a sum of Rs. 18,98,59,223 in Nagaur district of Rajasthan. As per the approved mining plan, the reserve of lignite is to be mined in 20 years. The ownership of the land would, however, remain with the company after excavation of the entire lignite reserves. According to the querist, the mining (freehold land) area is a hilly area and after mining of lignite, there could be deep pits partly filled with overburden. Such land, as per the querist, after complete excavation of the mining of lignite, would not be useful for the purpose of agriculture and also cannot be used for any other purposes. Besides, the water in the area is higly saline which is not useful for drinking and agriculture purposes. Accordingly, the company considers that the land will not be of any use and will not fetch any value after excavation, and accordingly, net realisable value of the land after complete excavation has been assumed at nil.

3. The querist has mentioned that though the lease agreement was signed on 29/06/2002 but the lease period was started from 25/08/2001 and is valid upto 24.08.2021. Further, there is a provision in the mining lease agreement that the period of mining lease can further be extended as per the relevant provisions of the Mineral Concession Rules, 1960.

4. According to the querist, as the mining lease was for a period of 20 years, the company has adopted the accounting policy to write-off the freehold land on the basis of future benefit likely to be accrued and started writing-off the value of land equally @ 1/20th per annum in view of the fact that as the lease is only for 20 years, the benefit shall be accrued only for the lease period of 20 years. This policy has been reflected in the books of account by way of note reproduced below:

> *Accounting Policies & Notes on Accounts (Schedule 'G')*
>
> "Cost of freehold mining land is amortised on the basis of future benefit likely to be accrued."

5. The querist has also mentioned that as per approved mining plan, the entire quantity of lignite was to be mined out within the period of 20 years by excavating the quantity as mentioned in the mining plan but due to some natural hazards beyond the control of the company, the company could not excavate the requisite quantity of lignite as per approved mine plan. The

mining was started in the financial year 2003-04 and till 31st March, 2009, the company could excavate 4.42 lakh MT of lignite as against envisaged production of 31.15 lakh MT. The company however, continued to amortise the land @1/20th each year in view of the fact that the mining lease would expire on 24.08.2021 and it is not certain whether the company would be able to get renewal of lease for a further period or not.

6. The Accountant General (AG) auditors while conducting supplementary audit under section 619(4) have commented that the method of writing off freehold land was not commensurate with the declared accounting policy and the matching principle. According to the auditors, as per matching principle, cost and revenue should match in the period in which they occur and as such, the company should have amortised the freehold land on the proportion of lignite mined during the year and total recoverable reserves available at the beginning of the year. The accounting done by the company was not as per matching principle and the accounting policy because the cost of amortising is not in accordance with the benefits accrued. As such, till 31st March, 2009, the freehold mining land should have been amortised to the extent of Rs. 44,03,809 (18,98,59,223 (cost of land)/172.9 (total recoverable reserves in lakh MT)*4.42(total reserves excavated till March 2009 in lakh MT)) as against Rs. 5,34,07,056. Thus, the company has over amortised the land by Rs. 4,90,03,247.

7. The querist has further stated that the company is also having internal roads in the mine area costing Rs. 3,88,21,682 and the same are depreciated as per Schedule XIV to the Companies Act, 1956, i.e., @ 5 % p.a. on the written down value (WDV). AG Auditor was of the view that internal roads in the mine area should have been depreciated on the line of amortisation of land and accordingly, depreciation on internal roads should have been charged at Rs. 9,92,434 on above lines as against total charge of depreciation of Rs. 65,62,544. Thus, the company has overcharged the depreciation by Rs. 55,70,110. According to the auditors, both these items have resulted in understatement of profit by Rs. 1,03,11,183 for the current year and Rs. 4,42,62,174 for earlier years.

8. While replying to the observations of the auditor, the company was of the view that amortising value of land on the basis of lignite actually mined would result in extending the life of the assets beyond the prescribed period of 20 years for which mining lease is available to the company. Further, as the power to extend the lease period vests with the statutory authorities

which may or may not accept the request of the company to grant further extension of the mining lease, amortising the value of the land on the basis of mineral actually mined and the mineral reserves is not justifiable. Further, as per the querist, actual mineable reserve of 172.9 lakh MTs of lignite is an estimated quantity and actual quantity may be different than the estimated quantity when actual mining would be done.

9. The querist has also stated that paragraph 22 of Accounting Standard (AS) 6, 'Depreciation Accounting', states that the useful life of a depreciable asset should be estimated after considering the following factors:

(i) expected physical wear and tear

(ii) obsolescence

(iii) legal or other limits on the use of the asset

Accordingly, as per the querist, when the company is having mining lease legally only for 20 years, the value of the asset can be amortised only over the period of 20 years. Thus, amortising land on the basis of the actual quantity of lignite mined may not be correct because of the following reasons:

(i) The company is having mining lease of 20 years only.

(ii) It is not necessary that the company may be able to get extension of mining lease period.

(iii) The actual reserve of lignite may not be equal to the estimated reserves.

10. The querist has stated that the actual quantity of lignite mined remained lower due to heavy inrush of water in the mines but the contractor has excavated/removed overburden more than the originally estimated stripping ratio. In case the accounting is to be done on the basis of the matching principle, the expenditure incurred on excavation and removal of higher quantity of overburden as well as expenses incurred for dewatering of mines and other expenses should have also not been charged in the accounts. Accordingly, in the opinion of the company, the policy of amortising 1/20th part of the value of the land every year is correct and is in line with the accounting policy of the company.

11. In reference to audit observation of charging of depreciation on the internal roads on the mining area on the basis of lignite actually mined, the

company has replied that the depreciation on the roads cannot be charged on the basis of lignite actually mined, as the roads shall have their own life which is not much affected by actual quantity of mineral excavated and transported through these roads. The roads would also get damaged due to weathering change/effect, even if, not a single tonne of lignite is mined and transported through these roads. The statutory auditors have also concurred with the reply of the company.

12. In response to the reply of the company, the AG auditors have stated that paragraph 22 of AS 6 does not hold good as the said AS 6 is not applicable on wasting assets including expenditure on exploration for and extraction of minerals. Further, paragraph 7 of AS 6 states that the useful life of depreciable asset is directly governed by extraction or consumption. The company has referred the mining lease period whereas paragraph 7 of AS 6 states about lease period of related assets. In the extant case, the related asset is a land which is a freehold property. Hence, the management's contention is not correct.

B. Query

13. Since the views of AG auditors are different from the accounting treatment given by the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) whether accounting treatment given by the company for amortisation of the land is in order or not. If not, whether the company should charge depreciation on the basis of mineral actually excavated with respect to the estimated reserves of lignite. Further, in case amortisation of the land is to be done on the basis of quantity of lignite excavated, whether the same is to be done retrospectively.

(ii) whether depreciation on the road constructed on such land should be charged on the same basis as that of the land or as per Schedule XIV to the Companies Act, 1956.

C. Points considered by the Committee

14. The Committee notes that the basic issues raised in the query relate to depreciation policy of freehold land having mineral reserves for which a mining right has been granted to the company for a period of 20 years and of the internal roads constructed on such freehold land. The Committee

has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as accounting for the right granted to the company for extraction of minerals; accounting for payments made, if any in respect of extraction; accounting for costs to be incurred on restoration of land, if any, after the extraction of minerals; accounting for expenditure incurred on extraction, accounting treatment of stripping costs and expenses incurred on dewatering of mines; impairment related issues; compliance with requirements of law, such as, Companies Act, 1956, in respect of the appropriateness of the method of depreciation; etc.

15. The Committee notes the introduction paragraph and the definition of the term 'depreciable assets' as contained in Accounting Standard (AS) 6, 'Depreciation Accounting', notified under the Companies (Accounting Standards) Rules, 2006, as below:

> **"Introduction**
>
> 1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:-
>
> …
>
> *This standard also does not apply to land unless it has a limited useful life for the enterprise*." (Emphasis supplied by the Committee.)
>
> ***"3.2 Depreciable assets are assets which***
>
> ***(i) are expected to be used during more than one accounting period; and***
>
> ***(ii) have a limited useful life; and***
>
> ***(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business."***

16. From the above, the Committee notes that a depreciable asset should essentially have a limited useful life. As per the GAAPs prevalent in India, freehold land is considered to have an unlimited life and, therefore, cost

thereof is not depreciated. In the extant case, the Committee notes that the querist has stated that after complete extraction of minerals, the land does not have any economic use to the company due to the reasons stated in paragraph 2 above. The Committee is of the view that keeping in view all the existing circumstances of the case, if it is clearly evident that such land can never be put to any other use, such land should be considered to have limited useful life. In that case, the principles of AS 6 would be applicable. In this context, the Committee notes paragraphs 3.3, 7, 8, 20 and 23 of AS 6 which provide as follows:

> ***"3.3 Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise."***
>
> "7. The useful life of a depreciable asset is shorter than its physical life and is:
>
> (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
>
> (ii) directly governed by extraction or consumption;
>
> (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
>
> (iv) reduced by obsolescence arising from such factors as:
>
> (a) technological changes;
>
> (b) improvement in production methods;
>
> (c) change in market demand for the product or service output of the asset; or
>
> (d) legal or other restrictions.
>
> 8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult

> for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis."
>
> "***20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset."***
>
> "***23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life."***

17. From the above, the Committee is of the view that the rate of depreciation to be applied to a fixed asset would depend on the depreciable amount of the asset and its useful life. With respect to the 'useful life', the Committee notes that paragraph 8 of AS 6 states that determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors, including experience with similar types of assets. The Committee also notes from paragraph 3.3 of AS 6 that useful life can be either the expected period over which asset would be used or expected production/no. of units to be obtained from use of the asset. Further, from the above-reproduced paragraph 23 of AS 6, the Committee notes that useful life of a depreciable asset may be reviewed periodically. The Committee is of the view that in this case, since the sole purpose of acquisition of land is to exploit it for extraction of mineral resources and extraction of such minerals is the only economic use of the land for the company, the useful life of the freehold land would be more appropriately governed by the extractable minerals available on the land and extraction thereof. In other words, it would be more appropriate to depreciate the freehold land on the basis of units of minerals extracted, viz., Units of Production method. Accordingly, keeping in view the aforesaid discussion, the Committee is of the view that the cost of acquisition of freehold land, in the extant case, should be depreciated on the basis of the actual quantity of lignite extracted during a period as against the estimated quantity of extractable mineral reserves. The Committee is of the view that at times, the estimated quantity of mineral reserves also undergoes changes due to subsequent developments, such as, information about the probability of finding additional reserves or information confirming the existence of

estimated quantity of reserves, etc. Accordingly, the Committee is of the view that the company should periodically review the estimated unextracted quantity of reserves and it should be used prospectively as the basis of calculating the depreciation of the freehold land. The Committee notes that in the extant case since the right to extract mineral reserves is also subject to the term of the mining lease, while calculating/reviewing the depreciation for a period, the remaining lease period and the reasonable certainty for its extension in the future should also be taken into account.

18. As regards the retrospective application of the depreciation rates determined in accordance with the above, the Committee notes that the change in the method of depreciation from straight-line method to Unit of Production would result into more appropriate presentation of financial statements of the company and accordingly, it should be classified and disclosed as 'change in accounting policy' in accordance with paragraph 21 of AS 6, which provides as follows:

> ***"21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed."***

Accordingly, the Committee is of the view that the impact of change in the method of depreciation should be calculated retrospectively from the date of the concerned asset coming into use considering the above-reproduced

requirements of paragraph 21 of AS 6 and should be discussed in the period in which such change is made.

19. With respect to charging of depreciation on internal roads in the mine area, the Committee notes that in the extant case, the internal roads may include two types of roads – roads that might exist when the freehold land is acquired and those developed, thereafter, by the company to gain access to mineral reserves. The Committee is of the view that the said roads in the mine area have an independent useful life which would not only depend upon the lignite mined but also on other factors, such as, wear and tear due to weathering effect, etc. Accordingly, the application of unit of production method for depreciation of roads does not appear to be appropriate and the same should be depreciated separately based on their useful life.

20. With respect to the 'useful life', the Committee also notes paragraph 13 of AS 6 and paragraph 9 of the Guidance Note on Accounting for Depreciation in Companies, issued by the Institute of Chartered Accountants of India, which provide as below:

> *AS 6*
>
> "13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute."
>
> *Guidance Note on Accounting for Depreciation in Companies*
>
> "9. The Committee is of the view that in arriving at the rates at which depreciation should be provided the company must consider the true commercial depreciation, i.e., the rate which is adequate to write off the asset over its normal working life. If the rate so arrived at is higher than the rates prescribed under Schedule XIV, then the company should provide depreciation at such higher rate but if the rate so arrived at is lower than the rate prescribed in Schedule XIV, then the company

> should provide depreciation at the rates prescribed in Schedule XIV, since these represent the minimum rates of depreciation to be provided. Since the determination of commercial life of an asset is a technical matter, the decision of the Board of Directors based on technological evaluation should be accepted by the auditor unless he has reason to believe that such decision results in a charge which does not represent true commercial depreciation. In case a company adopts the higher rates of depreciation as recommended above, the higher depreciation rates/lower lives of the assets must be disclosed as required in Note No. 5 of Schedule XIV to the Companies Act, 1956."

From the above, the Committee is of the view that while determining the rate of depreciation to be provided on roads, true commercial depreciation which is adequate to write off the asset (viz., roads) over its normal working life based on bonafide technological evaluation, should be considered. However, since Schedule XIV to the Companies Act, 1956 specifies the rates in respect of roads, the rate so determined should not be lower than the rates prescribed in Schedule XIV to the Companies Act, 1956, which represent the minimum rates of depreciation. Depreciation rates higher than the rates prescribed under Schedule XIV can be adopted only if such higher rates are justified on the basis of bona fide technological evaluation.

D. Opinion

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

(i) Considering the facts and circumstances of the case, the accounting treatment given by the company for amortisation of land is not in order. The depreciation on the freehold land should be determined on the basis of minerals actually extracted during a period with respect to the estimated quantity of extractable mineral reserves, as explained in paragraphs 16 and 17 above. The depreciation as per the correct method of depreciation should be provided retrospectively and the effect of the same should be treated and disclosed as a change in accounting policy as discussed in paragraph 18 above.

(ii) No, depreciation on the internal road in the mine area should be calculated and charged on the basis of their own useful lives,

which should be based on a bona fide technological evaluations, as explained in paragraphs 19 and 20 above.

Query No. 6

Subject: Accounting for leave liability.[1]

A. Facts of the Case

1. A public sector company is engaged in the manufacture of power equipments. The company has manufacturing units, power sector regions, service centers and regional offices besides project sites spread all over India and abroad. The shares of the company are listed in stock exchanges at NSE and BSE. The turnover of the company was Rs. 34,154 crore in the year 2009-10. The company had employee strength of 46,274 Nos. as on 31.03.2010.

2. The rules of the company relating to the leaves are as below:

Earned Leave (EL):

The entitlement of earned leave is related to the number of years of service put in by the employee as under:

Number of completed years of service	Entitlement of earned leave per annum (days)
Upto 5 years	22
Above 5, upto 10 years	24
Above 10, upto 15 years	26
Above 15, upto 20 years	28
Above 20 years	30

[1] Opinion finalised by the Committee on 3.5.2011.

The earned leave has two components, viz., encashable (EEL) and non-encashable (NEL). The company gives advance credit of leave in terms of encashable and non-encashable leave on the existing standard dates as given below:

No. of completed years of service	Entitlement of EL per annum (days)	Credit No. of days			
		On 25th June		On 25th Dec.	
		EEL	NEL	EEL	NEL
Upto 5 years	22	8	3	8	3
Above 5, upto 10 years	24	9	3	9	3
Above 10, upto 15 years	26	10	3	10	3
Above 15, upto 20 years	28	11	3	11	3
Above 20 years	30	11	4	11	4

3. The querist has stated that the accumulation limit of earned leave is 300 days, beyond which, it shall automatically lapse. The advance credit of encashable portion of earned leave will, however, not be taken into account for determining the accumulation limit. Encashable earned leave can be encashed or availed at any time subject to an accumulation limit of 300 days and NEL is encashable at the time of retirement only, but it can be availed at any time during the service period. There is no restriction on an employee in availing the earned leave (whether encashable or non-encashable) in the same year in which it has fallen due. It is an employees' discretion to avail/encash or accumulate the leave at any time. In a nutshell, the employee has an option either to avail the leave without any restriction or encash once in a year or accumulate subject to the ceiling limit of 300 days.

4. The querist has also explained the rules of the company relating to Half Pay Leave (HPL) as below:

(i) All employees are entitled to 20 days of half pay leave in a year.

(ii) Advance credit is allowed on 25th June/25th December each year at the rate of 10 days each time.

(iii) There is no limit for accumulation of half pay leave. However, it is encashable only at the time of superannuation subject to a maximum of 480 half days, i.e., 240 days.

(iv) Half pay leave can be availed at any time but encashable only at the time of superannuation.

(v) Half pay leave can also be commuted and availed, as 'sick leave', i.e., 2 half days will be counted as 'one sick leave'.

5. A summary of the above rules has been provided by the querist as under:

<table>
<tr><th></th><th>EEL</th><th>NEL</th><th>HPL</th></tr>
<tr><td>Accrued during the year (days)</td><td>16 to 22</td><td>6 to 8</td><td>20</td></tr>
<tr><td>Maximum accumulation limit (days)</td><td colspan="2">300 days both for EEL & NEL put together</td><td>No limit</td></tr>
<tr><td>Encashable during the service</td><td>Yes- once in a year with-out any restriction</td><td>No</td><td>No</td></tr>
<tr><td>Encashable limit on superannuation (days)</td><td colspan="2">300 days EEL & NEL both put together</td><td>480 half days. (240 full days).</td></tr>
<tr><td>Availment restriction at any time during service</td><td>No</td><td>No</td><td>No</td></tr>
</table>

6. The querist has stated that prior to the introduction of Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits', issued by the Institute of Chartered Accountants of India (ICAI), the leave liability was being accounted for on actuarial basis. However, pursuant to the introduction of AS 15 (revised 2005) from 01.04.2006, the company is accounting for the leave liability on accrual basis based on the opinion taken from a renowned consultant, which as per the querist, is in line with the requirements of AS 15 (revised 2005).

7. The accounting policy of the company relating to employee benefits is as below:

> "Earned leave, half pay leave, provident fund and employees' family pension scheme contributions are accounted for on accrual basis. Liability for gratuity, travel claims on retirement and post-retirement medical benefits are accounted for in accordance with actuarial valuation. The actuarial liability is determined with reference to employees at the beginning of each calendar year. Compensation under voluntary retirement scheme is charged-off in the year of incurrence on a pro-rata monthly basis."

8. The accounting practice of the company in respect of leave liability from 1.4.2006 is stated by the querist as below:

> Liability for encashable earned leave (EEL), non-encashable earned leave (NEL) and half pay leave (HPL) is provided for in the books on accrual basis for the value of leave outstanding at the end of the year. According to the querist, provision for half pay leave is made for the total leave balance at the year end without restricting it to 480 half days (240 full days) per employee in line with the requirements of AS 15(revised).

9. During the audit of annual accounts for the financial year 2009-10, the Government audit has raised a query stating that the past pattern indicates that the employees are unlikely to avail/encash the entire carried forward leave during the next twelve months and hence, the benefit would not be short-term. Accordingly, they are of the view that keeping in view the behavioral pattern of the employees, the leave benefit should be considered as long-term benefit and the provision should be made based on actuarial valuation.

10. The company has expressed its views as below:

> Paragraph 8 (b) of AS 15 (revised 2005), issued by the ICAI states as follows:
>
> > "8. Short-term employee benefits include items such as:
> >
> > (b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within

twelve months after the end of the period in which the employees render the related employee service;"

Paragraph 10 of AS 15 (revised 2005), issued by the ICAI states as follows:

> ***"10. When an employee has rendered service to an enterprise during an accounting period, the enterprise should recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service..."***

In the case of the company, leave is accrued when the employee renders his service and there is no restriction on an employee in availing /encashing in the same year in which it has fallen due. The accumulation or encashment is entirely an individual's discretion and the employee can avail/encash the entire accumulated leave balance in one financial year itself.

The point raised by Government audit for treating the leave benefit as long-term benefit is stated to be based on behavioral pattern of the employees on availing /encashing the leave based on the ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005), issued by the Institute of Chartered Accountants of India (ICAI). Since there is no provision in AS 15 (revised 2005), issued by the ICAI on treatment of benefits based on behavioral pattern, the treatment has to be in line with AS 15 and not based on the said Guidance which clearly states that it is not a part of standard.

11. The querist has enclosed the trend of leave accrued, leave availed/ encashed during the period 2008-09 and 2009-10 at Annexure A for reference. The querist has pointed out that it may be seen from the Annexure that approximately 96% of EEL and 82% of NEL accrued during the year were availed/encashed by the employees in the year 2009-10. Further, there is no clear trend that on an average how many employee will encash/avail or carry forward the leave. It may also be observed that in the financial year 2009-10, there is a substantial increase in leave encashment/availment as compared to year 2008-09. Therefore, as per the querist, when there is a full obligation of the company towards leave liability, it should be treated as short-term and accounted for on accrual basis.

12. According to the querist, in view of above and based on opinion given by the consultant when AS 15 (revised 2005) was introduced, leave liability

is accounted on accrual basis and being continuously followed from the financial year 2006-07 onwards.

B. Query

13. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether treatment of leave liability as short-term employee benefit and accounting on accrual basis by the company is correct and is in line with AS 15 (revised 2005) or not.

(ii) In case it is not, then how to account for the change during the year 2010-11, i.e., through profit and loss account or through retained earnings (balance sheet approach).

C. Points considered by the Committee

14. The Committee, while answering this query, has restricted itself to the issues raised in paragraph 13 above and has not touched upon any other issue arising from the Facts of the Case, such as, accounting policy of the company in general and particularly for provident fund, gratuity, pension, travel claims on retirement, post-retirement medical benefits and compensation under voluntary retirement scheme, etc. and the basis of acturial valuation etc.

15. The Committee notes the definitions of the terms 'short-term employee benefits' and 'other long-term employee benefits' as contained in paragraphs 7.2 and 7.8 of AS 15, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules') which are reproduced below:

> ***"7.2 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."***
>
> ***"7.8 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."***

16. The Committee also notes that paragraph 8 of AS 15 notified under the Rules provides as below:

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

The Committee also notes that although ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005) does not form part of the Standard, by virtue of this Guidance, the Accounting Standards Board has clarified in the context of short-term and long-term employee benefits, vide Issue 3 thereof, which, inter alia, provides as below:

> "Paragraph 7.2 of the Standard uses "***falls due"*** as the basis, paragraph 8(b) of the Standard uses "***expected to occur"*** as the basis to illustrate classification of short- term compensated absences. A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short-term compensated absences should be only when absences have ***"fallen due"*** and are also "***expected to occur"***. In other words, where employees are entitled to earned leave which can be carried forward to future periods the benefit would be a 'short-term benefit' provided the employee is ***entitled*** to either encash/utilise the benefit during the twelve months after the end of the period when he became entitled to the leave and is also ***expected to do so***. Where there are restrictions on encashment/availment, clearly the compensated absence has not fallen due and the benefit of compensated absences is more likely to be a long term benefit. For example, where an employee has 100 days of earned leave which he is entitled to an unlimited carry forward but the rules of the enterprise allow him to encash/utilise only 30 days during the next twelve months, the benefit would be considered as a 'long-term' benefit. In some situations where there is no restriction but the absence is not expected to wholly occur in the next twelve months, the benefit should be considered as 'long-term'. For example, where an employee has 400 days carry forward earned leave and the

past pattern indicates that the employees are unlikely to avail/encash the entire carry forward during the next twelve months, the benefit would not be 'short-term'. Whilst it is necessary to consider the earned leave which ***"falls due"***, the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether 'short-term' or 'long term'. The value of short-term benefits should be determined without discounting and if the benefit is determined as long-term, it would be recognised and measured as "Other long-term benefits" in accordance with paragraph 129 of the Standard. The categorisation in 'short-term' or 'long-term' employee benefits should be done on the basis of the overall behavioural pattern of all the employees of the enterprise and not on individual basis."

17. On the basis of the above, the Committee is of the view that short-term employee benefits include only those compensated absences which accrue to the employees and are expected to be availed (or encashed, as the case may be) within twelve months after the end of the period in which the employees render the related service. In other words, where it is expected that the employees will avail/encash the *whole* of the benefit accruing to them on account of earned leave (EEL and NEL) and half-pay leave within the twelve months after the end of the period in which the employees render the related service, the same would fall within the category of 'short-term employee benefits'. However, the Committee notes from the Facts of the Case that both the leave entitlements of the employees of the company can be carried forward for more than twelve months after the end of the period in which employees render the related service. Further, the Committee notes from the Annexure provided by the querist that both the types of leaves, which were accrued during the year 2008-09 and 2009-10, have been accumulated and carried forward by the employees. Therefore, the Committee is of the view that the benefit on account of both types of leaves does not fall within the category of 'short-term employee benefits'. Rather, the entire benefit on account of these leaves should be treated as 'other long-term employee benefits'.

18. 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.

19. As regards accounting for the change in the accounting treatment of these types of leaves, the Committee notes the definition of the term 'Prior period items' and paragraphs 15 and 19 from Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the Rules, which provide as follows:

> ***"Prior period items** are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."*
>
> ***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***
>
> "19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss."

From the above, the Committee is of the view that since earned leaves and half pay leaves are to be accounted for as 'other long-term employee benefits' instead of 'short-term employee benefits', as being done by the company, same is an error and accordingly, it should be treated as 'Prior period item', the nature and amount of which should be included and disclosed separately in the profit and loss account of the period in which such error is revealed.

20. The Committee also notes from the Facts of the Case and the wordings of the accounting policy of the company as reproduced by the querist in paragraph 7 above, that the company has made a distinction between the terms 'accrual' and 'acturial valuation'. The Committee wishes to clarify that the acturial valuation is also based on 'accrual basis of accounting'. Accordingly, the Committee is of the view that the wording of accounting policy of the company should also be changed in this respect.

D. Opinion

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

(i) No, the treatment of leave liability as 'short-term employee benefit' by the company is not correct. Such treatment is not in

line with the requirements of AS 15 (revised 2005). Refer to paragraphs 17 and 20 above.

(ii) The change in the accounting treatment of leave liability, in the extant case, from 'short-term employee benefits' to 'other long-term employee benefits' should be treated as 'prior period item'. Accordingly, the nature and amount thereof should be included and disclosed in the profit and loss account for the period in which such error is revealed as discussed in paragraph 19 above.

Annexure A

DETAIL OF LEAVE BALANCES – THE COMPANY

NUMBER OF EMPLOYEES – 46274 as on 31.03.2010 (In No. of days)

Description	Nature of leaves	F.Y. 2009 – 10			F.Y. 2008 – 09		
		Retired employees	Other employees	Total	Retired employees	Other employees	Total
Opening Balance (No. of days)	EL	332774	3084518	3417292	269548	3069913	3339461
	NEL	151459	1525442	1676901	127268	1473474	1600742
	HPL	524933	5797895	6322828	478722	5775591	6254313
Total number of Leaves accrued during the year (No. of days)	EL	33216	876446	909662	26714	879407	906121
	NEL	10973	299107	310080	8299	293219	301518
	HPL	27679	884884	912563	23032	859770	882802
Total number of Leaves availed/ encashed by the employees during the year (No. of days)	EL	365990	839457	1205447	296262	548713	844975
	NEL	162432	246112	408544	135567	168568	304135
	HPL	552612	289287	841899	501754	338280	840034
Closing Balance (No. of days)	EL		3121507	3121507		3400607	3400607
	NEL		1578437	1578437		1598125	1598125
	HPL		6393492	6393492		6297081	6297081
Leave avail/ encash as % age to leave accrued	EL		95.78%			62.40%	
	NEL		82.28%			57.49%	
	HPL		32.69%			39.35%	

Query No. 7

***Subject: Accounting for the share of expenditure incurred by the company on development of power sub-station and for obtaining power connection.*[1]**

A. Facts of the Case

1. A company is engaged in the manufacture of automobile parts for supplying the same to various automobile manufacturers. An industrial plot for establishing its new unit was acquired by the company in an industrial estate, which was developed by M/s A Ltd. (hereinafter referred to as 'Developer'). Since the unit is a manufacturing unit, it requires power to carry out its production and other operations. A State Power Corporation Limited (hereinafter referred to as 'SPCL') is the nodal agency to provide power connection to consumers. When the unit approached them for power connection, it was informed that it will take about 3 years to provide the power connection as they are not having any sub-station in the area. The unit has been in production since March, 2010 and all the power requirements are being met through in-house DG set. Presently, all the units in the industrial estate are operating through their self-operated DG sets. The cost of operating through DG sets is very high as compared to cost of power supplied by SPCL.

2. The Developer of the industrial estate then sought the approval of SPCL for developing the said power sub-station with its own expenditure. SPCL approved the same with the condition that the said power sub-station will be handed over by the developer to SPCL without any payment. The Developer, with mutual consent of all units, has decided that the said power sub-station will be developed by the Developer on behalf of all units and will be handed over to SPCL in industrial estate without any payment so that all the units in industrial estate may get power supply. This power sub-station will be operated and maintained by SPCL and it will also have the right to provide power connections to new units. The Developer estimated the cost of developing the sub-station and allocated the proportionate cost among all units in the industrial estate on the basis of load requirements by the respective units. The share of the company comes to Rs. 62.70 lakh. Thus, the Developer is working as a *nodal* agency between various units and SPCL (emphasis supplied by the querist).

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[1] Opinion finalised by the Committee on 3.6.2011.

3. Besides the above, the company will have to pay to SPCL for other expenses, like connection charges, line charges, pole and cable charges. The querist has also provided certain additional points for the consideration of the Committee:

(i) The company will not have any kind of ownership/ proportionate ownership in the said power sub-station as it will be transferred by the Developer to SPCL without any payment on behalf of all units.

(ii) It has been mentioned in the land allotment letter that the respective unit will have to bear the cost of obtaining power connection from SPCL.

(iii) The benefits derived from above expenditure of Rs. 62.70 lakh will last for more than one accounting period.

(iv) There will be cost saving in operating through electricity instead of DG Sets.

B. Query

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

(i) Whether the expenditure of Rs. 62.70 lakh to be paid to Developer and subsequent payments to SPCL for getting the power connection is capital or revenue in nature. If it is classified as capital expenditure, then the class of asset in which the expenditure should be booked may be clarified.

(ii) Whether such expenditure creates an intangible asset as defined and governed by Accounting Standard (AS) 26, 'Intangible Assets'.

C. Points considered by the Committee

5. The Committee notes that the basic issues raised in the query relate to accounting for the two types of expenditure incurred by the company, viz., (i) proportionate share of expenditure amounting to Rs. 62.70 lakh borne by the company for development of power sub-station and (ii) other expenditure incurred for obtaining power connection, like connection charges, line charges, pole and cable charges. The Committee has, therefore, considered

only these issues and has not touched upon any other issue that may arise from the Facts of the Case.

6. As regards the first type of expenditure incurred by the company towards development of power sub-station, 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."

> "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."

From the above, the Committee notes that an expenditure incurred by an enterprise can be recognised as an asset only if it is a 'resource *controlled* by the enterprise'. Thus, it is the *control* over the resource that is important for recognising an expenditure as an asset. The Committee is of the view that an entity that controls a resource can generally deal with it as it pleases. For example, the entity having control of a resource can exchange it for other assets, employ it to produce goods or services, charge a price from others to use it, use it to settle liabilities, or distribute it to owners. Further, the Committee is of the view that an indicator of control would be that the entity can restrict the access of others to the benefits derived from that resource. This view is also supported by the principles enunciated in paragraph 14 of AS 26, as reproduced below:

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

The Committee notes from the Facts of the Case that by incurrence of such expenditure, a power sub-station has been developed, which will be owned, operated and maintained by the SPCL and it shall have the right to provide power connection to new units. In other words, the company does not possess either the ownership or the control on the power sub-station. Accordingly,

the Committee is of the view that this expenditure cannot be recognised as an asset (tangible or intangible). The Committee is further of the view that in the absence of such 'control', the expenditure incurred on development of sub-station should be expensed and charged to the profit and loss account of the period in which it is incurred, even though the economic benefits are expected to flow to the enterprise from such expenditure. In this regard, the Committee notes paragraph 56 of AS 26 which provides as follows:

> "56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. ..."

7. As regards the accounting for other types of expenditure incurred by the company relating to connection charges, line charges and cable charges for obtaining the power connection, the Committee is of the view that it is necessary to determine the nature of such charges as to whether such charges create any asset which are being controlled by the company, as discussed in paragraph 6 above or these charges are paid to SPCL for using the assets of SPCL (viz., pole, cable). The Committee is of the view that the expression 'charges', in relation to power connection may be taken to mean the charges being paid for using the asset of SPCL and not that such charges would give rise to any asset (tangible or intangible) which would be controlled by the company. Accordingly, the Committee is of the view that subsequent payments to SPCL for getting the power connection is revenue expenditure in nature, unless it results in creation of an asset.

D. Opinion

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

(i) The expenditure of Rs. 62.70 lakh paid to the Developer and subsequent payments to SPCL for getting the power connection are revenue in nature. Refer to paragraphs 6 and 7 above.

(ii) In view of (i) above, answer to this question does not arise.

Query No. 8

Subject: Segment Reporting.[1]

A. Facts of the Case

1. An unlisted public limited company is engaged in the business of manufacturing products on contract basis. The turnover of the company for the financial year 2009-10 was Rs. 260 crore. The company manufactures engineering products, castings, etc. as per the design, engineering standards and specifications prescribed by the customers. The company manufactures industrial valves under brand name of its customer at USA. The company also manufactures castings both machined and unmachined and supplies the same to tractor and auto sector. Again, these are components used by manufacturers of tractors, trucks, etc. The company also supplies components to a public sector undertaking for use in earth moving equipment. According to the querist, the company has only one product sold in its brand name, i.e., gear boxes which account for less than 3% of the turnover. The company has not more than 12 customers who either use components supplied by the company in their own products, for example, tractor, truck, earth moving equipment, etc. or sell the products under their own brand name and the end customer does not recognise the company.

2. The querist has stated that the geographical distribution of the sales of the company is also restricted to one country/region. For example, more than 95% of valves are supplied to USA. Castings are sold in India with a small portion of export.

3. The querist has also stated that the financial statements presented and reviewed by the Board is for the company as a whole without any segmentation. Bank facilities are also arranged based on the financials of the company as a single segment organisation. Banks have accepted this position.

4. Based on these facts, the company has given the following note under Notes on Accounts in the published statement of annual accounts:

> “Segment Reporting
>
> The company has confirmed that they are operating as a single business

[1] Opinion finalised by the Committee on 3.6.2011.

and geographical segment. As such, there are no reportable segments as per Accounting Standard 17 on 'Segment Reporting'."

This is the settled position from the financial year 2001-02 to 2009-10. The company had a change of auditors recently and they desire that the position should be re-examined. The querist has stated that to be consistent, the company would prefer to continue the present practice.

B. Query

5. On the facts and circumstances stated above, the querist has sought the opinion of the Expert Advisory Committee as to whether it is in order to continue the present practice of treating the business as a single segment, i.e., contract manufacturing.

C. Points considered by the Committee

6. The Committee, while answering the query, has considered only the issues raised in paragraph 5 above and has not touched upon any other issue arising from the Facts of the Case. The Committee also wishes to state that in the absence of the facts related to risks and returns associated with various products of the company or various regions/countries in which the company operates, the Committee is, hereinafter, laying down broad principles to be applied while identifying the reportable segment as per the provisions of AS 17.

7. The Committee notes that as per the provisions of Accounting Standard (AS) 17, 'Segment Reporting', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), the components of an enterprise that are required to be reported separately have to first fall within the definitions of the terms 'business segment' or 'geographical segment' before being considered as 'reportable segments' as per the threshold criteria laid down in paragraph 27 of AS 17, notified under the Rules. In this context, the Committee notes the definitions of the terms 'business segment' and 'geographical segment' as per AS 17, notified under the Rules, which provide as follows:

"5.1 A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other

business segments. Factors that should be considered in determining whether products or services are related include:

(a) ***the nature of the products or services;***

(b) ***the nature of the production processes;***

(c) ***the type or class of customers for the products or services;***

(d) ***the methods used to distribute the products or provide the services; and***

(e) ***if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities."***

"5.2 A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) ***similarity of economic and political conditions;***

(b) ***relationships between operations in different geographical areas;***

(c) ***proximity of operations;***

(d) ***special risks associated with operations in a particular area;***

(e) ***exchange control regulations; and***

(f) ***the underlying currency risks."***

8. The Committee also notes that paragraphs 7 and 8 of AS 17, notified under the Rules, provide as follows:

"7. A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors."

> "8. Similarly, a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country."

9. The Committee also notes paragraph 12 of AS 17, notified under the Rules, which is reproduced below:

> "12. The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments."

The Committee notes from the above that to identify business and geographical segments, the enterprise needs to evaluate whether the risks and returns of different components are different as per the factors stated in the definitions of the terms 'business segment' and 'geographical segment'. The organisational structure of an enterprise and its internal reporting system are normally the basis for identifying the segments, subject to their fulfilling the criteria prescribed in the aforesaid definitions.

10. The Committee notes from the Facts of the Case that the company is engaged in the manufacturing of different types of engineering products/ components, castings, valves, etc. These products are both machine-made and hand-made. Further, many of these products are manufactured as per the specifications of the clients for either use in the products of the clients or for selling these products in the clients' brand name and some of these are sold by the company in its own name. However, the information about whether the risks and returns associated with the various products in which the company deals in, are different, is not clear from the Facts of the Case. In this context, the Committee notes from the above-reproduced definition of 'business segment' and other provisions of AS 17 that if various products of the company are subject to different risks and returns, these would constitute different business segments. For instance, in the extant case, some of the products manufactured by the company, for example, in the case of valves, sales are restricted to a single customer and accordingly, the risks and returns in such cases where the company is relying on a single customer may be different from the risks and returns of a product where the company is not so relying on a single customer. Similarly, risks and returns in case of products manufactured by machines may be different from the products which are hand-made. Thus, the Committee is of the view

that considering the nature of the products produced, production processes involved in manufacturing and type or class of customers, the company should evaluate that whether there can be different business segments in the present case.

11. Similarly, in the context of geographical segments, while, on one hand, the querist has stated that the geographical distribution of the sales of the company is restricted to one region, on the other hand, it is stated that more than 95% of the valves manufactured by the company are supplied to USA. Further, castings are sold in India with a small portion of export. However, the information as to whether or not the risks and returns associated with the different regions/countries in which the company supplies its products are different, is not clear from the Facts of the Case. In this context, the Committee is of the view that there may be different pricing strategies, credit risks and exchange control regulations involved for domestic and international sales. In such a case, the risks and returns in different geographical regions may be different and accordingly, the different geographical regions may be considered as different geographical segments in the present case. The Committee is also of the view that geographical segments may also be identified by segregating its total turnover into domestic sales and international sales irrespective of the nature or kind of the products being sold. Thus, the Committee is of the view that considering the above-mentioned factors, the company should evaluate that whether there can be different geographical segments in the present case.

12. After identifying various business and geographical segments as discussed above, in the view of the Committee, the company should decide whether these segments can be considered as reportable based on the requirements of paragraphs 27 to 29 of AS 17, notified under the Rules, which provide as follows:

> ***"27. A business segment or geographical segment should be identified as a reportable segment if:***
>
> > ***(a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or***

(b) its segment result, whether profit or loss, is 10 per cent or more of

(i) the combined result of all segments in profit, or

(ii) the combined result of all segments in loss, whichever is greater in absolute amount; or

(c) its segment assets are 10 per cent or more of the total assets of all segments.

28. A business segment or a geographical segment which is not a reportable segment as per paragraph 27, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

29. If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds in paragraph 27, until at least 75 per cent of total enterprise revenue is included in reportable segment."

From the above, the Committee is of the view that if the segments of the company meet the above-reproduced threshold criteria, the company should report the same as business and/or geographical segments as discussed above as per the other requirements of AS 17. The Committee is also of the view that if it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information is not required to be disclosed. The fact that there is only one 'business segment' and 'geographical segment' should be disclosed by way of a note as per the requirements of Explanation to paragraph 38 of AS 17, notified under the Companies (Accounting Standards) Rules, 2006.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the company should identify the reportable business and/or geographical segments based on the considerations stated in paragraphs 9 to 12 above.

Query No. 9

Subject: Revenue recognition in case of construction contracts.[1]

A. Facts of the Case

1. A public sector company (hereinafter referred to as the 'company'), listed in the stock exchanges at NSE and BSE, is engaged in the field of engineering, manufacture of equipments, erection and commissioning of power projects. In addition, the company is in the business of transportation, transmission and defence, etc. In power project business, the contracts received by the company are either Engineering, Procurement and Construction (EPC) contracts or Boiler, Turbine and Generator (BTG) Packages, where civil works and Balance of Plant (BOP) package items are not in the scope. The normal execution period of a contract ranges between 3 to 5 years. The scope of the contract includes supply of equipments, erection, commissioning, ensuring guaranteed output from the machines, completing the trial operation and synchronising the plant to the grid. The normal warrantee/guarantee period is between 18 to 24 months. The company has 15 manufacturing units, 4 power sector regions, service centers and regional offices besides project sites spread all over India and abroad. The responsibility of manufacturing units is engineering, manufacture and supply of the equipments as per the agreed specifications whereas the power sector regions/site offices are responsible for erections, commissioning, purchase of BOP items and civil works (for EPC contracts). Conducting trial operations and synchronising the power station to the grid are also the responsibility of the power sector regions.

2. The querist has stated that long-term construction contracts are obtained by the company's marketing wing which allocates the scope and value to various manufacturing units and regions/sites for execution. The units/regions bill the customer based on the Billing Break Up (BBU) agreed with the customer. The billing to the customer is based on agreed terms and conditions either based on BBU and in few contracts, on reaching certain milestones. According to the querist, the billing value may not represent the true value of the despatches or the project progress at the site. The billing is mainly to ensure cash flows. Hence, the turnover for a period is arrived at after adjusting the value of works done to the billed amount through valuation adjustment account.

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[1] Opinion finalised by the Committee on 12.8.2011.

3. The accounting policy of the company for revenue recognition in respect of construction contracts is stated by the querist as below:

> *A. For construction contracts entered into on or after 01.04.2003*
>
> "Revenue is recognised on percentage completion method based on the percentage of actual cost incurred upto the reporting date to the total estimated cost of the contract."

4. The accounting practice in respect of construction contracts covered under Accounting Standard (AS) 7 (revised 2002), 'Construction Contracts' is as below:

> For working out the percentage of completion, the following accounting practice is being followed from the financial year 2003-04. The percentage of completion is worked out based on actual cost incurred upto reporting period divided by total estimated cost of the contract. Total estimated contract cost is worked out based on actual cost incurred plus estimated remaining cost to complete the work at the end of the reporting period. Actual cost incurred upto reporting period is worked out as follows:
>
> *(a) By manufacturing units*
>
> Actual cost incurred for each contract is worked out based on actual cost incurred upto the reporting date in respect of items *manufactured and physically despatched to the project site* (emphasis supplied by the querist). Raw materials, stores and spares procured by the units and work in progress (WIP), which are not a despatchable unit are not considered as actual cost incurred for the purpose of working out the percentage of completion. Similarly, finished goods, which are lying at unit and not physically despatched from manufacturing unit to project site are not considered for the purpose of calculating actual cost incurred for working out percentage of completion for revenue recognition. The costs incurred on above are recognised as inventory in the accounts.
>
> *(b) By power sector regions/sites*
>
> Actual cost incurred towards engineering, commissioning, etc. by region/ site is considered for working out percentage of completion for revenue recognition. Further, items like steel, cement and bought-outs directly supplied from supplier to project site and billed to the customer are

also considered as part of actual cost incurred for working out percentage of completion for revenue recognition. Cost incurred in design and drawings for a project till milestones as per billing schedule, is exhibited as Contract WIP and no revenue is recognised till such date. Actual costs incurred including manhours spent, engineering, designing cost, etc. are part of actual cost incurred upto the reporting period.

5. The querist has stated that in case of construction contacts covered under AS 7 (revised 2002), normally more than one manufacturing unit/ region of the company are involved for execution of the contract. Each unit/ region of the company recognises its revenue in respect of allocated scope of work in their books based on the above accounting practice. Since the percentage of completion with respect to a contract will differ for each unit/ region of the company which is based on the progress of their scope of work, there is a need to work out the percentage of completion of a contract for the contract as a whole to recognise the revenue in line with the requirements of AS 7 (revised 2002). The total contract revenue, actual cost incurred upto the reporting period, estimated total cost at the end of the reporting period, etc. are consolidated based on the inputs given by units/ regions involved in a contract to concerned business sector to work out the percentage of completion at the total contract level and any adjustment between revenue recognised by unit and revenue to be recognised at overall contract level is made by the business sector. The difference between the revenue recognised by the unit/regions and revenue as worked out on consolidated level are recognised through valuation adjustment account in the accounts of business sector.

6. The querist has further stated that percentage of completion is worked out based on the actual cost incurred upto the reporting period based on the above as a percentage to the total estimated cost of the contract. The percentage as worked out is multiplied with the total estimated contract revenue to determine revenue upto the reporting period. The same is recognised as revenue upto the reporting period.

7. The disclosures made in the notes to accounts pursuant to AS 7 (revised 2002) have been stated by the querist as follows:

(a) Contract revenue recognised for the year as per AS 7 (revised 2002)

(b) In respect of contract in progress at the end of the year

— Cost incurred and recognised profit (less recognised losses)

— Amount of advance received

— Amount of retentions (deferred debts)

(c) In respect of dues from customers after appropriate netting off

— Gross amount due from customer for the contract work as an asset

— Gross amount due to customer for the contract work as a liability

— Contingencies

The following note is also given:

> "The estimates of total costs and total revenue in respect of construction contracts entered on or after 1st April, 2003 in accordance with Accounting Standard (AS) 7 (revised 2002), 'Construction Contracts' are reviewed and updated periodically during the year by the management and necessary adjustments are made in the current year's account."

8. During the audit of annual accounts for the financial year 2009-10, the querist has informed that the Government audit has raised the following queries:

(a) Revenue in respect of construction contracts is to be recognised on percentage of completion method based on the percentage of actual cost incurred upto the reporting date to the total estimated cost of the contract as per the significant accounting policy of the company. However, in contravention to its accounting policy, the company is considering the ratio of cost of despatches to the total estimated cost instead of the ratio of actual cost incurred upto reporting date to the total estimated cost for recognition of revenue from construction contracts.

(b) The Government audit is of the view that the cost of steel/ cement purchased at project sites specific to the projects which

has been billed to the customers as per BBU and in respect of which certain percentage of the money is also collected, is not to be treated as cost incurred, since these materials have not been put to use/or consumed in the construction activities. In the view of the Government audit, these materials are required for future activity of civil and structural work to be done subsequently and cannot be considered as cost incurred for working out percentage of completion for revenue recognition.

(c) Further, the Government audit is of the view that the estimated contract revenue and estimated contract cost in respect of construction contracts covered under AS 7 (revised 2002) are dynamic in nature and undergo series of changes in executing the contract, i.e., for projects which existed at opening of financial year and continuing at the end, there is a change in the estimated contract revenue and estimated cost of a contract due to factors given below, which have an effect on the turnover and profit for the year. In the view of the Government audit, in terms of paragraph 37 of AS 7 (revised 2002) it is a change in accounting estimate and the impact should have been disclosed in the accounts considering the requirements of AS 7 (revised 2002) and Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

9. The company has expressed its views as follows:

(a) In case of manufacturing units

Paragraph 26 of AS 7 (revised 2002) reads as follows:

> "A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress."

Actual cost incurred towards purchase of raw material, stores, spares etc., work in progress at the manufacturing units, as well as finished goods at stores, not physically despatched from manufacturing units to project sites are for future activity and hence, cannot be considered as part of actual cost incurred in ascertaining the percentage of completion.

Therefore, accounting treatment of showing these as part of inventory, contract WIP/finished goods is in order.

The wording of the accounting policy, i.e., 'actual cost incurred' is in line with the words used in AS 7 (revised 2002) and it should not be linked with the cost of purchases of raw material, stores and cost incurred on WIP/finished goods, etc.

(b) Power Sector Regions

As per paragraph 30 of AS 7 (revised 2002), the cost of materials delivered to a contract site has to be excluded from the contract costs, unless the materials have been made (purchased) specifically for the contract.

The cost incurred on steel, cement procured by power sector regions lying at project site is specifically for the project for which risks, rewards and ownership are on customer and billing is made to customer and the money is being realised.

Therefore, considering the same for calculation of actual cost incurred is in line with AS 7 (revised 2002). Further, since the ownership of the material has been transferred to the customer and the material is lying at the customer site under their custody, the same cannot be shown as inventory in the accounts of the company.

Further, supply of steel/ cement material at site are construed as contract activity and recognition of revenue is in line with paragraph 21 of AS 7 (revised 2002) which, inter alia, states that "***when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.***"

(c) Disclosure

The contract execution period in respect of long term contracts is between 36 months to 60 months, the estimated contract revenue and contract cost do have a lot of uncertainty at the initial stages and the estimates are refined as the project progresses based on the detailed engineering, bill of quantities, latest price trends of inputs and project

deliverables, unforeseen contingencies, addition/deletion to the scope, modification required, site constraints, exchange rate fluctuations and so on and these changes do impact estimated contract revenue and estimated cost.

The increase/decrease in the estimated contract revenue and estimated contract cost is bound to happen in case of long term contract due to increase/ decrease in the prices of steel, cement and other input cost, etc. These are not a change in accounting estimates.

Further, as per paragraph 37 of AS 7 (revised 2002), the effect of change in estimates of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as per AS 5. It does not mention about disclosure. Disclosure requirements are given under paragraphs 38 to 44 of AS 7 (revised 2002) which are being complied by the company as stated in the earlier paragraphs. Hence, further disclosures as per AS 5 in addition to disclosure as per AS 7 (revised 2002) are considered not required.

B. Query

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

(a) In the case of manufacturing units, whether the practice of cost of manufactured items despatched to project site alone being considered as 'cost incurred' without considering the cost of raw material in stocks, works in progress at the plant, finished goods at stores as cost incurred is in line with the revenue recognition principle as per AS 7 (revised 2002). Also, whether the wording of the accounting policy of the company is in line with the revenue recognition principle as per AS 7 (revised 2002).

(b) In the case of erection sites, whether the cost of cement and steel procured and delivered at the project site, specific to the project, in respect of which billing has been done as per the BBU agreed with the customer can be considered as 'cost incurred' in working out the percentage of completion as per AS 7 (revised 2002) and whether the same is in line with the revenue recognition principle as per AS 7 (revised 2002).

(c) Whether change in estimated revenue and estimated cost due to reasons explained in paragraph 9(c) above at the end of the reporting period in respect of long term contracts executed over a longer period needs to be disclosed as 'change in estimates' as per AS 5.

C. Points Considered by the Committee

11. The Committee notes that the basic issues raised in the query relate to determination of contract cost incurred in the facts and circumstances of the company for calculating the stage of completion while recognising contract revenue and disclosure of the effects of changes in estimated contract revenue and estimated contract cost. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, determination of turnover, recognition of revenue at unit/region level and at consolidated level, combining and segmentation of contracts, propriety of considering change in scope of contract as change in accounting estimates, etc. Further, the Committee, while answering the query has laid down the broad principles of determining the 'contract cost incurred'. The Committee further presumes that the construction contracts in the context of which the query has been raised are those that involve both manufacture of equipments at the manufacturing units of the company and erection and commissioning etc, at the project sites. The Committee also presumes from the Facts of the Case that it is at the company level that the contract cost incurred has to be determined and not at the manufacturing unit/project sites level.

12. At the outset, the Committee wishes to point out that contract cost incurred should be seen from the overall contract perspective irrespective of the fact that performance of the construction contract involves processing/ performance of various activities at different locations, viz., manufacturing units, project sites, etc. As regards the determination of 'contract cost incurred', the Committee notes the following paragraphs of AS 7, notified under the Companies (Accounting Standards) Rules, 2006 relating to recognition of contract revenue and expenses:

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

the construction contract should be recognised as an expense immediately in accordance with paragraph 35."

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

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

(b) surveys of work performed; or

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

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

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

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

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

13. The Committee notes that paragraph 21 of AS 7 requires recognition of contract revenue by reference to the stage of completion of the contract activity at the reporting date, when the outcome of the contract can be estimated reliably. Paragraph 31 of AS 7 deals with recognition of contract revenue when the outcome of the contract cannot be estimated reliably. Thus, percentage of completion method should be followed only when the outcome of the contract can be estimated reliably. Since the company, in the extant case, is following percentage of completion method, the Committee

presumes that outcome of the construction contract in this case can be estimated reliably.

14. The Committee notes from the above-reproduced requirements of AS 7 that determination of contract costs incurred for calculating stage of completion depends upon the performance of contract activity rather than mere incurrence of cost. Costs that relate to future activity are to be recognised as ‘work-in-progress’. As to what can be considered as performance of contract activity depends upon the facts and circumstances of the case. Every activity performed in relation to a contract may not lead to completion of a stage or milestones. Accordingly, a judgement is to be exercised by the management while determining contract costs incurred considering various factors, such as, terms and specifications of the contract, identifiability with the contract, achievement of milestone in relation to the contract, etc.

15. As regards the cost of items of raw material, work-in-progress and finished goods, purchased or manufactured and lying at stores or at manufacturing site, or at project site, the Committee is of the view that it should be seen whether these can be considered as ‘contract cost incurred’ applying the judgement based on the considerations stated in paragraph 14 above, viz., identifiability with the contract, i.e., whether these can be considered to be specific for a construction contract as per its specifications, achievement of milestone in relation to the contract, etc. In this regard, the Committee notes from paragraph 30 of AS 7 that there is no restriction in considering supply of materials to the customer site as ‘actual contract cost incurred’, which are manufactured/ purchased specifically for the contract. However, in case of items which are not manufactured/ purchased specifically for the contract e.g., the items which are commonly used across various contracts, the cost of such items if only delivered at the contract site should not be considered unless these are used/installed/applied during contract performance.

16. In view of the above, the Committee is of the view that the practice of the company to consider the cost of manufactured items despatched to the project site alone as ‘cost incurred’ is not correct since mere event of despatch cannot be considered as a completion of a stage and may not trigger revenue recognition. The Committee is of the view that it is performance of the contract activity rather than despatch of items from one location to another that should be considered while determining stage of completion.

17. The Committee notes from the Facts of the Case that materials, such as, steel and cement are directly supplied from the supplier to the project site and billed to the customer, however, these have not yet been applied or used. The Committee is of the view that mere billing to the customer or even receipt of money from the customer cannot be a sole criterion for considering an item as 'contract cost incurred' for determining the stage of completion. As regards whether steel and cement procured and delivered at the contract site can be considered to be specific as being argued in the Facts of the Case, the Committee is of the view that these items are general in nature for a construction activity and cannot be said to be specific for a project even though supplied directly at the contract site. Accordingly, these should be considered for determining 'cost incurred' only when these have been used/ applied for performance of contract activity. Till that time, these should be considered as 'Work in Progress'.

18. With regard to disclosure requirements of effect of change in estimated contract revenue and contract cost, the Committee notes the following paragraphs of AS 7 and AS 5 notified under the Rules (revised 2002) in respect of change in estimates:

> *AS 7*
>
> "37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods."
>
> *AS 5*
>
> ***"27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed."***

The Committee notes that the change in contract costs affecting the percentage of completion is inherent in construction business. The effect of change in either costs or revenue shall be a change in estimate to be accounted in accordance to AS 5 read with AS 7 (revised 2002). The querist's argument that no disclosure is required as AS 7 is silent does not hold good and not appropriate. The Committee further notes that AS 7 (revised 2002) requires the change in estimate to be accounted as per AS 5, which covers both recognition and disclosure. Accordingly, the effect of change in the estimated contract revenue and cost, which has or is expected to have a material effect in the current period or subsequent periods needs to be disclosed as per the requirements of AS 7 as well as AS 5. However, if it is impracticable to quantify the amount of change, this fact should be disclosed.

D. Opinion

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

(i) It is the performance of contract activity rather than despatch of items from one location to another that should be considered while calculating stage of completion, which is determined with reference to the contract costs that contribute to the performance of contract activity rather than the total cost incurred upto the reporting date as discussed in paragraph 14 above. Accordingly, the practice of the company of considering the cost of items merely despatched to the project site is not correct. The wording of the accounting policy of the company seems to be in line with the principles of AS 7. However, the application of this policy should be modified on the lines indicated above in paragraphs 14 and 17 above.

(ii) As regards steel and cement procured and delivered at the contract site, it should be seen whether these can be considered as 'contract cost incurred' applying the judgement based on the considerations stated in paragraphs 14 and 15 above. Mere billing to the customer cannot trigger considering a cost as 'contract cost incurred'. These items are general in nature for a construction activity and cannot be said to be specific for a project even though supplied directly at the contract site. Accordingly, these should be considered for determining 'contract

cost incurred' only when these have been used/ applied for performance of contract activity. Till that time, these should be considered as 'Work in Progress'.

(iii) Change in estimates on account of changes in estimated contract revenue and costs should be disclosed in accordance with AS 5 read with AS 7. Accordingly, the effect of change in the estimated contract revenue and cost, which has or is expected to have a material effect in the current period or subsequent periods needs to be disclosed as per the requirements of AS 7 as well as AS 5. However, if it is impracticable to quantify the amount of change, this fact should be disclosed.

Query No. 10

Subject: Treatment of tax expense on deemed income under section 56(2)(viia) of the Income-tax Act, 1961 arising on purchase of investments.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') in which public is not substantially interested is incorporated on May 5, 2010 under the Companies Act, 1956 with the object to generate, receive, purchase, develop, use, sell, supply, distribute, transmit and accumulate electrical or any other form of power and energy in general by conventional or non-conventional methods, from any source whether hydro, water, wind, solar, thermal, gas, oil, diesel, nuclear or otherwise at power stations, plants, establishments, works and other ancillary facilities of every kind and description and transmit, distribute and supply such power through transmission lines, cables, wires and other facilities on a commercial basis to cities, towns, streets, docks, factories, markets, buildings and other places both public and private. The

[1] Opinion finalised by the Committee on 12.8.2011.

company is a wholly owned subsidiary of a company, B Limited, which holds 15% of the equity shares of another unlisted company, C Limited.

2. During the financial year 2010-11, it was decided by the Board of the company to acquire, if possible, all the balance 85% equity shares of C Limited, which were held by other not related shareholders. The company intends to hold this for long term purposes being a strategic investment. Accordingly, the company has acquired additional equity shares (representing balance 85%) from various unrelated parties in separate trenches for an agreed consideration (excluding stamp duty and tax under section 56(2)(viia) of the Income-tax Act, 1961). The acquisitions were at a price lower than the fair value of the said shares calculated in accordance with manner prescribed under Rule 11 (UA) of the Income Tax Rules, 1962.

3. Under the provisions of section 56(2)(viia) of the Income-tax Act, 1961, in the instances, where shares of a company in which the public is not substantially interested are acquired for a consideration which is less than the aggregate fair value of the shares by an amount exceeding Rs. 50,000/-, the excess of the aggregate fair value over the consideration is an income under the head 'Income from Other Sources'.

4. The querist has stated that the company has paid tax on the the excess of the aggregate fair value over the consideration paid in accordance with the requirements of section 56(2)(viia). In addition to the above, the company has also incurred expenses on account of stamp duty, franking and bank charges in connection with the said acquisition.

5. According to the querist, the payment of income tax under section 56(2)(viia) has arisen out of the transaction of acquisition of shares and the company would not have incurred such an expense otherwise. The internal business case for acquisition of these shares was justified to the Board by considering the basic cost of acquisition, the transaction costs like stamp duties, the cost of transfer of shares and the tax payable under section 56(2)(viia), i.e., deemed income arising from purchase of investments, which would be directly associated with purchase of such shares.

6. The querist has further stated that the provision of tax under section 56(2)(viia) is a recent addition to the Income-tax Act, 1961, and such a situation of taxes payable due to acquisition is not covered directly in paragraph 9 of existing Accounting Standard (AS) 13, 'Accounting for Investments', which deals with various costs that could be considered as

part of cost of acquisition of an investment. In view of this, the querist has referred to relevant technical material from notified[2] Indian Accounting Standards (Ind ASs) for technical guidance on the subject matter.

7. The querist has stated that as per paragraph 11 of Indian Accounting Standard (Ind AS) 32, 'Financial Instruments: Presentation', definition of financial assets includes an equity instrument of another entity. Paragraph 38 of Indian Accounting Standard (Ind AS) 27, 'Consolidated and Separate Financial Statements' provides, *inter alia*, as follows:

> **"38 For preparing separate financial statements the entity shall account for investments in subsidiaries, jointly controlled entities and associates either:**
>
> **(a) at cost, or**
>
> **(b) in accordance with Ind AS 39"**

Paragraph 43 of Indian Accounting Standard (Ind AS) 39, 'Financial Instruments: Recognition and Measurement', provides as follows:

> **"43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."**

As per paragraph 9 of Ind AS 39, "*Transaction costs* **are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."**

Paragraph AG 13 of Appendix A, Application Guidance to Ind AS 39, states as follows:

> "AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and

[2] The Committee wishes to point out that although Ind ASs have been placed on the website of Ministry of Corporate Affairs, these Standards have not yet been notified by the Ministry.

transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs."

8. The querist has stated that in view of the above, especially paragraph 9 of Ind AS 39 and paragraph AG13 of Appendix A to Ind AS 39, the company is of the view that the tax on this notional deemed income is a transaction cost, which otherwise would not have been incurred by the company and should be treated as acquisition cost of the investment and hence, has capitalised the said tax cost.

B. Query

9. The company has considered the basic consideration, stamp duty charges and tax under section 56(2)(viia) as cost of investment in shares in its accounts. The querist believes that the purchase has resulted in a cash outflow on account of tax under section 56(2)(viia) and that this cost is a direct result of the acquisition of these said shares as also it was a part of the business case which justified the overall purchase at the all inclusive price. Had the acquisition of these shares not been made, the company would not have incurred such costs. On the basis of the above, the querist is seeking opinion of the Expert Advisory Committee on the following issues:

(i) whether the payment of tax under section 56(2)(viia) would qualify to be treated as part of the cost of investment in the balance sheet of the company in view of the explanation provided in paragraphs 9 and 43 of Ind AS 39 read along with paragraph AG13 of Appendix to Ind AS 39.

(ii) If answer to (i) is no, what is the correct accounting treatment of such tax expenses on deemed income under section 56(2)(viia) of the Income-tax Act, 1961?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to accounting for tax paid under section 56(2)(viia) in the separate financial statements of the company. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting for stamp duty, franking and bank charges, cost of transfer of shares and other costs incurred, accounting in the consolidated financial statements and accounting in the books of holding

company or company C, applicability of Ind AS 39 or other Ind ASs in the instant case, etc. Further, the opinion expressed hereinafter, is purely from accounting point of view and not from interpreting any legal enactment, such as, Income-tax Act, 1961.

11. The Committee notes paragraph 56(2)(viia) of the Income-tax Act, 1961, which provides as follows:

> "Where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year, from any person or persons, on or after the 1st day of June, 2010, any property, being shares of a company not being a company in which the public are substantially interested, –
>
> (i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;
>
> (ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration:"

12. The Committee wishes to point out that although Ind ASs have been placed on the website of the Ministry of Corporate Affairs, these Standards have not yet been notified by the Ministry. Accordingly, till the Ind ASs are notified by the Ministry, the existing notified Accounting Standards would be applicable. Therefore, in the instant case, the Committee is of the view that the transaction of acquisition of investment in shares would be governed by the existing notified AS 13.

13. With regard to accounting for the tax levied under section 56(2)(viia) of the Income-tax Act, 1961, the Committee notes paragraph 9 of AS 13, which provides that "the cost of an investment includes acquisition charges such as brokerage, fees and duties". Keeping in view the nature of the items of acquisition charges mentioned in AS 13, the Committee is of the view that the cost of acquisition should include only those direct charges which are incurred 'on' acquisition of investment, i.e., the expenses, without the incurrence of which, the transaction could not have taken place, such as, share transfer fees, stamp duty, registration fees, etc. The Committee notes that tax paid under section 56(2)(viia) is levied when consideration

paid for acquisition of investment is lower than its fair market value for an amount exceeding Rs. 50,000 and such lower consideration paid is deemed as income of the assessee acquiring such investment. Thus, this tax is not a tax 'on' acquisition of shares rather it is a tax on 'deemed income' under Income-tax Act, 1961. Accordingly, the Committee is of the view that such tax expense is not a cost incurred 'on' acquisition of investment rather it is incurred after the transaction of the acquisition of investment. In other words, it is not a means of acquiring such investments; rather it is a result of such acquisition. Accordingly, such tax cannot be considered as acquisition-related cost and, therefore, cannot be capitalised as cost of investment. The Committee is further of the view that such tax paid should be treated as normal tax and charged off to profit and loss account in the year in which it is incurred.

14. Since the querist has sought to take support in this regard from Ind ASs, the Committee has also examined this issue in the framework of Ind ASs independently without relating it to AS 13 or any other existing notified Standard. Under the framework of Ind ASs, the Committee notes that paragraph 38 of Ind AS 27 provides, inter alia, as follows:

> **"38 For preparing separate financial statements the entity shall account for investments in subsidiaries, jointly controlled entities and associates either:**
>
> **(a) at cost, or**
>
> **(b) in accordance with Ind AS 39"**

15. The Committee notes from the above that Ind AS 39 would be relevant only if the entity exercises the option to account for investment in subsidiary under that Standard. It may be noted that if that option is exercised, the Committee notes paragraph 43 of Indian Accounting Standard (Ind AS) 39, 'Financial Instruments: Recognition and Measurement', provides as follows:

> **"43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."**

16. Presuming that the investment is not a finacial asset at fair value through profit or loss, the Committee notes that paragraph 9 of Ind AS 39

provides, "*Transaction costs* **are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."**

17. The Committee further notes that paragraph AG 13 of Appendix A, Application Guidance to Ind AS 39, states as follows:

> "AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs."

18. The Committee notes from the above provisions of Ind AS 39 that only those transaction costs that are directly attributable to the acquisition of investment can be capitalised with the investment. The Committee is of the view that although the tax levied under section 56(2)(viia) may be considered as an incremental cost of acquisition of investment, it cannot be considered as 'a directly attributable cost' due to the reasons stated in paragraph 13 above. Accordingly, even on considering the relevant provisions of Ind AS 39, such tax levied cannot be capitalised as cost of investment.

D. Opinion

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

(a) The payment of tax under section 56(2)(viia) does not qualify for capitalisation as a cost of investment in the balance sheet of the company as mentioned in paragraphs 13 and 18 above.

(b) Tax paid under section 56(2)(viia) should be treated as normal tax and charged off to profit and loss account of the year in which it is incurred as discussed in paragraph 13 above.

Query No. 11

Subject: Off-setting of various components of tax and disclosure of tax expenses.[1]

A. Facts of the Case

1. A company is a public sector company under the administrative control of the Ministry of Mines, Govt. of India and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power in Captive Power Plant for use in Smelter Plant and selling alumina and aluminium both in domestic and international market. It has a capacity to produce 15,57,000 MT of calcined alumina, 3,41,000 MT of aluminium ingots per annum and 960 MU of power.

2. Paid-up share capital of the company is Rs. 644.31 crore and 12.85% of its shares are listed in Bombay Stock Exchange and National Stock Exchange. As per the provisions of clause 42 of SEBI Guidelines, the quarterly un-audited financial results are to be furnished to stock exchanges and be published in news papers. The un-audited financial results of the company for the quarter ended 30th September, 2009 were taken on record by its Board of Directors at 238th meeting held on 30th October, 2009. Thereafter, the financial results were submitted to the auditors for limited review and report.

3. The querist has stated that in un-audited financial results for the quarter ended 30th September, 2009, a sum of Rs. 110.51 crore was considered towards tax expenses, consisting of:

(a)	Provision for taxation current year	-	Rs. 117.01 crore
(b)	Provision for taxation-deferred	-	Rs. 21.51 crore
(c)	Provision for taxation for earlier year written back	-	(Rs. 28.01 crore)
			Rs. 110.51 crore

Provision for taxation for earlier year written back, included Rs. 14.77 crore on account of reversal of liability provided for the financial year 2008-09.

[1] Opinion finalised by the Committee on 12.8.2011.

Liability of Rs. 43.44 crore was made on account of leave encashment on the basis of actuarial valuation. For the assessment year 2009-10, corresponding to the previous year 2008-09, provision for income tax liability was made considering inadmissibility of provision of Rs. 43.44 crore on account of leave encashment under section 43 (B)(f) of the Income-tax Act, 1961 and tax payment was made.

4. The querist has further stated that as per the practice followed by the company, provision for tax liability is made as per annual accounts. After tax audit, the provision for taxes made is adjusted as per Income Tax Return. Excess or short of tax between provision made as per annual accounts and Income Tax Return is either claimed as refund or paid.

5. The querist has stated that for accounting, as stated at paragraphs 3 and 4 above, the following facts/judgments were considered:

(a) As per hon'ble Calcutta High Court decision vide judgment dated 27.06.2007 in Exide Industries Ltd & Another vs Union of India & Ors, section 43(B)(f) relating to leave encashment is struck down being arbitrary, unconscionable and de hors the Apex court decision in the case of Bharat Earth Movers Ltd.

(b) Subsequent to above, petition for special leave to Appeal (Civil) No.22889/2008 was filed by Commissioner of Income Tax and as per the interim judgment order dated 08.05.2009, the Hon'ble Apex court made it clear that the assessee would, during the pendency of this civil appeal pay tax as if section 43(B)(f) is on the statute book but at the same time it would be entitled to make a claim in its returns.

6. In support of the above, a note was appended at paragraph 4 of un-audited financial results for the quarter ending 30th September, 2009 furnished to stock exchanges and also published in news papers, which reads as follows:

> "The tax expense is net of the provision written back amounting to Rs. 28.01 crore (Rs. 14.77 crore on account of admissibility of leave encashment, based on interim order of Hon'ble Supreme Court in another case and Rs. 13.24 crore on account of employer's related expenses) for which refund have been claimed while filling Income Tax Return."

7. In review report on un-audited financial results for the quarter ending 30th September, 2009, the auditors made the following qualification:

> "We report that subject to para-4 of the Notes to Un-audited financial results for the period ended 30.09.2009 on the matter regarding write back of Rs. 14.77 crore on account of related tax provisions made during previous year and netting off the same with current tax provisions, considering the liability on account of leave encashment as an admissible expenditure is not in line with the provisions of section 43 B of the Income Tax Act, where such provisions are considered as inadmissible resulting in overstatement of profit after tax to that extent".

8. In view of the qualification, the company considered it prudent to obtain an opinion from tax consultant on taking credit of Rs. 14.77 crore, as detailed at paragraphs 3, 4 and 5 above.

9. The auditors, while reviewing the un-audited financial results for the quarter ending 31st December, 2009 raised an objection as to whether an opinion of tax consultant can be obtained on the qualification of auditors and advised to seek opinion from the Expert Advisory Committee of the Institute of Chartered Accountants of India.

B. Query

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

(i) The format prescribed by SEBI for submitting un-audited financial results mention "Tax Expenses" only. It does not specify (i) current tax liability (ii) deferred tax liability and (iii) previous years' tax liability/income. In such a situation, whether netting off all the tax expenses and putting under one head, i.e., 'Tax Expenses' (as prescribed in format) is in contravention of the provisions required for publication of un-audited financial results.

(ii) Whether the opinion obtained from tax consultant on the qualification given by auditors is proper.

C. Points considered by the Committee

11. The Committee notes that the basic issues raised in the query relate to appropriateness of netting off all the tax expenses, viz., current tax liability,

deferred tax liability and previous year tax liability and putting under one head, i.e., 'Tax Expenses' for publication of un-audited financial results in view of the formats prescribed by SEBI for the same. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as, appropriateness of recognition of provision on account of leave encashment or reversal thereof, its admissibility as per the provisions of Income-tax Act, 1961, preparation of interim financial statements, provisioning requirements in respect of income taxes, deferred tax effect of provision for leave encashment or any other item arising from the Facts of the Case, etc. Further, the Committee has opined purely from accounting point of view and not from interpreting any legal enactments, such as, Income-tax Act, 1961 or decision of any Court of law, etc.

12. The Committee notes paragraph 27 of Accounting Standard (AS) 25, 'Interim Financial Reporting', which provides as follows:

> "***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."***

On the basis of the above, the Committee is of the view that for interim financial statements, the same accounting policies as adopted for annual financial statements should be applied. The Committee further notes that as per the requirements of SEBI (SEBI Circular SMDRP/Policy/Cir-44/01 dated August 31, 2001), "Companies shall be required to comply with the accounting standard on "Accounting for Taxes on Income" in respect of the quarterly un-audited financial results with effect from the quarters ending on or after September 30, 2001". Thus, the companies have to follow the requirements of AS 22 in the quarterly financial results.

13. The Committee notes the definitions of the terms 'tax expense' and 'current tax', as defined in paragraphs 4.3 and 4.4 of AS 22 and paragraph 9 thereof, which provide as follows:

"4.3 <u>Tax expense (tax saving)</u> is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

4.4 <u>Current tax</u> is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period."

"9. Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period."

From the above, the Committee is of the view that deferred tax and current tax are part of the 'tax expense'. Tax expense is an expense determined on the pre-tax income of the period for which results are being drawn. Accordingly, the Committee is of the view that asset/liability representing deferred tax and current tax can be netted off to determine a net figure of 'tax expense' for a period. However, the Committee is of the view that previous year's tax liability being not related to tax expense for the current period cannot be netted off against the 'tax expense' for the current period. In this regard, the Committee also notes that clause 3(ix)(a) and (b) of Part II, 'Requirements as to Profit and Loss Account' of Schedule VI[2] to the Companies Act, 1956 requires the aggregate, if material, of the amounts withdrawn from the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments, as no longer required, to be arranged under the most convenient heads and in particular, to be disclosed in the profit and loss account. Accordingly, the Committee is of the view that for the purposes of reporting in un-audited interim financial results as per the formats prescribed by SEBI, additional separate line item for provision for tax no longer required, related to previous year would be technically more appropriate. However, netting off of such provision for tax related to previous year against the current year's provision for tax may also be acceptable for the purposes of such interim un-audited results for reporting to SEBI provided adequate disclosure thereof is made either in the inner column or through a separate note to the financial results.

[2] Schedule VI has been revised. Revised Schedule VI came into force for the Balance Sheet and Profit and Loss Account for the financial year commencing on or after 01.04.2011.

14. As regards the issue on obtaining opinion of tax consultant on the qualification in the auditor's report, the Committee is of the view that there is no bar for the company on obtaining any opinion on any issue from anybody. However, it may also be mentioned that the opinion given by the auditor in his limited review report stands, irrespective of a different opinion expressed on that issue by any other professional.

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) Although asset/liability representing deferred tax can be netted against the current year's tax to disclose the tax expense for the period, the previous years' tax liability/asset cannot be netted against the current year's tax as discussed in paragraph 13 above. Accordingly, for the purposes of reporting in un-audited interim financial results as per the formats prescribed by SEBI, additional separate line item for provision for tax no longer required, related to previous year would be technically more appropriate. However, netting off of such provision for tax related to previous year against the current year's provision for tax may also be acceptable for the purposes of such interim un-audited results for reporting to SEBI provided adequate disclosure thereof is made either in the inner column or through a separate note to the financial results.

(ii) There is no bar for the company on obtaining any opinion on any issue from anybody. However, it may also be mentioned that the opinion given by the auditor in his limited review report stands, irrespective of a different opinion expressed on that issue by any other professional.

Query No. 12

Subject: Determination of cost of investment, accounting treatment and disclosure of advance for shares issue pending finalisation of modalities of the shares issue and thereafter. [1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as 'the company'), which is wholly owned subsidiary of a listed government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. The company acquires oil and gas properties/ blocks by way of acquisition of property/block, acquisition of participating interest therein or through acquisition of the legal entity owning right in the properties/blocks.

2. A Cyprus based company (hereinafter referred as 'ABC') was acquired (100% of share capital) during the financial year 2008-09 by the company. During the same year, ABC acquired entire issued share capital of a UK based company (hereinafter referred to as 'XYZ'). XYZ, through its direct/ indirect subsidiaries/joint ventures, operates in several oil and gas blocks in Russia. The funds for the acquisition of XYZ amounting to USD 1,922 million equivalent to Rs. 93,664 million were provided by the company to ABC with an intention to treat these as share application money in the quarter ended 31.03.2009 without entering into any formal agreement at the time of remittances. The querist has mentioned that the advances were made on several dates and each such advance was ab-initio recorded at the exchange rate applicable on the respective advance date.

3. Subsequently, the company entered into a 'Shareholders' Investment Agreement' with ABC on 11th June, 2009. As per the terms of Shareholders' Investment Agreement, ABC agreed to issue equity/preference shares on or before 31.12.2009 at mutually agreed terms and conditions. The agreement made clear the intention to convert the advance of USD 1,922 million given for acquisition of XYZ into preference/ equity shares, however, no concrete modalities regarding vital issues like, the nature of shares (i.e., equity/ preference shares), number of shares, face value and premium, etc. were firmed up till the accounts were finalised and approved.

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[1] Opinion finalised by the Committee on 10.10.2011.

4. Pending allotment of the shares, the amount was accounted for as 'Advance to ABC' and disclosed as 'Loans and Advances' in the accounts of the company for the year ended 31st March, 2009.

5. The company intended to convert the advances of USD 1,922 million into equity/preference shares. Thus, the advance given to ABC was considered an extension to the company's net investment in ABC, which is a non-integral foreign operation. Accordingly, the advance was treated as 'Net Investment in ABC', revalued at closing exchange rate and accounted for in accordance with the requirements of paragraphs 15 and 16 of Accounting Standard (AS) 11 (revised 2003), 'Accounting for the Effects of Changes in Exchange Rates', issued by the Institute of Chartered Accountants of India, as on 31.03.2009. Accordingly, the resulting exchange difference was taken to 'foreign currency translation reserve'.

6. During the year 2009-10, the company and ABC continued the discussions and finalised the terms and conditions of the shares leading to signing of share subscription agreement ('SSA') dated 31.03.2010. The SSA provided, inter alia, that (a) ABC will issue 1,92,210 optionally convertible redeemable preference shares (OCRPS) of face value USD 1 per share at issue price of USD 10,000 per share, (b) ABC will have the right to redeem at its option 80% of the OCRPS by payment of pre-agreed premium, (c) the company has the right to convert 20% of the OCRPS into equity shares of face value USD 1 per share at issue price of USD 10,000 per share (i.e., 1 equity share for 1 preference share). Accordingly, ABC allotted shares for USD 1922 million as on 31.03.2010. The company accounted for the amount as investment in shares of wholly owned subsidiary in the financial statements for the year ended 31.03.2010. The investment in shares was measured at exchange rate on the date of issue/allotment (31.03.2010) and the resulting exchange difference was taken to foreign currency translation reserve. The company proposes to treat the shares post-issuance as non-monetary item and not to revalue it.

B. Query

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

(i) For the financial year 2008-09 and interim periods upto the shares issue date (i.e., 31.03.2010), appropriate accounting treatment of advances so paid and treatment of foreign exchange

gain/loss arising on revaluation thereof, i.e., whether the advance as described above is covered within the scope of paragraphs 15 and 16 of AS 11 such that it is revalued on balance sheet date and resulting difference taken to foreign currency translation reserve;

(ii) For the financial year 2008-09 and interim periods upto the shares issue date (i.e., 31.03.2010), whether the advance should be disclosed as 'loans and advances' or as 'investments', specially till the nature and applicable terms and conditions of the underlying shares are decided; and

(iii) Whether during the financial year 2009-10 in which the shares were issued (i.e., on 31.03.2010), the investment in shares in foreign exchange should be recorded in the company's financial statements (prepared in Indian Rupees) at (i) the exchange rate applicable on share issue date (31.03.2010), being the transaction date, or (ii) at the *ab initio* recorded amounts of advance, i.e., at the exchange rates applicable on the dates when the respective advances were initially given.

C. Points considered by the Committee

8. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 7 above and has not considered any other issue that may arise from the Facts of the Case, such as, accounting treatment in the books of ABC and XYZ of the funds advanced by the company, treatment of shares post-issuance as non-monetary item, etc. Further, the Committee notes from the Facts of the Case that the company in the extant case treats ABC as a 'non-integral foreign operation'. In the absence of any information to the contrary, the Committee presumes that the company has correctly classified investment in ABC as investment in a non-integral foreign operation in accordance with the provisions of AS 11, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules').

9. The Committee notes that on the same issue, the querist had earlier sought an opinion from the Expert Advisory Committee, which has been published as Query No. 14 of Volume XXX of the Compendium of Opinions. The Committee notes that in the earlier opinion which pertained to the year 2008-09, in respect of the advance of USD 1922 million, the Committee had opined that though the company has entered into a 'shareholders' investment

agreement' with ABC, it only contains the intention to convert the said advance into preference/equity shares, and no concrete modalities regarding nature of shares (i.e., equity/preference shares), number of shares, face value, premium, etc. have been decided till the balance sheet date, and, therefore, the advance is of the nature of 'monetary item' as per the definition provided in AS 11, notified under the Rules. Accordingly, it should be reported using the closing rate. Further, on the presumption that since the intention of the company is to convert the said advance into equity/preference share capital and settlement of such advance is neither planned nor likely to occur in the foreseeable future as envisaged in paragraph 16 of AS 11, notified under the Rules, the Committee, keeping in view that ABC is a non-integral foreign operation of the company, had opined that in substance, the advance would be an extension to the company's net investment in ABC, and therefore, the exchange difference arising on the balance sheet date should be accumulated in a foreign currency translation reserve in accordance with paragraph 15 of AS 11, notified under the Rules. However, in case the presumption stated above with respect to the settlement of the advances does not hold good, the advances cannot be treated as an extension of the company's net investment in ABC. In that case, the exchange difference arising on the balance sheet date should be recognised as income or as expense in the profit and loss account of the company in accordance with paragraph 13 of AS 11, notified under the Rules. With respect to the disclosure of the advances in the financial statements of the company, the Committee had opined that the advance should be disclosed under the head 'Loans and Advances' with appropriate disclosure regarding their nature.

10. The Committee notes from the Facts of the Case that the company has advanced money at different dates during the quarter ending March 31, 2009 and the same have been accounted for as 'Loans and Advances' in the financial statements of the company for the year ending March 31, 2009 as no modalities in respect of the monies advanced were final by the balance sheet date or till finalisation/approval of the accounts. Further, the exchange difference arising on revaluation at the closing rate as on the balance sheet date, i.e., March 31, 2009 was taken to 'Foreign Currency Translation Reserve' treating the advance as extension to 'Net Investment in ABC'. Subsequent to this, share subscription agreement dated 31.03.2010 has been signed and the shares have been allotted to the company as per the agreement on 31.03.2010.

11. As regards the accounting treatment for the money advanced and the exchange differences arising thereon at the balance sheet date (31.03.2009), the Committee notes paragraphs 3.2, 8.1 and 8.2 of Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', notified under the Rules as follows:

> ***"3.2 Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.***
>
> ***Two types of events can be identified:***
>
> ***(a) those which provide further evidence of conditions that existed at the balance sheet date; and***
>
> ***(b) those which are indicative of conditions that arose subsequent to the balance sheet date."***
>
> "8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.
>
> 8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date."

From the above, the Committee is of the view that the financial statements are prepared upto the balance sheet date considering the events occurring between the balance sheet date and the date of approval of the financial statements by the approving authority (Board of Directors in case of company). Any event occurring after the approval of financial statements is irrelevant for preparation of the financial statements. In the extant case, the Committee notes that even till the approval of financial statements for the financial year ended March 31, 2009, since the modalities in respect of

issuance of shares were not final, the Committee reiterates its earlier opinion that the advance is of the nature of 'monetary item'. Accordingly, it was appropriate to report and disclose as 'Loans and Advances' using the closing rate at the balance sheet date, viz., 31st March, 2009. Further, since during that period, the intention of the company was to convert the advance into equity/preference share capital and settlement of the advance was neither planned nor likely to occur in the foreseeable future as envisaged in paragraph 16 of AS 11, notified under the Rules, keeping in view that ABC is a non-integral foreign operation of the company, it was appropriate to treat the advance as an extension to the company's net investment in ABC, and to transfer the exchange difference arising on the balance sheet date in the foreign currency translation reserve in accordance with paragraph 15 of AS 11, notified under the Rules. As regards the interim financial reporting, the Committee is of the view that the same accounting principles and policies should be applied as applied for annual financial reporting and accordingly, if the said modalities are not final till the reporting date of every quarter during the financial year 2009-10, the above treatment should be followed.

12. As regards the treatment of the advance post-issuance of shares, the Committee notes the definition of the term 'Investments', as defined in paragraph 3.1 of Accounting Standard (AS) 13, 'Accounting for Investments', which, inter alia, provides that ***"<u>Investments</u> are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise".*** Since the shares acquired by the company fall into the above definition, the Committee is of the view that the same should be accounted for as 'Investment' in the books of the company. As regards the value at which the shares should be recorded, the Committee notes paragraph 9 of AS 11, which provides as follows:

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

The Committee is of the view that the date of transaction in the instant case would be the date when the modalities in respect of shares have been finally concluded. Accordingly, investment acquired should be recorded by applying the exchange rate between the reporting currency and the foreign currency as on the date of final conclusion of modalities in respect of issuance

of shares to foreign currency amount of advances. Further, since the investment in ABC has been treated as non-integral foreign operation and by such conclusion of modalities in respect of issuance of shares, there would be an extension to the company's net investment in ABC, the resulting exchange differences should be transferred to 'Foreign Currency Translation Reserve'.

D. Opinion

13. On the basis of the above, subject to paragraph 8 above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

(i) and (ii) For the financial year 2008-09, since even till the approval of financial statements, the modalities in respect of issuance of shares were not final, the Committee reiterates its earlier opinion that the advance is of the nature of 'monetary item'. Accordingly, it was appropriate to report and disclose as 'Loans and Advances' using the closing rate at the balance sheet date, viz., 31st March, 2009. Further, since during that period, the intention of the company was to convert the advance into equity/preference share capital and settlement of the advance was neither planned nor likely to occur in the foreseeable future as envisaged in paragraph 16 of AS 11, notified under the Rules, keeping in view that ABC is a non-integral foreign operation of the company, it was appropriate to treat the advance as an extension to the company's net investment in ABC, and to transfer the exchange difference arising on the balance sheet date in a foreign currency translation reserve in accordance with paragraph 15 of AS 11, notified under the Rules. As regards the interim financial reporting, the Committee is of the view that the same accounting principles and policies should be applied as applied for annual financial reporting and accordingly, if the said modalities are not final till the reporting date of every quarter during financial year 2009-10, the above treatment should be followed.

(iii) Investment in shares should be recorded in the financial statements of the company at the exchange rate applicable on the date of final conclusion of modalities in respect of

issuance of shares, which should be considered as the transaction date, as discussed in paragraph 12 above.

Query No. 13

Subject: Computation of depreciation on extra shift workings.[1]

A. Facts of the Case

1. A company is a joint venture company of three public sector enterprises and is engaged in transportation of petroleum products through underground pipeline. The company was incorporated as limited company on 31st July, 1998.

2. The company is following depreciation policy of its fixed assets on Straight Line Method (SLM) at applicable rates as prescribed in Schedule XIV to the Companies Act, 1956. The company is charging average rate of depreciation on plant & machinery and main pipeline considering single shift @ 4.75%, double shift @ 7.42% and triple shift @10.34% as per the rates specified in Schedule XIV to the Companies Act, 1956. Zero depreciation was considered for shutdown period as no rate has been specified for shutdown period in Schedule XIV to the Companies Act, 1956. The methodology has been followed consistently since commissioning from the financial year 2003-04 onwards.

3. During the supplementary audit conducted by the Comptroller and Auditor General of India (C&AG) for the financial year 2009-10, the methodology of calculation of extra shift depreciation on plant & machinery and main pipeline by the company, viz., Rs. 42.45 crore was commented upon as follows:

"The above is understated by Rs. 6 crore due to the following:

[1] Opinion finalised by the Committee on 10.10.2011.

(i) According to para 6 of the Schedule XIV of the Companies Act, 1956, the extra shift depreciation (double/triple shift) was to be computed in the proportion for which the Company worked for double shift or triple shift bears to the actual number of working days or 240 days whichever is higher. However, the Company had worked out depreciation based on 365 working days instead of actual number of 329 working days during the year 2009-10 thus, the Company applied the average rate of depreciation of 7.381 percent against required 8.547 percent during the year 2009-10.

(ii) The Company while computing the average rate of Depreciation as above has also not considered any depreciation for 36 days on which the plant remained closed.

The above have resulted in understatement of depreciation for the year and overstatement of net block of fixed assets by Rs. 6 crore."

4. Audit Committee and Board of the company advised that the present depreciation policy be reviewed keeping in view the comments made by C & AG.

5. The company had reviewed the calculation of extra shift depreciation based on the comments of C&AG and has also referred to an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on the similar subject (published as Query No. 1.26 of Volume XIII of the Compendium of Opinions). As per the querist, the opinion on Clause 6 of Notes to the Schedule XIV to the Companies Act, 1956 provides that the average depreciation on shift working of plant & machinery is to be calculated on normal working days in a year. While calculating number of normal working days during the year, the idle days on account of maintenance etc. for which the factory/ concern have worked should be included even though the individual machine/ labourers in the factory/ concern might not have actually worked during these days.

6. Based on above, the average rate of depreciation for the financial year 2009-10 was worked out as follows as against the average rate of 8.547% as advised by the C&AG and average rate of 7.381% as considered by the company:

Shift	No. of Days	Average No. of days	Rate of Depreciation as per SLM	Average Rate of Depreciation
Shut Down	36	36/365	4.75	0.468.
Single Shift	77	77 / 365	4.75	1.002
Double Shift	95	95/ 365	7.42	1.931
Triple Shift	157	157/365	10.34	4.448
Total	365			7.849

7. The calculation was forwarded to C&AG for their concurrence to enable us to adopt the above depreciation policy on main pipeline and plant & machinery from the financial year 2010-11. However, C&AG advised that the earlier opinion of the Expert Advisory Committee of the ICAI forwarded by the company relates to iron and steel industry. As there are different plant units in the integrated steel plants referred to in the opinion, the comparison may not be relevant and the company should follow the depreciation policy as per note no. 6 (b) to Schedule XIV to the Companies Act, 1956. The company may seek the opinion of the Expert Advisory Committee of the ICAI in this specific case.

8. In view of the above, the querist has sought the opinion of the EAC on calculation of average depreciation on plant & machinery and main pipeline as per the two methods illustrated as follows:

Method - I

Shift	No. of Days	Average No. of days	Rate of Depreciation as per SLM	Average Rate of Depreciation (%)
Shut Down	36	36 / 365	4.75	0.468
Single Shift	77	77/365	4.75	1.002
Double Shift	95	95/365	7.42	1.931
Triple Shift	157	157/365	10.34	4.448
Total	365			7.849

Method – II

Shift	No. of Days	Average No. of days	Rate of Depreciation as per SLM	Average Rate of Depreciation (%)
Shut Down	36	36/365	4.75	0.468
Single Shift	77	77/365	4.75	1.002
Double Shift	95	95/329	7.42	2.143
Triple Shift	157	157/329	10.34	4.934
Total	365			8.547

B. Query

9. The querist has sought the opinion of the Expert Advisory Committee on the adoption of the method of depreciation on extra shift working from among the two methods to comply with the minimum depreciation as per Schedule XIV to the Companies Act, 1956.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to extra shift depreciation on plant and machinery and main pipeline for various shifts worked. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case.

11. The Committee notes the definition of the term 'Depreciation' as provided in paragraph 3.1 of Accounting Standard (AS) 6, 'Depreciation Accounting', notified under the Companies (Accounting Standards) Rules, 2006, which provides as follows:

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

The Committee notes from the above that depreciation arises due to several factors including effluxion of time and wear and tear due to use. Accordingly,

depreciation occurs with the passage of time, even if concerned asset is not in use. The Committee notes that Schedule XIV to the Companies Act, 1956 specifies separate rates of depreciation in respect of single shift, double shift and triple shift.

12. As regards depreciation to be charged in respect of *extra* shift working, the Committee further notes that Schedule XIV to the Companies Act, 1956, lays down higher rates of deprecation for certain items of plant and machinery in case these are worked for extra shifts. The Committee also notes clauses 4 and 6 of Notes to Schedule XIV to the Companies Act, 1956, which provide as follows:

> "4. Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on *a pro rata* basis from the date of such addition or, as the case may be, upto the date on which such asset has been sold, discarded, demolished or destroyed."
>
> "6. The calculations of the ***extra depreciation*** for double shift working and for triple shift working shall be made separately in the proportion which the number of days for which the concern worked double shift or triple shift, as the case may be, bears to the normal number of working days during the year. For this purpose, the normal number of working days during the year shall be deemed to be –
>
> (a) in the case of a seasonal factory or concern, the number of days on which the factory or concern actually worked during the year or 180 days, whichever is greater;
>
> (b) in any other case, the number of days on which the factory or concern actually worked during the year or 240 days, whichever is greater."(Emphasis supplied by the Committee)

The Committee is of the view that physical wear and tear of a depreciable asset, which is operated for more than a shift, is generally higher than the one, which is used on a single shift basis. Accordingly, Schedule XIV to the Companies Act, 1956, prescribes higher rates of depreciation for the assets operating for extra shifts. Further, it prescribes methodology to compute 'extra depreciation' for the assets operating for extra shifts. The Committee is further of the view that the rates of depreciation specified in respect of single shift have been determined based on two factors – effluxion of time

and wear and tear. However, in case of double shift and triple shift, the factor of effluxion of time remains constant. Therefore, rates for extra shifts include only the incremental/extra depreciation due to extra wear and tear. Thus, the Committee is of the view that single shift depreciation rate should be applied for the time period when the asset is held by the company irrespective of the fact whether such asset is in use or not. As regards 'extra depreciation' to be computed for items of plant and machinery operating for extra shifts, the incremental depreciation should be determined by applying the differential rate of depreciation, i.e., depreciation rate as specified for the relevant shift less the rate specified for the single shift in the proportion which the company worked for the double/triple shift bears to the number the number of days on which the factory or 'concern' actually worked during the year. The formula for arriving at the 'depreciation' shall be as under:

Depreciation for single shift working
+
(Depreciation for double/triple shift working – Depreciation for single shift working) x (Number of days worked double or triple shift / Normal working days during the year)

13. The Committee further notes that clause 6 of Schedule XIV to the Companies Act, 1956 requires that, for 'extra depreciation', normal number of working days would be the number of days on which the factory or 'concern' actually worked during the year. Thus, it is not the working days of individual plant and machinery item, which should be considered for the purpose of computing extra shift depreciation rather it is the working days of the factory or 'concern'. In this regard, it may be mentioned that various units/departments/ mills/ factories should be taken as separate concerns. Accordingly, the Committee is of the view that 'normal number of working days' should be calculated after deducting shut down period of the factory or 'concern'. In view the above, for the convenience of the querist, the Committee has also provided the calculations of depreciation for the concerned plant and machinery in the extant case as Annexure I.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that the company should calculate depreciation as per principles laid down in paragraphs 12 and 13 above. For calculations, refer Annexure I.

Annexure I

It may be noted that the extant case indicates two situations – first, when the factory/concern was actually working for the whole year, whereas, the individual plant and machinery was shut down for a period of 36 days and the other, when both the factory/concern as well as plant and machinery were shut down for the period of 36 days.

Situation I: When the factory/concern was actually working for 365 days, whereas, the individual plant and machinery was shut down for a period of 36 days.

Depreciation for the concerned plant and machinery (%)	=	4.75 + (7.42 – 4.75) x 95/365 + (10.34 – 4.75) x 157/365
	=	7.849%

Situation II: When both the factory/concern as well as plant and machinery were shut down for a period of 36 days.

Depreciation for the concerned plant and machinery(%)	=	4.75 + (7.42 – 4.75) x 95/329 + (10.34 – 4.75) x 157/329
	=	8.189%

Query No. 14

Subject: Accounting for sales returns.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') has been in the business of manufacture of readymade garments for the last 5 to 6 years. It sells its products to franchisees located across the country.

2. The querist has stated that the sale is said to be completed at the time when risks and rewards of ownership of goods are transferred to the

[1] Opinion finalised by the Committee on 10.10.2011.

franchisees. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and the company accepts them back as sales returns. According to the querist, sales returns are said to be completed when the goods have been physically received back in the factory premises and all the risks and rewards of ownership have been transferred to the company. Hence, the company records the sales returns in its books of account on their physical receipt. On the basis of the past trend, sales returns work out to be approximately 20 to 22% of the sales for the year.

3. The querist has further stated that the company has accounted for the sales returns received during the financial year upto the balance sheet date but has not reversed the sales returns likely to be received after the balance sheet date, on the basis of the past trend.

4. During the course of audit for the financial year 2010-11, the auditors have raised an objection regarding booking of revenue from sales. The auditors are of the opinion that since there is a past trend indicating the return of goods sold to franchisees, the company should effect the reversal of sales on 31st March, 2011 to the extent that the goods sold in the year 2010-11 are likely to be returned by the franchisees in the year 2011-12 and subsequent years. Though the company has accounted for sales returns upto the date of the balance sheet, the auditors are of the view that the company should also account for sales returns likely to be received after the balance sheet date on the basis of past trend.

5. The querist has also stated that the auditor proposes to make the following qualification:

> "Though the actual sales returns after 31st March, 2011 upto the conclusion of the financial statements have been recognised, the impact of further sales returns, likely to happen based on the past trend of such returns, has not been estimated and recognised in these financial statements. This is not in accordance with Accounting Standard (AS) 9, 'Revenue Recognition'. In the absence of the above estimation and recognition, we are unable to comment in the matter and the consequential effect on the financial statements."

6. The company is of the view that the stand of the auditors is not correct because of the following reasons:

(a) Paragraph 11 of Accounting Standard (AS) 9, 'Revenue Recognition' is reproduced below:

> ***"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:***
>
> ***(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and***
>
> ***(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."***

The querist is of the view that the company has complied with both the above conditions necessary to recognise revenue from the sale of goods in the year. Although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods. Since the goods are not in the possession of the company and risks and rewards of ownership still lie with the franchisee and he is the one who is responsible for the goods, the company cannot record the sales returns in its books of account in respect of goods likely to be received back after the date of the balance sheet.

(b) As per the querist, the case of the company is also not covered by paragraph A(2)(c) of the Appendix to AS 9, issued by the Institute of Chartered Accountants of India, which, inter alia, states as below:

> *"In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to*

> *recognise the sale but to make a suitable provision for returns based on previous experience."*

Although in the company's case, the franchisee has a right to return the goods, the return of goods by the franchisees in subsequent years is entirely contingent upon the situation prevailing in the market at that time.

B. Query

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

(i) Whether the present policy of the company regarding recognition of sales returns after the date of the balance sheet in the books of account only upon the physical receipt of goods from the franchisees is correct.

(ii) If the company records the sales returns received after the date of the balance sheet on estimated basis taking into account the past trend, whether it will be proper accounting to prepare financial statements of the company on estimation basis.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting for sales returns that occur after the date of balance sheet in a situation where the customers (franchisees) have a right to return the goods. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, recognition of revenue as per the principles of AS 9, etc. The Committee presumes from the Facts of the Case that franchisee is neither acting as an agent of the company nor as a consignee as covered under paragraph A(2)(c) of the Appendix to AS 9 which states as given below:

> "(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return
>
> Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment..."

9. The Committee notes from paragraph 5 of the Facts of the Case that the auditor proposes to make the qualification that "though the actual sales returns after 31st March, 2011 *upto the conclusion* of the financial statements have been recognised, the impact of further sales returns, likely to happen based on the past trend of such returns, has not been estimated and recognised in these financial statements", whereas it is also stated in the Facts of the Case that the company has accounted for sales returns *upto the date of the balance sheet*. Thus, there is an apparent contradiction in the Facts of the Case, although, that does not affect the accounting for the basic issue raised.

10. The Committee notes from the Facts of the Case that the querist has stated in paragraph 6 above that the company has complied with the conditions of paragraph 11 of AS 9 relating to conditions of recognition of revenue in the case of sale of goods. Accordingly, the Committee presumes that the requirements of AS 9 relating to recognition of revenue are fulfilled. The Committee is of the view that in case conditions relating to recognition of revenue are fulfilled at the time of making sale, it would be correct to recognise revenue in respect of sale of goods at the time of sale itself. However, the Committee notes from the Facts of the Case that in the extant case, there is a right of return by the franchisees (refer paragraph 6 above). The existence of such right would give rise to a present obligation on the company. In this context, the Committee notes the definition of the term 'provision' as defined in paragraph 10 of Accounting Standard (AS) 29, Provisions, Contingent liabilities and Contingent Assets, notified under Companies (Accounting Standard) Rules, which provides 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."***

The Committee is of the view that since obligation in respect of sales return can be estimated reliably on the basis of past experience and other relevant factors, such as, fashion trends, etc., in the extant case, a provision in respect of sales returns should be recognised. The provision should be measured as the best estimate of the loss expected to be incurred by the company in respect of such returns including any estimated incremental

cost that would be necessary to resell the goods expected to be returned. The Committee is also of the view that as per paragraph 52 of AS 29, provisions should be reviewed at each balance sheet date and if necessary, should be adjusted to reflect the current best estimate. As far as actual sales returns that occur between the balance sheet date and the date of approval of financial statements are concerned, the Committee is of the view that necessary adjustments should be made in this regard to the amount of the provision.

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, the present policy of the company regarding recognising sales returns after the date of the balance sheet in the books of account upon the physical receipt of goods from the franchisees is not correct. The company should recognise a provision in respect of sales returns at the best estimate of the loss expected to be incurred by the company in respect of such returns including any estimated incremental cost that would be necessary to resell the goods expected to be returned, on the basis of past experience and other relevant factors as discussed in paragraph 10 above. Necessary adjustments to the provision should be made for actual sales return after the balance sheet date upto the date of approval of financial statements. Such provision should also be reviewed at each balance sheet date and if necessary, should be adjusted to reflect the current best estimate.

(ii) If the treatment prescribed in (i) above is followed, it will be appropriate accounting treatment for preparing the financial statements of the company.

Query No. 15

Subject: Accounting for payments made in respect of land pending execution of conveyance deeds and borrowing costs incurred in respect thereof. [1]

A. Facts of the Case

1. The Government of India directed a State Port Trust, (SPT) to construct a new Port. Accordingly, SPT acted as the executing agency and completed a Port. The Government of India provided a sum of Rs. 426.11 crore to SPT towards implementation of the Port. The Government of India vide their letter dated 14.02.2002 directed SPT to handover the completed Port to ABC Limited (hereinafter referred to as 'the company') which is owned by the Government of India and was incorporated with the specific purpose of corporatising the Port. Both parties acknowledge that cost of land acquired by the SPT for the Port amounting to Rs. 14.81 crore has not been included in the estimated cost of the project arrived at as on 22.06.2001 (which is the date on which commercial operation of the Port was achieved) on the advice of the Government of India. Both parties expressly undertook to be bound by the decision of the Government of India on the cost of the land. Accordingly, the SPT handed over all the assets (excluding land) and liabilities with respect to the Port Project to the management of the company on 22.06.2001.

2. The querist has stated that the Port has been developed / constructed on 2,083.74 acres of land acquired from 3 Government agencies as given below. The following amounts were paid to the Government agencies being the vendors of land while taking possession of the land. The kind of title that will accrue to the company against these payments was not known at the time of making these payments.

[1] Opinion finalised by the Committee on 10.10.2011.

Vendors of acquired land	Extent (in acres)	Total Amount	Paid by SPT	Paid by the company
State Electricity Board (SEB), State Government	1103.98	15,20,87,099	5,20,8 7,099	10,00,00,000
State Industrial Development Corporation Ltd (SIDCO), a State PSU	950.00	9,56,72,600	9,56,72,600	Nil
Salt Department, Government of India	29.76	11,35,692	11,35,692	Nil
Total	2083.74	24,88,95,391	14,88,95,391	10,00,00,000

3. The above amount of Rs. 24.89 crore was paid by (i) SPT to the extent of Rs. 14.89 crore and (ii) the company to the extent of Rs. 10.00 crore, all during the construction period.

4. SPT used its own financial resources and constructed the Port. The entire amount spent by SPT (as the Executor of the Project) together with all the assets created except land was transferred by SPT to the company on 22.06.2001 at its actual values as per the Government directives. However, the amount of Rs. 14.89 crore paid by SPT towards taking possession of land for the company was retained by SPT in its books and not transferred to the books of the company as per the Government directions.

5. After nearly 6 years, viz., in the financial year 2007-08, the Government of India finally decided that the land can be owned by the company and directed the company to pay to SPT the amount of Rs. 14.89 crore (originally paid by SPT towards land for the port of the company) together with interest of Rs. 16.51 crore, all totaling to Rs. 31.40 crore (a copy of the Government Order has been supplied by the querist for the perusal of the Committee). The breakup for interest of Rs. 16.51 crore is (i) interest from the date(s) of payments to 22.06.2001- Rs. 6.58 crore and (ii) interest from 23.06.2001 to the day of payment by the company- Rs. 9.93 crore.

6. The company paid the said sum of Rs. 31.40 crore to SPT. Since the nature of title that will accrue to the company was not known at the time of making these payments, the company retained the entire amount of Rs. 31.40 crore in its books as ‘Advance for Land’ and grouped under ‘Loans and Advances’ in its balance sheet as on 31.03.2008.

7. Thus, the total amount retained in 'Advance for Land' in the books of the company stands at Rs. 41.40 crore as on 31.03.2008, comprising (i) Rs. 24.89 crore of amounts paid for acquisition of land and (ii) Rs. 16.51 crore of interest relating to the period after taking possession of the land / commencement of commercial operations.

8. Based on the subsequent developments in this regard between the company, the Government and Government agencies involved in this issue, the company expects to get 'Orders of Alienation of Title' for the land from the respective vendors of the land in due course of time. The querist has informed that formal transfer of title for the land would be through issuance of 'Orders of Alienation of Title' by the transferor Government, when land is transferred by Government agencies to a Public Sector Undertaking.

B. Query

9. On the facts and in the circumstances of the case, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the company can capitalise the value of land at Rs. 24,88,95,391 in the financial year 2010-11, with a suitable disclosure in the Notes to Accounts as 'Pending receipt of formal Orders of Alienation of Title, the consideration of Rs. 24,88,95,391 paid for acquisition of land in earlier years is capitalised during this year'.

(ii) Whether the company can charge the interest of Rs. 16.51 crore paid to SPT to its profit and loss account of the financial year 2010-11 as a separate line item with a suitable disclosure in the Notes on Accounts by stating that "Interest of Rs. 16.51 crore paid to SPT during the financial year 2007-08, which was kept under 'Advance for Lands' has been charged to revenue during this year as the company expects to get Orders of Alienation of Title for the land from the respective vendors of the land in due course of time. This is an extraordinary item and non-recurring in nature".

(iii) If the answer to the above questions are negative, what is the correct treatment to be accorded in the books of account of the company for this total amount of Rs. 41.40 crore? What kind of disclosure would be required to be made in the Notes to Accounts of the company?

C. Points Considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to accounting treatment of payment made in respect of land of Port pending execution of conveyance deeds. The Committee, while answering the query, has considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for the assets (except land) and liabilities transferred from SPT to the company, propriety of deducting TDS from the amounts paid by the company to SPT, etc. The Committee also wishes to point out that in paragraph 1 of the Facts of the Case, the querist has stated that the amount paid by the SPT towards acquisition of land is Rs. 14.81 crore, whereas, at other places, the same is stated at Rs. 14.89 crore. Accordingly, the amount of Rs. 14.81 crore seems to be a typographical error.

11. As regards accounting for payments made in respect of land, the Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' and paragraph 35 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, which provides as follows:

> *AS 1*
>
> *"17(b) Substance over Form*
>
> The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form."
>
> *Framework for the Preparation and Presentation of Financial Statements*
>
> "35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into."

From the above, the Committee is of the view that for accounting purposes, the transactions and events should be recorded in accordance with their substance and economic reality rather than legal form. The Committee notes from the Facts of the Case that in the extant case, the company has paid consideration for purchase of land and it is not only possessing such land but also utilising the same for its commercial purposes. However, the formal transfer of such land is yet to be executed in favour of the company. The Committee is of the view that in the present case, the execution of Orders of Alienation of Title is only procedural in nature and if it does not affect the beneficial interest which are bestowed on the company, the company can account for such land in its books at the time of transfer of such beneficial interest to the company provided other conditions for recognition of asset as detailed in paragraph 12 below are fulfilled. The company, in such case, should also give suitable disclosures to convey to the users of financial statements that the execution of conveyance deeds in favour of the company is in progress.

12. The Committee further notes paragraphs 49(a), 58 and 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, as below:

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

> "58. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. ..."

> "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*." (Emphasis supplied by the Committee.)

The Committee notes from the Facts of the Case that until and unless the Government issued a final order that the title to the land can be obtained by the company alongwith determining the final payments that the company would make to SPT, the cost of land cannot be measured reliably.

Accordingly, in accordance with paragraph 88 of the Framework, as reproduced above, the Committee is of the view that although in the extant case, the land may meet the criteria of an asset for the company, but before the financial year 2007-08 when the said order was issued by the Government of India, it cannot be recognised in the books of the company.

13. The Committee notes that as per the Government Order issued during the financial year 2007-08, the company was requested to make payment to SPT of the amount invested by it for land acquisition along with interest thereon @ SBI PLR as amended from time to time. The Committee is of the view that the payments determined on the basis of SBI PLR cannot be treated as 'borrowing costs' as neither the company has borrowed any funds from SPT on which the borrowing costs may be said to have incurred nor it is payment for any delays on the part of the company. In fact such delay has occurred on the part of the Government for reaching the final decision for transfer of land. The Committee notes that it is based on the order of the Government that assets are being transferred from one entity to another at the amounts specified in the Order. Considering the principle of 'Substance over Form', as discussed in paragraph 11 above, the Committee is of the view that in the extant case, the reference by the Government to a rate of interest is only as a reference point for determination of final sale consideration of the land and does not automatically lead to an inference that the amount so computed is of the nature of interest. In substance, the company is paying the total amount as a consideration to obtain the title to land. Accordingly, the company should recognise the total amount of Rs. 41.40 crore as cost of land in its books of account. The Committee is, therefore, of the view that the question of disclosure of interest paid, as an extraordinary item, does not arise.

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 company should capitalise the total amount of Rs. 41.40 crore paid to SPT as 'land' and not as 'Advance for land' from the date when the company possess the beneficial interest in the same and its cost can also be measured reliably as discussed in paragraphs 11 and 12 above and not in the financial year 2010-11. However, the company should give suitable disclosures

to convey to the users of financial statements that the execution of conveyance deeds in favour of the company is in progress.

(ii) The Government has made reference to a rate of interest as a means to compute final sale consideration of the land. The amount so determined is in substance not "interest" in the facts and circumstances of the case as stated in paragraph 13 above. Therefore, the question of disclosure of interest paid as an extraordinary item does not arise.

(iii) Refer to (i) above.

Query No. 16

Subject: Treatment and disclosure of interest on fixed deposits in the financial statements of a financial enterprise. [1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a public limited company registered under the Companies Act, 1956. The entire equity of the company is held by the Government of India. The company was set up as a special purpose vehicle to provide long- term infrastructure finance as per Scheme for Financing Viable Infrastructure Projects (hereinafter referred to as 'the financing scheme'). The company provides infrastructure finance through direct lending, refinancing and take out finance as per the financing scheme.

2. The company is engaged in the business of providing long-term financial assistance to infrastructure projects in the country. The paid-up equity capital of the company is Rs. 2,000 crore. The company has raised long-term debt by way of loans from Life Insurance Corporation of India, National Small Saving Fund (NSSF), bonds listed in India and foreign currency loans from

[1] Opinion finalised by the Committee on 10.10.2011.

bilateral and multilateral institutions. Borrowings of the company are backed by sovereign guarantee.

3. The resources raised by the company are utilised for providing infrastructure finance through direct lending, refinancing and take out finance as per the financing scheme. Pending disbursement, the resources of the company are held in the form of bank deposits and investments, such as, Central/ State Government securities, bonds issued by public sector undertakings (PSUs), Certificate of Deposits with scheduled banks, etc. as per investment policy approved by the board of directors of the company.

4. As per the Office Memorandum of Government of India dated 23rd April, 2007, the company is also recognised as 'sui-generis' organisation under direct supervision of the Ministry of Finance, Government of India. The company is not registered as a Non-Banking Financial Company (NBFC) with the Reserve Bank of India although the statutory auditors of the company have opined that the company is an NBFC.

5. The querist has stated that as the nature of its business is that of an NBFC, the company has been treating interest on bank deposits as income from operations in its books of account and accordingly, considers and discloses interest on bank deposits as income from operations in the financial statements as well as in the cash flow statement.

6. The Comptroller and Auditor General of India (CAG) which conducts supplementary audit of accounts of the company under section 619(3)(b) of the Companies Act, 1956, while conducting audit of accounts of the company for the year ended 31st March, 2010 and subsequently for the year ended 31st March, 2011, inter-alia, however, commented that interest on fixed deposits with banks has been included under income from operational activities instead of disclosing the same as other income. This has resulted in the overstatement of income from operations and understatement of other income by Rs. 56,516.94 lakh. In this regard, the company, vide letter dated 27th June, 2011, has given assurance to CAG that matter regarding treatment of interest on fixed deposits with banks as operational income will be referred to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for its opinion for appropriate treatment from the next financial year.

7. As per the observations of CAG auditors, the interest income from fixed deposits with banks should be treated as 'other income' instead of 'income from operations'. Their observations are as follows:

> "As per MOU of the company, the core activity of the company is to provide long- term financial assistance to infrastructure projects in India and surplus funds arising out of asset-liability mismatch is to be invested only in marketable government securities till its deployment in financing the infrastructure projects in terms of the guidelines issued by the Ministry of Finance, i.e., the financing scheme which is the mandate for the company. However, the company has invested partial amount of surplus funds into the fixed deposits with banks which do not fall under the category of marketable government securities.
>
> *It is observed that interest of fixed deposit with banks has been included under the income from operation activities instead of showing the same under the other income. This has resulted in the overstatement of the income from operations and understatement of the other income by Rs. 56,516.94 lakh* (emphasis supplied by the querist)."

8. According to the querist, the company has been treating interest on fixed deposits with banks as income from operations considering the following factors:

(a) Nature of disbursement of infrastructure loans - The period of implementation of infrastructure projects generally extends over 3 to 5 years and accordingly, the disbursement of loan is made in tranches over this period as per the progress of implementation of projects. As a result, funds raised by the company get deployed over a period of time. It may be highlighted that as on 31st March, 2011, the company had made net sanctions of Rs. 25,205 crore and undertaken disbursements aggregating Rs. 15,325 crore.

    Pending disbursement, surplus funds are invested in various short-term instruments as per the investment policy of the company approved by the board of directors**.** These include Central or State Government securities, bonds issued by PSUs, Certificate of Deposits with scheduled banks, etc. The company believes that this activity is an integral part of its operations to fund infrastructure loans; hence it has classified the interest

income from these investments as 'income from operations' in the profit and loss account as well as cash flow statement.

(b) Compliance with Accounting Standard (AS) 3, 'Cash Flow Statement' – The company is a financial enterprise. Therefore, while forming the above opinion, the company has also taken guidance from paragraph 30 of AS 3, which reads as follows:

> ***"30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities."***

B. Query

9. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether it is appropriate for the company to treat interest on bank deposits as income from operations in its books of account and accordingly, to consider and disclose interest on bank deposits as income from operations in the preparation of financial statements including cash flow statement.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to the disclosure of interest on bank deposits received by the company in the financial statements including cash flow statement. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, classification and disclosure of bank deposits made by the company, classification of the company as an NBFC or a financial institution, etc. Since the querist has raised the issue in the context of AS 3, the Committee presumes that AS 3 is applicable to the company. Further, since the query makes reference to the financial statements for the periods ending March 31, 2011 and prior to

that, it is presumed that the query has been raised in the context of pre-revised Schedule VI[2] to the Companies Act, 1956. Also, the opinion expressed hereinafter is purely from the accounting angle and not from the angle of interpreting the provisions of any legal document/agreement, such as, the financing scheme or MOU.

11. The Committee is of the view that the fact that the MOU/the financing scheme did not permit the investment of funds in fixed deposits with banks does not change the nature of the interest received from such deposits and accordingly, its accounting would remain the same irrespective of whether it was permitted or not to invest the funds of the company in fixed deposits. As far as the disclosure of such interest income in the financial statements including cash flow statement is concerned, the Committee notes the definition of the term 'operating activities' as provided under paragraph 5 of AS 3 and paragraphs 12 and 30 thereof which provide as follows:

> "***Operating activities*** ***are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.***
>
> "12. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. ..."
>
> ***"30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities."***

From the above, the Committee is of the view that operating activities are the principal revenue-producing activities of the enterprise. The Committee is of the view that being a financial enterprise, the main business of the

[2] Schedule VI has been revised. Revised Schedule VI came into force for the Balance Sheet and Profit and Loss Account for the financial year commencing on or after 01.04.2011.

company in the extant case is to provide long-term infrastructure loans and financial assistance while optimally managing and utilising its funds. The Committee is of the view that the company is in the business of earning income by managing its funds which also includes the management of surplus funds between the date of receipt of funds to the date when the funds are finally disbursed. Accordingly, the Committee is of the view that interest earned on investment of surplus funds of the enterprise arises from its principal revenue-producing activities and therefore, it should be treated and classified as income from operating activities. Further, in the context of cash flow statement, the Committee notes that paragraph 30 of AS 3 specifically states that cash flows arising from interest and dividends received in case of financial enterprise should be classified as 'cash flow from operating activity'.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that it is appropriate for the company to treat interest on bank deposits as income from operations in its books of account and, accordingly, to consider and disclose interest on bank deposits as income from operations in preparation of financial statements including cash flow statement as discussed in paragraph 11 above.

Query No. 17

Subject: Accounting for sales tax exemption benefit under Ind AS.[1]

A. Facts of the Case

1. A leading cement manufacturing company in India has set-up cement plants across India including in the State of Maharashtra. Plants set-up in the State of Maharashtra are eligible for sales tax incentive under Package Scheme of Incentives, 1993 framed by the Government of Maharashtra

[1] Opinion finalised by the Committee on 10.10.2011.

(hereinafter referred to as the 'Scheme'). The querist has furnished a copy of the Eligibility Certificate from the State Industrial and Investment Corporation of Maharashtra (SICOM) Ltd., which is the implementing agency of the Scheme, for a Unit of the company.

2. As per the querist, the company is covered in Phase I of Roadmap for Convergence with IFRS and will be required to adopt Indian Accounting Standards (the 'Ind ASs') for the accounting periods commencing on or after the date to be notified. The company is conducting a diagnostic study based on Ind ASs as issued by the Ministry of Corporate Affairs to enable it to better prepare for migration to Ind ASs.

3. In the process of the diagnostic study, the company has identified one issue. The issue relates to accounting for sales tax exemption benefits available for the aforesaid Unit of the company under Ind ASs.

4. The querist has stated the salient features of the Scheme as below (copy of the Scheme with various amendments and a copy of the sample invoice for sale of goods have been furnished by the querist for the perusal of the Committee):

Objective of the Scheme

Sales tax incentive is given under Package Scheme of Incentives, 1993 (the 'Scheme') framed by the Government of Maharashtra. The Objective of the Scheme is to achieve dispersal of industries outside the Bombay –Thane – Pune belt and to attract them to the underdeveloped and developing areas of the State.

Units eligible to avail the benefit

Eligible Units operating in the Industries specified in the Scheme are considered for sales tax exemption benefit under the Scheme. To get the sales tax exemption benefit, the Eligible Unit needs to make specific Gross Fixed Capital Investment. Gross Fixed Capital Investment shall mean and include –

- new fixed assets;
- second hand fixed assets (cost of such fixed assets for computing Gross Fixed Capital Investment is the cost of acquisition or value certified by valuer whichever is lower); and

- shifting of fixed assets (depreciated value of fixed assets on the date of shifting together with the actual expenditure incurred on dismantling, transportation, insurance and re-erection which is allowed to be and is capitalised under the Indian Income Tax Act.

The term ‘fixed assets’ shall mean and include the following:

1. Land / area in effective possession and as required for the project,
2. Building, i.e., any built up area used for the Eligible Unit including administrative building, residential quarters, industrial housing and accommodation for all such facilities as are required for the manufacturing processes,
3. Plant and machinery, i.e., Tools and equipment including handling and haulage equipments, or tools as are necessarily required and exclusively used for sustaining the working of the Eligible Unit,
4. Cost of development of the environment of the location of the Eligible Unit,
5. Installation charges and pre-operative expenses capitalised,
6. Technical know-how including cost of drawings and know-how fees, and
7. The amount paid as non-refundable interest-free deposit to Maharashtra State Electricity Board for supply of power.

Other conditions to be satisfied are:

- Fixed assets acquired by an Eligible Unit and forming part of the Gross Fixed Capital Investment cannot be disposed of/sold/ written off except with the prior written permission of the implementing agency.
- The holder of the Eligibility Certificate shall keep true and proper account of the value of raw materials purchased, finished goods manufactured/sold by the Eligible Unit, raw material/finished

goods returned with proper classification of both purchases as well as sales of goods.

- Full record of the employment in the unit, wages and salaries paid should be kept.
- Government or its authorised entity shall have right to carry out full inspection of the Eligible Unit including its properties, assets, accounts, records, registers, documents etc., and cost of such inspection will be paid by the Eligible Unit.
- The holder of the Eligibility Certificate shall ensure that in the matter of employment of personnel for the Eligible Unit for which the Eligibility Certificate is issued, scheduled castes/scheduled tribes and local candidates are recruited in conformity with the guidelines issued from time to time.
- Monthly or quarterly returns applicable under sale tax law should be furnished.
- Such periodical statements/such information/follow up statements in the form and manner as required by SICOM should be furnished.

Nature of benefit

Eligible unit will get sales tax exemption on all sales (both local as well as inter-state) made from the Unit.

Extent of sales tax benefit

The company will get sales tax exemption without any ceiling on all sales made by it for a period of 18 years. During such period, if sales tax incentives are not availed to the extent of ceiling mentioned (i.e., 130% of fixed capital investment), an additional period upto 7 years shall be extended till such ceiling is reached.

Eligible period of incentive

The sales tax incentive will be without any monetary ceiling for a period of 18 years. During such period, if sales tax incentives are not availed to the extent of ceiling mentioned (i.e., 130% of fixed capital

investment), an additional period upto 7 years shall be extended till such ceiling is reached.

5. The querist has quoted the following definition given in paragraph 3 of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance':

> "*Grants related to assets* **are government grants whose <u>primary condition</u> is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held." (Emphasis supplied by the querist.)**

6. The querist has also drawn the attention of the Committee to the following paragraphs of Ind AS 20:

> "16. It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see Ind AS 1 *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received."

> "19. Grants are sometimes received as part of a package of financial or fiscal aids to which a number of conditions are attached. In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another."

B. Query

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

(i) Whether the exemption is in the nature of government grant. The company is exempt from payment of sales tax on cement and accordingly, the company does not charge the sales tax to

its customer on invoice. However, the sales tax is inbuilt in the price of cement. Is the exemption from collection and payment of taxes a benefit in the nature of government grant?

(ii) Whether the sales tax exemption scheme benefit is a grant which relates to an asset or whether it is a revenue related grant.

(iii) Whether this grant is in the nature of fiscal aid.

(iv) If the grant is relating to asset, how it should be accounted for? Various possibilities are given below:

- Should the company estimate total benefit of sales tax exemption over the period of 18 years and recognise it upfront with a corresponding credit to deferred income?
- Would the accounting treatment be different if the present value of the estimated total benefit exceeds the cost of fixed asset?
- Recognise the exemption benefit based on sales made each year and recognise the grant in profit or loss by matching it with depreciation charge.
- Recognise cumulative exemption benefit received till current year over the life of the asset.

(v) If the grant is regarded as fiscal aid, then company needs to allocate the grant among various components of cost. Various possibilities are:

- Eligible sales are the primary condition to earn the grant and other obligations are more in the nature of going concern obligations on which a value cannot be placed. Thus, recognise grant to the extent of eligible sales made in profit or loss.
- Recognise the grant to the extent of depreciation of eligible capital investment made by the company and match the recognition of grant with depreciation. Recognise excess grant based on other appropriate basis.

- Allocate the grant revenue over the period for which cost is incurred to satisfy the various conditions relating to the grant (cost is actual cost and not incremental cost).
- Allocate the grant revenue over the period as the conditions are satisfied. However conditions are evaluated based on their significance/importance rather than based purely on cost. In this case, an issue will arise as to how the significance/ importance of conditions will be decided?
- Recognise the grant to income on a straight-line basis for term of the Scheme, i.e., 18 years.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to the treatment of sales tax exemption under the Package Scheme of Incentives, 1993 (the 'Scheme') in respect of sales made by the company in the context of Ind ASs. 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, exemption from the payment of any sales tax on the purchases made by the company. Further, the Committee has opined only from the accounting point of view and not from the point of view of interpreting any legal enactments, like the Scheme or implications under Income- tax Act, 1961 or various sales tax enactments. Incidentally, the Committee has noted that the objective of the Scheme is ''to intensify and accelerate the process of dispersal of industries from the developed areas and for development of the underdeveloped regions of the State, particularly those farther away from the Bombay-Thane-Pune belt".

9. The Committee notes the definition of the term 'Government grant' as defined in paragraph 3 of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance' and paragraphs 9, 34 and 35 thereof, as below:

> "*Government grants* **are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. 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 entity."**

"9. The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government."

"34. Excluded from the definition of government grants in paragraph 3 are certain 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 entity.

35. Examples of assistance that cannot reasonably have a value placed upon them are free technical or marketing advice and the provision of guarantees. ..."

The Committee notes that in the extant case, sales tax exemption under the Scheme is granted by the Government subject to fulfillment of conditions relating to investment and operation in underdeveloped areas. The Committee is of the view that the sales tax foregone by the Government is, in substance, a transfer of resources by the Government to the company. Therefore, exemption from sales tax liability subject to conditions relating to the operating activities of the company should be treated as a government grant. The Committee is also of the view that while it may not be possible to quantify sales tax exemption for the entire period of grant upfront, it is possible to quantify the amount of the exemption included in each sales transaction and accordingly, paragraphs 34 and 35 of Ind AS 20 quoted above are not applicable to the grant by way of sales tax exemption. In this regard, the Committee also notes Appendix A, Government Assistance—No Specific Relation to Operating Activities to Ind AS 20, which is an integral part of Indian Accounting Standard (Ind AS) 20 as follows:

"Issue

1 In some countries government assistance to entities may be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity. Examples of such assistance are transfers of resources by governments to entities which:

(a) operate in a particular industry;

(b) continue operating in recently privatised industries; or

(c) *start or continue to run their business in underdeveloped areas.* (Emphasis supplied by the Committee.)

2 The issue is whether such government assistance is a 'government grant' within the scope of Ind AS 20 and, therefore, should be accounted for in accordance with this Standard.

Accounting Principle

3 Government assistance to entities meets the definition of government grants in Ind AS 20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors. Such grants shall therefore not be credited directly to shareholders' interests." (Emphasis supplied by the Committee.)

From the above, the Committee is of the view that government assistance in the form of sales tax exemption in the extant case is government grant.

10. The Committee further notes that Ind AS 20 defines only two types of government grants, viz., grants related to assets and grants related to income. There is no separate category of grants in the nature of financial or fiscal aids. The Committee notes that paragraph 19 of Ind AS 20 (which makes reference to grants received as part of a package of financial or fiscal aids) quoted by the querist in paragraph 6 above merely emphasises the need for identifying the conditions giving rise to the costs and expenses for determining periodic allocation of the grant to profit or loss, when multiple conditions are involved. In a broad sense, all government grants are in the nature of financial or fiscal aids.

11. The Committee notes that the principal conditions for sales tax exemption under the Scheme are investment of certain amount in certain fixed assets and operating in specified activities (production of specified products) in underdeveloped areas for the operative period of the grant. The grant is receivable only on sale of the finished product. One important condition as per the copy of the Eligibility Certificate furnished by the querist is that during the operative period of the grant, the Eligible Unit should not be closed or should not continue to remain below the normal production during the year. (Some conditions such as maintenance of records, conformity

with guidelines in the matter of employment etc., are merely of administrative nature, though their non-compliance will result in the grant becoming repayable). The Committee is of the view that while it may appear that the purpose of the grant is partly to subsidise the capital cost of the project and partly to act as an incentive in operating in underdeveloped areas, *the grant is not related to assets* considering the totality of the following facts (and not based on any individual factor in isolation):

(i) The main purpose of the grant as evident from the Preamble to the Scheme is to encourage entities to make investment in underdeveloped areas *in preference* to developed areas. This is to compensate for the disadvantages generally faced in *operating* in underdeveloped and developing areas.

(ii) There is no monetary ceiling for the exemption from sales-tax during the period of 18 years. The monetary ceiling linked to quantum of investment (130% of the investment) becomes relevant only if the ceiling is not reached within the period of 18 years. Thus, during the period of 18 years, the actual grant is linked to value of sales made without any limit. If the amount of such grant does not reach the monetary ceiling during the period of 18 years, during the extended period of 7 years the grant is still linked to the value of sales made, subject to the monetary ceiling.

(iii) Part of the investment can be made even after the commercial production starts as per the copy of the Scheme and various amendments furnished by the querist for the perusal of the Committee. Further, apart from acquisition of new and second-hand fixed assets in some situations, even existing assets shifted by the Eligible Unit to the project eligible for the benefits under the Scheme can form part of the Gross Fixed Capital Investment subject to some conditions as per the Scheme. Thus, investment requirement appears to be more of the nature of a qualifying condition rather than the purpose of the grant.

(iv) The grant enables the company to earn additional revenue on a recurring basis during the operative period of the grant. In the absence of the grant, the company would have paid the sales tax to the government. The grant enables the company to retain the entire sale consideration including sales tax element inbuilt

in the price. This results in additional revenue to the company each time a sale transaction occurs.

12. From the above, the Committee is of the view that since the grant is not related to assets, it should be treated as the grant related to income. In this connection, the Committee notes the following definition given in paragraph 3 of Ind AS 20:

> “*Grants related to income* **are government grants other than those related to assets.”**

13. As regards recognition of government grant, the Committee notes the following paragraphs of Ind AS 20:

> **“7. Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:**
>
> **(a) the entity will comply with the conditions attaching to them; and**
>
> **(b) the grants will be received.”**
>
> “8. A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.”
>
> **“12. Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.”**
>
> “16. It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see Ind AS 1 *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.”

"29. Grants related to income are sometimes presented as a credit in the statement of profit and loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense."

14. The Committee notes that in the present case, it is not possible to infer from the Scheme, the costs intended to be compensated by the grant. The purpose of the grant seems to finance the general activities of the company subject to compliance with the conditions attached with the grant. The various conditions do not clearly indicate the costs intended to be compensated. The Committee notes that paragraph 7 of Ind AS 20 provides that grant should be recognised only when there is a reasonable assurance that the entity will comply with the conditions attached to the grant and that the grant will be received. The Committee is of the view that in the extant case, the conditions relating to recognition of grant for sales tax exemption are fulfilled as and when sales take place subject to the reasonable assurance that the other conditions as specified in the scheme are fulfilled and accordingly, as and when sales take place, the portion of the price representing the sales tax element should be recongised as government grant. The Committee is further of the view that since sales tax exemption is a grant, it cannot be a part of sales and accordingly, it should be disclosed separately under the head 'other income'.

D. Opinion

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

(i) The exemption is in the nature of government grant. The exemption from payment of sales tax is a benefit in the nature of government grant, when the sales tax is inbuilt in the price of cement and retained by the company.

(ii) The sales tax exemption scheme benefit is a revenue related grant.

(iii) Although sales tax exemption is in the nature of fiscal aid, however, it should be recognised as discussed in paragraph 14 above.

(iv) This question does not arise since the grant is not related to assets.

(v) Grant related to sales tax exemption in the extant case should be recognised as discussed in paragraphs 13 to14 above.

Query No. 18

Subject: Disclosure of 'buyer's credit' and 'supplier's credit'.[1]

A. Facts of the Case

1. A company was incorporated as a 50:50 Joint Venture between ABC Ltd. and a foreign company. The company is engaged in the business of crushing of edible oil seeds, refining crude vegetable oils, manufacturing of vanaspati through hydrogenation and trading in edible oils and De-Oiled Cakes (DOC). The company also exports Castor oil and its De-Oiled Cakes. The facilities of the company are spread across 6 states. The company is a leading edible oil manufacturer in India with more than 85 stock points and 5,000 distributors catering to 1 million outlets. The company has a variety of products comprising a range of refined edible oils, vanaspati, bakery shortening and unrefined mustard oil.

2. The querist has stated that the company is also an importer of edible oils in India and finances its import in following ways:

(i) Cash Against Documents (CAD-DP/DA)

(ii) Buyer's Credit

(iii) Letter of Credit (LC or Suppliers Credit)

(iv) Buyer's Credit against 100% Fixed Deposit

[1] Opinion finalised by the Committee on 10.10.2011.

The querist has further elaborated on Buyer's Credit and LC/Suppliers Credit in the following paragraphs.

Buyer's Credit

3. Under buyer's credit arrangement, loans are tied-up with a foreign bank by importer against the Letter of Undertaking (LoU) issued by an Indian bank. Under buyer's credit, the foreign bank pays directly to supplier and on maturity, the importer pays to the foreign bank through LOU issuing bank. The flow of transaction and corresponding accounting entries have been stated by the querist as under:

Flow	***Accounting entries***
Import documents received at Indian bank's counter.	—
Importer gives acceptance to Indian bank to pay on due date (DP/DA).	Creditors are booked in the books.
Importer ties-up funds with foreign bank for financing the import payment on due date.	—
Importer approaches Indian bank to issue LOU to foreign bank.	—
Foreign bank pays to the creditor under loan arrangement.	Creditors are liquidated by booking buyer's credit liability in books of account.
On maturity of buyer's credit, importer pays to the foreign bank through LOU issuing bank along with interest.	Buyer's credit liability is liquidated against bank payment.

4. The querist has stated that in the case of the company, a consortium of banks has sanctioned working capital facility which includes buyer's credit. The entire working capital limits are secured with first charge over the current assets and second pari-passu charge over the fixed assets ranking pari-passu inter-se. The charges so created are registered with the Registrar of Companies (ROC). The LOUs are issued against the said secured limits. In some cases, the buyer's credit is also issued against 100% margin money kept with the banks in the form of Fixed Deposit Receipts (FDRs) pledged. All the buyer's credits are issued for a maximum of 360 days from Bill of Lading (BL) date.

Letter of Credit (LC) /Suppliers' Credit

5. In this arrangement, an LC is being issued by an Indian bank favouring foreign suppliers advised through its bank. The suppliers obtain the finance against the said LC from a bank finalised by the importer. The flow of transaction and corresponding accounting entries have been stated by the querist as under:

Flow	**Accounting entries**
On application by importer, Indian bank issues LC.	—
Import documents received at Indian bank's counter.	—
Importer gives acceptance to Indian bank to pay on due date.	LC liability is booked in the books as 'Acceptances'. Supplier receives payment from discounting bank arranged by importer.
On maturity of LC, importer pays to the Indian bank along with interest who in turn pays to foreign bank.	LC liability (Acceptances) is liquidated against bank payment.

6. The querist has stated that in the case of the company, a consortium of banks has sanctioned working capital facility which includes letter of credit. The entire working capital limits are secured with first charge over the current assets and second pari-passu charge over the fixed assets ranking pari-passu inter-se. The charges so created are registered with the ROC. The LCs are issued against the said secured limits. All the LCs are issued for a maximum of 360 days from BL date.

B. Query

7. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee considering the prevalent provisions/guidelines under the Foreign Exchange Management Act (FEMA)/ Companies Act, 1956/ Accounting Standards on the following issues:

(i) Whether Buyer's credit issued against limits is to be classified as 'Buyer's Credit' and shown under the schedule of 'Secured

Loans' or to be shown under the 'Current Liabilities and Provisions'.

(ii) What would be the disclosure requirement for Buyers credit issued under 100% margin FDRs? Would these also be classified as 'Buyer's Credit' and shown under the schedule of 'Secured Loans' or to be shown under the 'Current Liabilities and Provisions'.

(iii) Whether LCs issued against secured limits and classified as 'Acceptances' to be shown under the schedule of 'Current Liabilities and Provisions' with a suitable note in Notes on Accounts for securities given to banks or whether it can be shown under the schedule of 'Secured Loans'.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to classification and disclosure of supplier's credit (LCs) and buyer's credit in the specific facts and circumstances of the case. Accordingly, the Committee has considered only this issue and has not considered any other issue arising from the Facts of the Case, such as, propriety of the various entries passed in respect of supplier's credit or buyer's credit in the books of the company, accounting for 'Cash against Documents', etc. Further, the Committee has considered the query keeping in view only the general accounting principles involved and not from the angle of interpreting provisions of any legal enactments, such as, Foreign Exchange Management Act (FEMA), since as per Rule 2 of its Advisory Service Rules, the Committee cannot answer queries involving legal interpretation of various enactments.

9. The Committee also wishes to point out that as the querist has used the term 'Secured Loans' while raising the query, it is presumed that the query has been raised in respect of pre-revised Schedule VI[2] (which is applicable till 31st March, 2011) to the Companies Act, 1956 since it is only in the pre-revised Schedule VI, the liabilities are distinctly classified into 'Secured Loans' and 'Current Liabilities and Provisions'.

[2]Schedule VI has been revised. Revised Schedule VI came into force for the Balance Sheet and Profit and Loss Account for the financial year commencing on or after 01.04.2011.

10. The Committee notes the definition of the term 'Current Liability' as contained in the Guidance Note on the Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, as below:

> "**3.35 Current Liability**
>
> *Liability* including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months."

The Committee notes from the above that the definition of the term 'current liability' includes all liabilities, including those which are of the nature of loans, deposits, etc., that are payable within a period of twelve months. In the view of the Committee, it implies that the basis for *determining* a liability as 'current liability' as per the Guidance Note is the timing of its payment/ repayment falling due irrespective of its disclosure as 'secured' or 'unsecured' liability (including loans), as per the requirements of pre-revised Schedule VI to the Companies Act, 1956.

11. The Committee further notes that in pre-revised Schedule VI, Part I – 'Form of Balance Sheet', on the liabilities side of the balance sheet under the head 'Unsecured Loans', there is an item 'short-term loans and advances' for which note (d) has been given in the 'General Instructions for Preparation of Balance Sheet' at the end of the Form, which provides as follows:

> "(d) Short-term loans will include those which are due for not more than one year as at the date of the balance sheet."

From the above, it is clear that as per the disclosure requirements of pre-revised Schedule VI, the primary bifurcation of liabilities is on the basis of whether the liabilities are secured or unsecured rather than on the basis of current or non-current liabilities. Thus, as per pre-revised Schedule VI, a liability which is of the nature of loans and borrowings will be *disclosed* under the head 'Secured Loans' or 'Unsecured Loans' even if it is a short term liability.

12. In the extant case, the Committee notes that both the buyer's credit and supplier's credit are payable within a period of less than a year and these are dues arising from purchase of raw materials/ goods in which the company deals. The Committee also notes that under the buyer's credit arrangement, the importer is entering into financing arrangement with a foreign bank to make payments to the foreign supplier against the imports.

Similarly, under the supplier's credit arrangement, the importer enters into an arrangement with Indian bank to issue letter of credit (LC) in favour of foreign supplier who gets it discounted from a discounting bank, which is also arranged by importer. Further, the Committee notes that in the extant case, on maturity of LC, the importer is also incurring interest cost against the facility being extended to it. Thus, in this case, under the supplier's credit also, the importer is the primary party who enters into financing arrangements to make payments to the foreign supplier. Accordingly, the Committee is of the view that both the buyer's credit and supplier's credit are primarily of the nature of loan taken by the importer.

13. On the basis of the above, the Committee is of the view that since both the buyer's credit and supplier's credit are of the nature of a 'loan' and are also secured by charge over current assets or secured against FDRs, these should be disclosed under the head 'Secured Loans' in the balance sheet of the company as per the requirements of Schedule VI to the Companies Act, 1956.

14. As regards the classification and disclosure of the amounts due against buyer's credit and supplier's credit, the Committee is of the view that in the extant case, these should be classified and disclosed under the sub-head 'loans and advances from banks' under the head 'Secured Loans' using an appropriate nomenclature which would appropriately disclose their nature to the users of the financial statements.

D. Opinion

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

(i), (ii) and (iii) The buyer's credit whether issued against limits or issued against 100% margin FDRs and supplier's credit/LCs issued against secured limits, in the extant case, should be classified and disclosed under the sub-head 'loans and advances from banks' under the head 'Secured Loans' using an appropriate nomenclature which would appropriately disclose their nature to the users of the financial statements as discussed in paragraphs 13 and 14 above.

Query No. 19

Subject: Revenue recognition in case of project managers.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'ABC') is a wholly owned subsidiary of a listed Central Public Sector Undertaking (CPSU). ABC was incorporated in the year 2002 under the Companies Act, 1956. The main objective of the company is to acquire, establish and operate electrical systems etc. for distribution and supply of electrical energy, to undertake works on behalf of others, and to act as engineers/consultants amongst others.

2. Under the Bharat Nirman programme of the Government of India, the Ministry of Power (MoP) has been entrusted with the formulation and implementation of the Rajiv Gandhi Gramin Vidyutikaran Yojana (RGGVY). The RGGVY aimed at electrifying all villages and habitations and providing access to electricity to all rural households of the country through Central Public Sector Undertakings (CPSU), with M/s XYZ as the nodal agency, since the CPSUs have the technical and professional competence and expertise to implement such a scheme on a massive scale. The scheme was launched in April 2005 under which 90% grant is provided by Government of India and 10% as loan by the State Governments.

3. A MOU was signed on 16th August, 2004 between XYZ and ABC with the objective to be associated in the formulation and implementation of projects under the programme in association with the concerned State Government/power utility. In accordance with the said MOU, ABC entered into agreements with XYZ, State Governments and State Power Utilities (SPUs) for implementation of projects in those states on behalf of the State Governments/SPU. Under the said MOU, the funds required for the execution of the project are released directly to ABC by XYZ including 12% service charges. ABC is responsible for selecting executing agencies (contractors) through open tenders. Project-wise separate contracts namely "Supply Contract" and "Erection Contract" are entered into between ABC and the selected contracting companies, for execution of the work. At no point of time, XYZ, State Government or SPU enters into any kind of contract with the executing agency, i.e., the contractors. The executing agency furnishes

[1] Opinion finalised by the Committee on 21.12.2011.

a performance bank guarantee in favour of ABC only for executing the work. Further, the responsibility of levying and collecting the liquidated damages, if any, from the executing agency is that of ABC and, the amount so recovered will be adjusted in the project cost. Relevant extracts of the various documents are given hereinbelow for ready reference:

MOU between XYZ and ABC dated 16.08.2004:

"Clause 4. Role of ABC

4.1

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

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

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

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

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

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

or

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

“Clause 5. Project Execution and Development Expenditure

5.1

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

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

(c) Separate accounts for development and implementation of such XYZ funded projects shall be maintained by ABC.

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

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

“Clause 7. Representation and Warranties

Neither Party shall have the right or power to bind the other party(ies) to any agreement without the prior written consent of the party(ies) concerned. Unless specifically agreed in writing, no Party is authorised to make commitments, representations,

warranties or agreements on behalf of the other parties and each party agrees that it will not hold itself out as having such authority. If any Party acts in violation of the foregoing the said Party agrees to indemnify, defend and hold the other parties harmless from and against any and all claims, demands, losses, damages, liabilities, law suits and other proceedings judgments and awards, the reasonable cost and expenses (including, but not limited to, reasonable attorneys' fee) arising directly or indirectly, in whole or in part, out of the breach of this article by such party, whether committed by the indemnifying party, its employees, agents, successors or assigns."

"Clause 8. Limitation of Liability

Neither party shall be liable to each other for any financial liability or any consequential loss incurred by the party individually in respect of any of the project(s), so identified herein above as per provision of Clause 5 under these present. The MOU is subject to the detailed terms and conditions of the Accelerated Electrification of Villages and Households Programme, as may be agreed / desired / decided by the Government of India / XYZ."

*Agreement between XYZ, State Government, SPU and A*BC entered separately for each state

"3.0 Construction / Implementation

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

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

3.3 ABC shall suitably incorporate the provisions towards levy of liquidated damages in their agreements with contractors for delay in completion of the project(s) and also other relevant contractual provisions pertaining to the procurement of goods

and works. Declaration in this regard shall be furnished by ABC before setting the actual expenditure on the project in line with the provisions under clause 1.3(g) of this agreement. All amounts towards Liquidated Damages, if any, as may be recovered by ABC under this provision, shall be suitably adjusted in the project cost.

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

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

(c) On behalf of the project authority (State Government and SEB), ABC shall ensure that the equipment & material specifications and construction practices & standards are as those approved/ stipulated by XYZ…"

General Terms & Conditions of Contract between ABC and Executing agencies

"1.0 Definition of Terms

1.1 'Contract' means the agreement entered into between the Employer and the Contractor as per the Contract Agreement signed by the parties including all attachments and appendices thereto and all documents incorporated by reference therein.

1.2 'Employer' shall mean_____ (entrusted by the_______ with the concurrence of Government of ________) and shall include its legal representatives, successors and assigns.

1.3 Contractor or Manufacturer shall mean the Bidder whose bid will be accepted by the Employer for the award of the Works and shall include such successful Bidder's legal representatives, successors and permitted assigns.

1.4 Sub-Contractor shall mean the person named in the Contract for any part of the Works or any person to whom any part of the Contract has been sublet by the Contractor with the consent in writing of the

Engineer and will include the legal representatives, successors and permitted assigns of such person. ..."

"*Special Conditions of Contract*

Volume – IA

All the conditions stipulated in Special Conditions of Contract (SCC) shall supplement the General Conditions of Contract (GCC), Erection Condition of Contract (ECC), Instructions to Bidders (INB) and Technical Specification Vol. IIA & IIB. Wherever there is a conflict, the provisions herein shall prevail over those in the GCC, ECC, INB and Technical Specification Vol. IIA & IIB. (Emphasis supplied by the querist.)

1.0 General Information

1.1 ABC incorporated under the Companies Act, 1956, having its Registered Office at … (hereinafter called the Employer) has been contracted by the State Electricity Board (hereinafter called the Owner) with the concurrence of State Government for execution of Rural Electrification Works for electrification of villages and rural households in one of the district of the State.

1.2 ABC, therefore, invites sealed bids for the following packages of Rural Electrification Works in District on domestic competitive bidding basis:

Rural Electrification Work in the District under RGGVY Scheme of GOI on turnkey basis.

1.3 The project shall be executed by ABC on deposit work basis with funds made available out of the proceeds of the financial assistance received by the State Government from XYZ and the ownership of the aforesaid package shall remain vested with the State Electricity Board. All eligible payments against this work shall be made by ABC under suitable arrangement with the State Government.

1.4 "Owner" shall mean the State Electricity Board.

For the purpose of execution of the Contract, the contractual activities on the part of the 'Owner', wherever context requires so, shall be performed by ABC (the Agency appointed by the State Electricity Board)

for and on behalf of the State Electricity Board, except in case where the State Electricity Board itself is statutorily required to do so.

1.5 Wherever reference to ABC is made in the bidding documents, Contract/Notification/Letter of Award (in the event of Award of Contract) or any related papers/documents, it shall be deemed to be for and on behalf of the State Electricity Board. ..."

"14.0 Liquidated Damages

14.1 For Equipment Portion

14.1.1 If the Contractor fails to successfully complete the commissioning within the time fixed under the Contract, the Contractor shall pay to the Employer as liquidated damages and not as penalty a sum specified for each specified period of delay. The details of such liquidated damages are brought out in the accompanying Special Conditions of Contract.

14.1.2 Equipment and materials shall be deemed to have been delivered only when all its components, parts are also delivered. If certain components are not delivered in time the equipment and materials will be considered as delayed until such time the missing parts are also delivered.

14.1.3 The Contractor shall pay to ABC as liquidated damages and not as penalty, a sum of half percent (0.5%) of the contract price for each calendar week of delay or part.

14.2 Total amount of liquidated damages for delay under the Contract will be subject to a maximum of 5% of the Contract price.

14.3 Liquidated damages for not meeting performance guarantee during the performance and guarantee tests shall be assessed and recovered from the Contractor as detailed in Technical Specifications / Special Conditions of Contract. Such liquidated damages shall be without any limit whatsoever and shall be in addition to damages, if any, payable under any other clause of conditions of Contract. ..."

4. The querist has stated that the accounting policy of the company on revenue recognition provides as follows:

> "Income from consultancy services is accounted for on the basis of actual progress/ technical assessment of work executed, in line with the terms of respective consultancy contract."

According to the querist, in accordance with this accounting policy, at present, the company is recognising only the service charges (professional fee) as its revenue/ turnover. In other words, gross amount of cost of project is neither reflected in revenue nor in expenses as they are offset. Further, the amount received as advance for deposit works is shown under 'Current Liabilities' as 'Amount received against deposit works'. Any amount received from XYZ is being credited to this account and all the payments made to agencies are debited to this account.

Company's justification for this accounting policy

5. As per the MOU, it is clear that the ownership of the entire work shall vest with the various State Governments/State Power Utilities. ABC works only as an agent on their behalf and the funds are provided by the Government of India under a fiduciary relationship of principal and agent. ABC is to utilse the funds as per the terms and conditions of the MOU. After meeting the actual expenses on the work, the balance is to be refunded. This definition of ownership is contained in clause 1.0 of 'XYZ Guidelines for procurement of goods and services' under the chapter 'Invitation to Bids'. Further, as per clause 6.2 of the said guidelines, the statutory deduction of taxes and duties at source related to these works shall be done by ABC on behalf of the State Power Utilities and TDS so deducted shall be deposited with the relevant tax authorities on their behalf. TDS certificates shall also be issued on their behalf by utilising their PAN/TAN/TIN. Also as per clause 8.7.2, all invoices under the construction contracts, awarded by ABC, shall be raised by the contractor on "State Power Utilities acting through ABC" and all payments shall be made to the contractor by ABC on behalf of State Power Utilities. The waybills/road-permits are also being issued by the owner, i.e., the State Power Utilities. Therefore, ABC is performing these services as an implementing agency on nomination basis, and not as a contractor as ownership of the assets vests with the State Power Utilities. Therefore, Accounting Standard (AS) 7, 'Construction Contracts', is not applicable.

Contentions of the Auditor (querist)

6. It is apparent from the clauses 4 and 5 of the MOU with XYZ and also in the multi-lateral agreement amongst ABC and separate State Governments

(relevant extracts reproduced above) that ABC is acting as project managers. ABC is given the turnkey responsibility to execute the project under a 'cost plus' basis. According to paragraph 4 of AS 7, contracts for rendering of services, which are directly related to the construction of assets, for example, services of project managers and architects, fall within the scope of a construction contract that is required to follow an accounting policy in accordance with AS 7. Paragraph 5 of AS 7 classifies two types of contracts, fixed price and cost plus. The contracts engaged into by ABC are cost plus 12% contracts, according to substance of the agreement. The querist has also provided the following arguments in his support:

- Modus operandi described in the arrangement for compliance of TDS provisions etc. are no criterion for deciding the applicability of AS 7.

- ABC is not acting as an agent of the State Government or SPU because ABC is solely responsible for the completion of the project, through the contractors. All the agreements entered into by ABC are on 'Principal to Principal' basis. XYZ or the SPU are nowhere held responsible for the acts of ABC. In fact, all the guarantees given by the executing agencies are also in favour of ABC and not the SPU. Had it been a case of an agency, then these guarantees should have been given directly in favour of the State Government /SPU.

- Contention of the company's management that ownership of the asset vests with Government and hence, it is not a 'construction contract' holds no water as in all cases of construction contracts too, the ownership of assets built vest with the principal and not with project manager. Ownership of asset is not a criterion for the applicability of AS 7.

- Expert Advisory Committee in the context of Query No. 19 of Volume XXVIII of the Compendium of Opinions on the subject, 'Accounting treatment of receipt and utilization of project-specific funds', had opined in paragraph 13 as follows:

  "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 accounting policy followed by the company facilitates understatement from its profit and loss account, of thousands of crores in the form of revenue or expenses, which is spent by the national exchequer towards nation building, through the responsibility and the accounts of the government company ABC, thus, undermining 'substance accounting' as laid in the Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India (ICAI).
- In this background, the querist believes that the accounting policy to be followed by ABC should be 'proportionate completion method', for a cost plus contract under AS 7.

B. Query

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

(i) Whether or not the company is required to follow proportionate completion method prescribed for a 'cost plus contract' method, in accordance with AS 7.

(ii) Whether the existing accounting treatment followed by the company of recognising only the service charges, i.e., professional fee, as its revenue is in order.

C. Points considered by the Committee

8. The Committee notes that the basic issues raised by the querist are related to (i) applicability of AS 7 in the extant case, and (ii) propriety of accounting treatment followed by the company of recognising only service charges as its revenue. Therefore, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of arrangement for compliance of provisions

of income-tax/deduction of TDS on payments as per the provisions of Income-tax Act, 1961, or interpretation of the terms of the agreements entered into with the State Government or State Power Utilities, or sub-contractors or XYZ, etc. Further, the Committee wishes to point out that its opinion is expressed purely from the accounting point of view.

9. For the sake of convenience, the Committee deals firstly with the second issue relating to recognition of revenue. The Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', which is reproduced below:

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

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

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

(b) Clause 3.4 of Agreement between XYZ, State Government, SPU and ABC clearly reflects that the company is just acting under

the instructions/ specifications of the XYZ, the nodal agency appointed by the Government of India.

(c) It is clearly stated that the State Electricity Board would be the owner of the project and the company is an agency appointed by the State Electricity Board (refer clause 1.4 of Special Conditions of contract between ABC and executing agencies).

(d) The company is getting only a fixed percentage of income as service charges depending on the nature of contract awarded to it.

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

10. On the basis of the above, the Committee is of the view that since the significant risks and rewards related to the ownership of project do not vest with the company, the costs and revenues related to the construction of the project and the procurement of the products as per the project should not be recognised in the books of account of the company. The Committee is further of the view that as the company is merely providing services in relation to construction/procurement to the State Governments/ State Power Utilities for which it is receiving fixed service charges, keeping in view the consideration of substance over form as explained above, the company should recognise only the service charges received in consideration of its services as its revenue. In this regard, the Committee also notes paragraphs 10 and 11 of Accounting Standard (AS) 7, 'Construction Contracts', notified under the Companies (Accounting Standards) Rules, 2006, which provide as follows:

"10. Contract revenue should comprise:

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

..."

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

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

11. The Committee is also of the view that the project assets and liabilities of the said business should also not be recorded in the books of account of the company. In this regard, the Committee notes that the terms 'Asset' and 'Liability' are defined in paragraphs 49(a) and 49(b) respectively of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, as follows:

> "(a) An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."
>
> "(b) A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

Accordingly, the Committee is of the view that insofar as the company is concerned, the project assets and project liabilities do not meet the definitions of 'Asset' and 'Liability' respectively. This is because the future economic benefits from the project assets are not expected to flow to the company. On completion of the project, the assets are taken over by the respective State Governments or State Power Utilities. The project assets are not funded by the company. In substance, they are funded by the State Government /Government. Accordingly, the liabilities which arise during the transactions are those of the Government and not that of the company.

12. As regards the recognition of contract revenue in the extant case as per AS 7, the Committee notes that for execution of the projects, the company enters into 'supply' and 'erection' contracts with the selected contracting companies (sub-contractors/executing agencies). Thus, the company is rendering services directly related to the construction as in case of project managers and accordingly, the principles of AS 7 should be applied while recognising revenue (viz., service charges) from such services. In this connection, the Committee notes paragraph 4 of AS 7, notified under the Companies (Accounting Standards) Rules, 2006, which is reproduced below:

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

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

(b) ..."

Accordingly, the company should recognise the service charges on the proportionate completion basis as per the principles of AS 7.

13. As regards the contention of the auditor that the contracts entered into by the company are cost plus contracts, the Committee does not agree with it. The Committee is of the view that under a cost plus contract, the contractor is paid cost *plus* fixed percentage (the entire sum being recognised as contract revenue) whereas in this extant case, the company is being paid only a fixed percentage of project cost as service charges in relation to its rendering of services. Accordingly, the question of treating the project in the extant case as 'cost plus contract' does not arise.

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) The company should follow proportionate completion method in accordance with AS 7 as discussed in paragraph 12 above and apply this for recognition of only the service charges as revenue. However, the contracts in the extant case cannot be called as cost plus contracts as discussed in paragraph 13 above.

(ii) The company should recognise only the service charges as discussed in paragraph 10 above.

Query No. 20

Subject: Treatment of payments made and materials supplied for construction of assets not owned by the company and its subsequent recovery in instalments.[1]

A. Facts of the Case

1. A public sector undertaking (hereinafter referred to as 'the company') is a leading steel-making company in India having five integrated steel plants and three special steel plants located at different places in India. A subsidiary company of the company produces ferro-alloys. The company produces both basic and special steels for domestic construction, engineering, power, railway, automotive and defence industries as well as for sale in export markets. The turnover of the company in the financial year 2008-09 was Rs. 48,681 crore. It has a direct employment of about 1,10,000 people.

2. The company also owns iron ore mines, flux mines and coal mines located in various states. The company is one of the largest producers of iron ore. The company is in the process of developing new iron ore and coking coal mines. The company has a competitive edge in terms of captive availability of iron ore, limestone, and dolomite, which are essential inputs for iron and steel making.

3. The company, jointly with National Mineral Development Corporation (NMDC) Limited, has entered into an agreement with the Ministry of Railways for the construction of Broad Gauge (BG) rail link in two phases. The phase-1 is for 95 km and phase-2 is for 140 km at an approximate cost of Rs. 968 crore to provide sustained iron ore supply to a steel plant (hereinafter referred to as 'SP') of the company. The total time period of construction will be 5 years for the phase-1. The commencement of the work on the phase-2 will be taken up simultaneously along with the phase-1.

4. The company will bear the actual cost of construction of the new BG line for the phase-1 (95 km.) estimated at Rs. 702.93 crore at June 2008 price level and any escalation during the construction period of 5 years. For the portion of the railway line section in the phase-2 (140 km), the company and NMDC will provide a proportionate assistance of Rs. 141.30 crore and Rs. 70.70 crore (2004-05 price level) respectively and any escalation therein.

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[1] Opinion finalised by the Committee on 6.2.2012.

Out of the total estimated construction cost of Rs. 844.23 crore of both phases of laying of railway line, till date, the company/SP has made payments towards phase-1, of Rs. 123 crore in cash and Rs. 9.49 crore in kind, i.e., steel produced by the SP/the company. There is no progress of job in phase-2 and the agency for job in phase-2 is yet to be finalised. Accordingly, as per the querist, the company does not have revised estimates for phase-2 at 2008-09 price level. The querist has also stated that for phase-1, the estimate was of Rs. 304.30 crore (at 2004-05 price level), which was preliminary without observed data base and also did not include Interest During Construction (IDC). The updated estimate of Rs.702.93 crore (at 2008-09 level) was based on ground topographic data and on realistic basis. It also includes Rs. 71.15 crore towards IDC. The increase in estimates is towards both change in scope of work (Rs. 138.92 crore) as well as price escalation (Rs. 188.56 crore). The querist has also mentioned that the revised estimate in phase-1 was furnished by a third party, M/s. ABC Ltd. The State Government will provide concessions by making available, Government land free of cost, for construction of the said railway line and other benefits. The ownership of the railway line will remain with the Railways.

5. The querist has stated that the Railways will pay at the end of every year to the company, cash at the rate of 7% per annum for 37 years on total contribution towards redemption of the company's contribution, commencing from the 1st year after commissioning of the phase-I of the project, provided that the company ensures a minimum of 4 million tonnes of iron ore traffic per year from the 1st year and 9 million tonnes from the 3rd year of operation onwards for the phase-2 as per their commitment. Reconciliation of compliance of minimum traffic guaranteed by the company shall be done at the end of every 4 years over the period of 37 years and the 37th year on cumulative basis. In case, any shortfall is observed during such reconciliation, further payment shall be made only after the shortfall, if any, in the minimum traffic guaranteed for the period reconciliation is made good.

6. Ministry of Railways will pay at the end of every year, cash at the rate of 7% per annum for 37 years on total investment by NMDC commencing from the 1st year after commissioning of phase-2 of the project. Railways will provide priority to traffic transportation requirements of the company and NMDC on this route for 37 years.

7. The querist has further stated that there is no uncertainty with regard to minimum traffic movement of 9 million tonnes annually, as the iron ore

requirements of the company/SP will be sourced mainly through this rail route only.

8. According to the querist, against the payment of Rs. 844.23 crore, the company would recover Rs. 2,186.55 crore over a period of 37 years. As on 31st March, 2011, cost incurred on the project amounting to Rs. 123 crore is shown as 'Deposit with Railways' under the head 'Loans & Advances'.

B. Query

9. The opinion of the Expert Advisory Committee (EAC) is being sought by the querist on the following matters:

(i) Whether the payments of Rs. 844.23 crore by the company to Railways should be disclosed as 'Advance Recoverable' under Current Assets. Whether the amount received from Railways every year should be bifurcated into principal and interest by applying the effective rate of interest. The Deposit Advance amount should be reduced by the principal recovery amount and interest amount will be disclosed as income.

or

(ii) Whether the payments to Railways should be charged to revenue as per the opinion given by the EAC, published in January 2011 issue of the Institute's Journal, 'The Chartered Accountant', for assets constructed on land not owned by the company and either the amount recoverable from railways should be treated as 'Advance Recoverable', to be adjusted over 37 years against recoveries thereof from Railways after bifurcation between principal recoveries and interest income or the amount recoverable at the rate of 7% p.a. should be disclosed as income of the year every year.

or

(iii) Whether the payments to Railways should be capitalised under the head 'Railway Lines' to be depreciated over its normal life and the amount recoverable after reducing the amount paid to Railways should be classified as advance recoverable, to be adjusted over 37 years against recoveries thereof from Railways

after bifurcation between principal recoveries and interest income.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised in the query relate to accounting treatment of payments/contribution made and materials supplied for construction of assets not owned by the company and its subsequent recovery (along with interest) at a fixed rate after commissioning of the relevant phase of the Project. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for interest paid by the company during construction, accounting treatment under the situation when the company fails to make good the shortfall in minimum traffic guarantee of iron ore, correctness in calculation of total recovery amount from the Railways and appropriateness of using the term 'Deposit with Railways' for the payment made by the company, etc. At the outset, the Committee wishes to point out that while making estimate of the total expenditure required for construction of the Project, the estimates for Phase-1 have been determined at the 2008-09 price level, whereas for Phase–2, the estimates have been determined at the 2004-05 price level; however, the Committee is of the view that this does not affect the opinion of the Committee expressed hereinafter. The Committee, while expressing its opinion, has also presumed that there is no uncertainty with regard to the guaranteed minimum traffic movement of 4 million tonnes / 9 million tonnes of iron ore annually as per the terms agreed with the Government. The Committee also notes that the amount of Rs. 844.23 crore at certain places in the Facts of the Case has been stated as estimates and at other places, it has been stated as payments. The Committee wishes to point out that the opinion expressed hereinafter is only in respect of the actual payment/contribution made to the Railways as that is the issue raised by the querist.

11. The Committee notes from the Facts of the Case that the contribution is being made by the company to the Railways in cash as well as in kind, viz., supply of materials (steels). With regard to recognition of contribution made by the company in cash/kind, 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."
>
> "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."

From the above, the Committee notes that an expenditure incurred by an enterprise can be recognised as an asset only if it is a 'resource controlled by the enterprise'. Therefore, the issue raised by the querist requires examination from the point of view of the type of the resource that the company controls, if any, as a result of contribution towards the construction of the BG rail link. For this purpose, the Committee has examined whether such contribution results into recognition of a tangible asset, an intangible asset or an advance to be reimbursed in future.

12. The Committee is of the view that the above-mentioned contribution would be considered to result into a tangible asset, i.e., BG rail link, only when, the company is able to control such asset(s). The Committee is of the view that an entity that controls an asset can generally deal with that asset as it pleases. For example, the entity having control of an asset can exchange it for other assets, employ it to produce goods or services, charge a price for others to use it, use it to settle liabilities, hold it, or distribute it to owners. Further, the Committee is of the view that an indicator of control of an item of (tangible) fixed asset would be that the company is ordinarily responsible for the repairs, maintenance, upgradation and replacement of that item. In other words, the company should have the ability to decide how the fixed asset is operated and maintained and when it is replaced. Since no such indicators exist in the extant case, the Committee is of the view that the company, although utilising the rail link for its business, does not possess any control over the 'BG rail link', and accordingly, such contribution cannot be recognised as a tangible asset in the books of the company.

13. The Committee now examines whether the payment results into an intangible asset for the company. In this regard, the Committee notes the definition of the term, 'intangible asset' as provided by paragraph 6.1 and paragraphs 11 and 13 of Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006, which provide as follows:

"An <u>intangible asset</u> is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes."

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

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

From the above, the Committee notes that 'identifiability' is a necessary condition for recognition of an intangible asset. The Committee notes from the Facts of the Case that although the company may acquire a right of priority in terms of traffic transportation on the BG rail link, from the above-mentioned contribution; yet, from the Facts of the Case and circumstances, it appears that the primary objective of the transaction is to develop infrastructure for transportation of the material, rather than to obtain a right of priority to transport the material. In the view of the Committee, therefore, such right does not appear to satisfy the test of identifiability. Accordingly, it cannot be recognised as an intangible asset in the books of the company.

14. The Committee further notes from the Facts of the Case that while the company contributes towards construction of the BG rail link both in cash as

well as in kind, viz., supply of materials (steels), the ownership of the BG rail link shall remain with the Railways. Further, such contribution will be reimbursed by the railways in cash at the rate of 7% of the contribution per annum for a period of 37 years, thus, repaying more than the contribution made by the company. As regards contribution made by the company in cash, the Committee is of the view that since the amount being recovered is more than the amount originally contributed by the company, such contribution, in substance, is an interest-bearing advance to the Railways from the company. It is irrelevant that the amount so advanced is being utilised by the Railways for construction of the BG rail link. Further, the Committee notes that as per Schedule VI[2] (pre-revised) to the Companies Act, 1956, the sub-head, 'Loans and Advances' of the head ' Current Assets, loans and Advances' to the 'Assets' side of the balance sheet include 'Advances recoverable in cash or kind or for value to be received'. Hence, the Committee is of the view that the aforesaid amount should be disclosed as an 'advance'. Under revised Schedule VI also, such advance is to be classified under the sub-head 'Long-term loans and advances' under the head 'Non-current assets' on the assets side of the balance sheet. As regards the contribution made by the company in kind, viz., through supply of materials, the Committee is of the view that the company is in a way selling its goods to the Railways, for which consideration will be received in future. Thus, it is sale of goods on deferred credit terms. In this regard, the Committee notes that paragraph 4.1 of Accounting Standard (AS) 9, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') defines the term 'revenue', which provides as follows:

> ***"4.1 Revenue** is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the*

[2]Schedule VI has been revised. Revised Schedule VI came into force for the Balance Sheet and Profit and Loss Account for the financial year commencing on or after 01.04.2011.

> ***revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."***

From the above, the Committee is of the view that the contribution by the company in kind should be recognised as 'revenue' at the time when the material is supplied to the Railways provided other conditions for recognition of such revenue as per the principles of AS 9 are satisfied. The revenue so recognised should be disclosed as 'sundry debtors' as per the pre-revised Schedule VI and as 'trade receivables' as per revised Schedule VI under the head 'Current Assets'. The Committee also notes from the Facts of the Case that the amount contributed by the company is recoverable every year at the rate of 7% of the contribution over a period of 37 years, thus, the total contribution which includes the revenue earned by the company is being recovered in instalments. In this regard, the Committee notes paragraph A(8) of the 'illustrations' to AS 9, notified under the Rules, which provides as follows:

> *"8. Instalment sales*
>
> When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller."

15. From the above, the Committee is of the view that as far as recovery against the contribution in kind is concerned, on receipt of each instalment, the company should recognise the interest element as 'other income' proportionately to the unpaid balance of debtors due to the company and balance will be treated as principal recovery amount. Accordingly, on such recovery, the debtors' balance will be reduced by the principal recovery amount.

16. The Committee notes that out of the total amount being recovered, besides recovery against installment sales, the balance amount being recovered against 'advances' (as discussed in paragraph 14 above) also consists of two elements – the principal amount as well as the interest amount. So, while accounting for the same, it should be bifurcated into the 'principal' and the 'interest' elements by applying a rational method, for example, by adopting an appropriate effective rate of interest. Accordingly, on each recovery, the interest portion will be recognised as 'other income' in the books of account of the company and the principal portion will be

treated as recovery of the 'advances' which will reduce the amount of 'advances'.

D. Opinion

17. On the basis of the above, the Committee is of the opinion that the payments being made by the company to the Railways cannot be recognised either as a tangible or intangible asset. Based on the nature of contribution being made, viz., in cash or in kind, the contribution in kind should be recognised as 'revenue' from sale of goods and the contribution in cash should be recognised as an Advance under the head 'Loans and Advances'. On recovery of the contribution in kind, the company should recognise the interest element as 'other income' proportionately to the unpaid balance of debtors due to the company and the balance should be treated as recovery of the principal amount. Accordingly, the debtors' balance will be reduced by the recovery of the principal amount on each recovery. Further, recovery against the cash contribution, i.e., advances, should again be bifurcated into the 'principal' and the 'interest' elements as discussed in paragraph 16 above. The reasoning and methodology of the said treatment is given in paragraphs 11 to 16 above.

Query No. 21

Subject: Applicability of AS 17 to a company engaged in refining.[1]

A. Facts of the Case

1. A public sector company (hereinafter referred to as 'the company') is engaged in refining of crude oil. The refined petroleum products sometimes undergo primary processing as well as secondary processing. The different variants of petroleum products from both the processes are stored together in their respective tanks. Thus, the company is in a process industry with single input and multiple outputs where, as per the querist, the multi-stage

[1] Opinion finalised by the Committee on 6.2.2012.

processed and single stage processed products have same market value as they are same class of products.

2. The company sells most of its products domestically and around 35% of the products are exported. The export is dominated by two main products, viz., fuel oil and Naphtha which are inevitable resultant products of crude oil processing. The querist has provided a process flow diagram of the crude refining for reference of the Committee (Refer to Annexure A). An issue has arisen during the course of audit as to whether export sale is to be considered as a separate segment as per Accounting Standard (AS) 17, 'Segment Reporting' or not.

3. A view has been expressed that the export sales may be a separate segment as per the provisions of AS 17, since the sales revenue from exports are more than 10% and as such, this segment is a reportable segment and accordingly, necessary disclosures are to be made in the annual accounts. The other view is that considering the standard requirement as explained hereinafter, the disclosure presently being given would suffice.

4. The company has been making the following disclosure regarding applicability of AS 17 in its annual accounts:

> "The Company is engaged in refining crude oil, all activities of the Company revolve around this business and the operations are in India. As such there is no other reportable segment as defined by Accounting Standard 17 – Segment Reporting issued under the Companies (Accounting Standards) Rules, 2006."

5. The querist has stated that the main business of the company is refining of crude oil which is a single input and multiple output process industry. The risks and returns of the products produced by the company are same whether sold domestically or exported. Further, the querist has stated that as the components of an enterprise that are required to be reported separately, have to first fall within the definition of the terms, business segment and geographical segment, an analysis of factors determining the business segment and geographical segment with specific reference to standard requirement have been provided by the querist as follows:

(a) Business Segment:

(i) The company produces petroleum products, viz., Liquid Petroleum Gas (LPG), Naphtha, Motor Spirit, High Speed

Diesel, Fuel Oil, etc. which are sold domestically as well as exported. The nature of products sold in both the markets is same.

(ii) The production process is refining of crude oil only. There is no separate process involved for manufacture of products exported.

(iii) The customers for all the products produced are basically oil marketing companies, domestic or international. The company is mainly selling its products in domestic markets. However, export is inevitable as domestic demand for such products is lower.

(iv) The products are sold on Free on Board (FOB) basis and mode of transport for bulk movement is by ship for domestic as well as for export. For domestic market, in addition to movement by ship, it is also transported through pipelines and tank trucks.

(v) There is no regulatory environment as far as sale of products from refinery is concerned. It is free to sell the products domestically as well as internationally. All products except LPG and kerosene can be exported. LPG and kerosene are not exported by the company, as the full quantities produced by the company are absorbed by domestic market.

Considering the above facts, the risks and returns related to all products whether exported or sold in domestic market are same.

(b) Geographical Segment:

(i) The company exports its products only on FOB basis, and therefore, there is no effect on economic and political conditions prevailing in domestic as well as export market. The products exported other than those sold under term contract, are bought by oil majors or traders who in turn supply these products to the end users. The company does not have any foreign offices and does not operate in other countries. All sales are done in India on FOB sales basis.

(ii) The exports made by the company are on FOB basis and as such, the ownership of the product is transferred to the buyers at the load port in India. No special risks are associated.

(iii) The company does not have any production facilities or marketing installations/marketing network abroad. Accordingly, the economic and political environment prevailing in India only is having an impact on both exports as well as domestic sales. There are no special exchange control regulations, like, restrictions on repatriation of money to India, which are applicable in case of realisation of export sale proceeds.

(iv) The basis of fixation of pricing of the products for exports as well as domestic sales are similar as both the prices are determined with reference to the international prices in $ (US Dollar) terms. Hence, there are no separate underlying currency risks for both types of sales.

(v) Most of the payments are through Letter of Credit (LC) and LC is opened prior to shipment.

Considering the above facts, the risks and returns under both the economic environments, i.e., for domestic and export market are same.

6. The querist has stated that as the company is engaged in crude oil refining, determination of cost of production of individual products emanating from crude oil refining meant for export and domestic market is difficult as apportionment of cost is not possible and each method also has its own merits and demerits. Determination of segment expenses is not possible for both business and geographical segments as determination of cost of production of individual products or group of related products is not possible.

7. Further, the capital assets used for production of individual products are same irrespective of whether it is sold domestically or exported. Further, the majority of products produced and exported are inevitable in the process of production as domestic demand for such products is lower and therefore, these have to be necessarily exported. There are no separate segment assets earmarked for both business and geographical segments. The querist has further stated that in view of commonality of assets used for products exported, the cost of assets relating to export sale cannot be quantified. No separate profit and loss account is made for determining profit or loss on

export of products. There are also no separate exclusive expenditures incurred for export.

B. Query

8. In this background, the querist has sought the opinion of the Expert Advisory Committee as to whether export sale is to be considered as a separate segment as per AS 17 or not and if so, the applicable disclosure requirements of AS 17.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised in the query relate to whether 'export sale' can be considered as a separate segment as per the provisions of AS 17 and the disclosure requirements in case AS 17 is applicable. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of the querist's statement regarding Government's or other regulations in case of a petroleum refinery. At the outset, the Committee wishes to point out that as per the principles of AS 17, a 'business segment' is a distinguishable component of an enterprise that is engaged in providing product(s)/service(s) subject to different risks and returns. Accordingly, business segment can be identified only on the basis of risks and returns involved in various products/services being produced by the company rather than the difference in risks and returns of the products being sold in different markets (domestic/international). Thus, although 'export sale' can be a factor for identifying the business segment of different products/ services but it cannot itself be a separate 'business segment'. The Committee notes from the Facts of the Case that the querist has analysed the 'export sale' as business segment, which is not appropriate, as is clear from the above. Accordingly, the Committee does not find merit in considering the arguments of the querist in respect of 'export sale' as a business segment. Accordingly, the Committee has, hereinafter, considered the issue only from the angle of 'geographical segments'.

10. The Committee is of the view that for identifying geographical segments, as per the provisions of AS 17, the management has to apply its judgement considering the specific facts and circumstances of the case while evaluating whether the risks and returns of various geographic regions of an enterprise are related or different. These risks and returns are influenced both by the geographic location of its operations and also by the location of its customers.

The organisational structure of an enterprise and its internal reporting system are normally the basis for identifying the segments, subject to their fulfilling the criteria prescribed in the definition of 'geographical segment' reproduced as below. The Committee also notes the following paragraphs of AS 17:

> ***"5.2 A <u>geographical segment</u> is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:***
>
> ***(a) similarity of economic and political conditions;***
>
> ***(b) relationships between operations in different geographical areas;***
>
> ***(c) proximity of operations;***
>
> ***(d) special risks associated with operations in a particular area;***
>
> ***(e) exchange control regulations; and***
>
> ***(f) the underlying currency risks."***
>
> "8. Similarly, a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.
>
> 9. The risks and returns of an enterprise are influenced both by the geographical location of its operations (where its products are produced or where its service rendering activities are based) and also by the location of its customers (where its products are sold or services are rendered). The definition allows geographical segments to be based on either:
>
> (a) the location of production or service facilities and other assets of an enterprise; or
>
> (b) the location of its customers.

> 10. The organisational and internal reporting structure of an enterprise will normally provide evidence of whether its dominant source of geographical risks results from the location of its assets (the origin of its sales) or the location of its customers (the destination of its sales). Accordingly, an enterprise looks to this structure to determine whether its geographical segments should be based on the location of its assets or on the location of its customers.
>
> 11. Determining the composition of a business or geographical segment involves a certain amount of judgement. In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in this Standard and the qualitative characteristics of financial statements as identified in the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. The qualitative characteristics include the relevance, reliability, and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise as a whole.
>
> 12. The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments."

11. The Committee notes from the Facts of the Case that the querist has also analysed the factors for determining geographical segments in the case of the company (refer paragraph 5 above). From the said analysis, the Committee notes that although, the company does not have any production facilities or marketing installations/marketing network abroad, there can still be separate geographical segments in view of the following:

(i) The Committee notes that paragraph 8 of AS 17 provides that a geographical segment may be a single country, a group of two or more countries, or a region *within a country*. Accordingly, even though all the refineries of the company are located in India, these may be subject to different risks and returns due to proximity of operations between various geographical locations – domestic and international.

(ii) Further, the Committee is of the view that in the extant case, the company may be subject to different risks and returns due to difference in economic and political conditions prevailing in various countries, different credit policies for various customers belonging to a region, etc., although the company does not have any production facilities/marketing installations/network abroad. For instance, Britain, France and Germany, being members of the European Union, may have similar economic environment on the basis of the relevant factors stated above but not similar to those that exist in USA or Singapore. Accordingly, Britain, France and Germany may be considered as one segment and a similar evaluation shall be made for customers based in other countries.

(iii) For identifying the geographical segments, the company should also consider organisational and internal reporting structure of the enterprise. For example, where internal reporting system of the company provides information according to the geographical location of the customers it indicates that the company has more than one geographical segments.

(iv) The Committee notes that although the querist has stated that the basis of fixation of pricing of products for export and domestic sales is determined with reference to international prices in terms of dollars, but for identifying geographical segments, one should also consider the currency in which payment would be received against sales and whether that currency would give rise to different risks and returns rather than the formula based on which the price is determined.

12. From the above, the Committee is of the view that export sale is, thus, subject to different risks and returns from that of domestic sales due to economic and political conditions as well as currency risk and accordingly, there appears to exist atleast two geographical segments, viz., export sales and domestic sales. The Committee is further of the view that a judgement has to be made by the management while determining the geographical segments even within export sales as to whether these segments are subject to significantly differing risks and returns based on the above-mentioned discussion considering various factors and attaching appropriate weightage to different factors keeping in view its own facts and circumstances based

on its past experience and any changes expected to take place. As per paragraph 11 of AS 17, the management while making this judgement, should also consider the objective of reporting financial information by segment as set out in AS 17 and the qualitative characteristics of financial statements, viz., relevance, reliability, comparability over time and understandability of the resulting information.

13. The Committee is also of the view that after the above evaluation, it should be considered as to whether such geographical segments should be reported under the primary segment reporting format or secondary segment reporting format (if any) of the company, which should be identified based on the dominant source and nature of risks and returns of the enterprise as per the requirements (paragraphs 19 to 23) of AS 17. The internal organisational and management structure of an enterprise and its system of internal reporting to the decision makers should again be considered for determining the dominant source and nature of risks and returns of the enterprise.

14. After such identification of primary and secondary segment reporting formats, the disclosures regarding various segments determined on the basis of above considerations should be made as per the requirements (paragraphs 38 to 59) of AS 17. As regards determination of segment assets, segment liabilities, segment expenses and segment revenue for disclosure purposes, the Committee notes paragraphs 13 and 14 of AS 17, as reproduced below:

> "13. The definitions of segment revenue, segment expense, segment assets and segment liabilities include amounts of such items that are directly attributable to a segment and amounts of such items that can be allocated to a segment on a reasonable basis. An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segment.
>
> 14. In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but

> that could be deemed arbitrary in the perception of external users of financial statements. Such an allocation would not constitute a reasonable basis under the definitions of segment revenue, segment expense, segment assets, and segment liabilities in the Standard. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in the Standard."

On the basis of the above, the Committee is of the view that the company should consider its internal financial reporting system as the starting point for identifying items that can be reasonably allocable to segments. However, if items have been allocated for internal financial reporting purposes on a basis that is understood by management but that can be deemed arbitrary in perception of external users, the same would not constitute a reasonable basis for the purpose of segment reporting as per AS 17. If, however, an item has not been allocated due to limitation of existing internal financial reporting system of the enterprise, the enterprise should develop an appropriate system, as non-availability of requisite information is not sufficient reason to classify an item as an unallocated reconciling item, if a reasonable basis for allocation can be arrived at.

15. As regards the basis of allocation, the Committee also notes paragraph 37 of AS 17, which provides as follows:

> "37. The way in which asset, liability, revenue, and expense items are allocated to segments depends on such factors as the nature of those items, the activities conducted by the segment, and the relative autonomy of that segment. It is not possible or appropriate to specify a single basis of allocation that should be adopted by all enterprises; nor is it appropriate to force allocation of enterprise asset, liability, revenue, and expense items that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary. At the same time, the definitions of segment revenue, segment expense, segment assets, and segment liabilities are interrelated, and the resulting allocations should be consistent. Therefore, jointly used assets and liabilities are allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments. For example, an asset

> is included in segment assets if, and only if, the related depreciation or amortisation is included in segment expense."

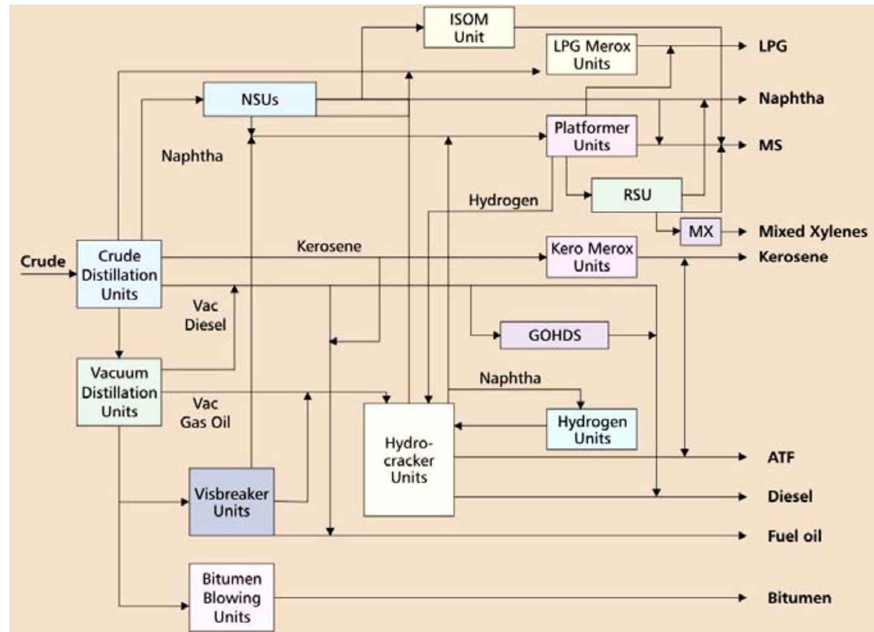
Accordingly, the Committee is of the view that in the extant case, the company should determine segment assets, segment liabilities, segment expenses and segment revenue for disclosure purposes on the basis of the above discussion. As regards, the querist's assertion that no exclusive expenditure is incurred for export sales and apportionment of cost is not possible, the Committee is of the view that still the segment expense for export sales can be determined by reference to some suitable method, e.g., quantity of products sold in each geographic region and allocation of common overheads on a reasonable basis. On the basis of paragraph 37 of AS 17, the Committee is further of the view that if expenses and revenue related to common assets like utilities plant, storage facilities, etc., are allocated to different geographical segments on a reasonable basis, such common assets and related liabilities should also be allocated to segments based on utilisation by each segment or any other reasonable basis.

D. Opinion

16. On the basis of the above and subject to paragraph 9 above, the Committee is of the opinion that there appears to exist atleast two geographical segments, viz., domestic sales and export sales, as discussed in paragraph 11 above. Other geographical segments, if any, should be evaluated on the basis of considerations as stated in paragraphs 11 and 12 above. The disclosures regarding various segments should be made as per the requirements (paragraphs 38 to 59) of AS 17.

Annexure A

PROCESS FLOW DIAGRAM



Query No. 22

Subject: (i) Disclosure requirements for defined benefit plans in case of group administration plans.

(ii) Accounting for provident fund contribution in case of provident fund trust run by the holding company. [1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a wholly owned subsidiary of a listed public sector undertaking (hereinafter referred to as 'the holding company') . The company was incorporated in the year 2002 under the Companies Act, 1956. The main objective of the company is to acquire, establish and operate electrical systems etc. for distribution and supply of electrical energy, to undertake works on behalf of others and to act as engineers/consultants amongst others.

2. The querist has stated that all the personnel of the company are employees on the rolls of the holding company and are under deputation to the company on secondment basis. Every month actual share of employees related expenses of the company, like salary, provident fund (PF) contribution, etc. are being debited to the company by the holding company, for payments and accounting purpose. Other employee benefits like retirement benefits are allocated at the year end and accordingly accounted for in the accounts of the company, payable to the holding company. The holding company has constituted separate trusts for administering and managing employee benefits towards gratuity and provident fund.

3. The querist has further stated that the holding company gets the actuarial valuation done, at the year end, for all of its employees together, including those deputed to its subsidiary companies. In other words, no separate valuation report is obtained for the employees of subsidiary companies. Therefore, identifying employee liability and corresponding plan assets attributable to the personnel on deputation to its subsidiaries is not possible. However, the amount being proportionate share of expenses (for the year under consideration) is determined by the actuary and allocated to the subsidiary companies for accounting purpose. Therefore, the company and the auditor of the company rely upon the allocated figure for recognising expenses in the profit and loss account of the company. As a corollary, all

[1] Opinion finalised by the Committee on 6.2.2012.

the other information required to be disclosed as per paragraphs 119 and 120 of Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005), since not available, is not disclosed in the Notes on Accounts. The expenses on account of long term defined benefits included for actuarial valuation are gratuity, leave encashment, post retirement medical benefits, transfer/ travelling allowance on retirement/death, long service awards to employees, farewell gift on retirement and economic rehabilitation scheme.

4. In the case of provident fund, however, the accounting is done on the basis of actual contribution, although the holding company in its financial statements admits it as a defined benefit. The company is of the view that actuarial valuation is not required for provident fund liability. Further, the holding company (sponsor employer) is not making disclosures in its financials as required by paragraphs 119 and 120 of AS 15 in the case of provident fund, unlike in the case of other defined benefits.

Disclosures made by the company:

- Accounting policy

  "The liabilities towards employee benefits are ascertained by the holding company i.e. ……Limited on actuarial valuation. The company provides for such employee benefits as apportioned by the holding company."

- Notes on Accounts

  "All the employees of the company are on secondment from the holding company, i.e….. Ltd."

  "Employees' remuneration and benefits include Rs. …. (Previous year Rs. ….) in respect of gratuity, leave encashment, post retirement medical benefits, transfer traveling allowance on retirement/death, long service awards to employees, farewell gift on retirement and economic rehabilitation scheme as apportioned by the holding company i.e. .... Limited on actuarial valuation, being defined benefits, at the year end. Therefore, disclosures in compliance of AS 15 are not being made as the same are being done by the holding company."

Company's view on the above accounting policy

5. The company's management is of the view that, as all the employees of the company are on secondment from the holding company and the defined plans are that of the holding company, by following paragraph 35 of AS 15, the other group enterprises are allowed to recognise, in their separate financial statements, a cost equal to their contribution payable for the period which the company is doing. Hence, no separate disclosure of details is required in the separate financials of the company. Accordingly, the disclosure requirements spelt out in paragraphs 119 and 120 of AS 15 are not applicable to other group enterprises.

6. In the case of PF, the contribution is made to the PF trust at statutorily specified rate. The company has accounted for the expenses on actual contribution basis. Actuarial valuation is required only for the purpose of statutory interest rate guarantee as per AS 15 which is being undertaken by the holding company. Further actuarial valuation, in order to determine sufficiency of assets for meeting obligation etc. is not required, as that is the industrial practice all across the country.

Auditor's view point

7. The auditor of the company is of the view that, in accordance with AS 15, various enterprises under common control are permitted to share risks on defined benefit plans and accordingly can follow a system of recognising expenses in the accounts of group enterprises, a cost equal to their contribution to the sponsoring employer (which is the holding company in this case). However, unlike in paragraph 30 of AS 15 (that deals with similar situations in case of multi employer plans, where the employee costs can be treated as defined contribution, even if they are defined benefit), paragraph 35 of AS 15 does not specify whether similar accounting treatment of deeming the defined benefits as defined contribution is possible or not. Where employee benefits are defined contributions, disclosures under paragraphs 119 and 120 of AS 15 are not necessary. So long as items dealt with under paragraph 35 of AS 15 are defined benefits, disclosures as per paragraphs 119 and 120 of AS 15 are also necessary. Therefore, the position of the company, that disclosures are not required as the holding company is disclosing the same, is not in compliance with AS 15.

8. Further, the auditor of the company is of the view that provident fund contribution in the case of the company is also a defined benefit plan as the

management is responsible for ensuring the statutory benefits to employees by managing the funds through the company run trusts. Therefore, carrying out actuarial valuation and making provisions based on such actuarial valuation is necessary to comply with AS 15. The company has instead accounted for the same on the basis of actual contribution only. This is not in compliance with AS 15.

B. Query

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

(i) Whether the position of the company that it is not liable to make complete disclosures in its separate financial statements, in view of the fact that the same have been done by the holding company, is correct.

(ii) Whether the company's policy of accounting for the provident fund based on actual contribution instead of actuarial valuation basis (and not making disclosures even in its parent's financials, as a defined benefit, as required in paragraphs 119 and 120 of AS 15) is correct.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised by the querist are related to the disclosure requirements for defined benefit plans as per paragraphs 119 and 120 of AS 15 in the financial statements of the subsidiary company when the same are being made in the financial statements of the holding company; and accounting for the provident fund based on actual contribution instead of actuarial valuation basis and its disclosures in the financial statements of the company. Therefore, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, recognition and measurement of employees related expenses other than contribution to PF, accounting in the financial statements of the holding company, statutory obligations relating to employee benefits arising under various laws and statutes, etc.

11. At the outset, the Committee notes from the Facts of the Case that *all the employees* of the subsidiary company have been sent by the holding company on secondment basis. In order to determine the nature of relationship between such employees with the subsidiary company, the

Committee notes Issue No. 1 of 'ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)', issued by the Accounting Standards Board of the ICAI, which provide as follows:

> ***"1. What are the kinds of employees covered in the revised AS 15 and whether a formal employer-employee relationship is necessary or not, for benefits to be covered under the Standard?***
>
> The Standard does not define the term "employee". Paragraph 6 of the Standard states that 'an employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer-employee relationships. There is no requirement for a formal employer-employee relationship. Several factors need to be considered to determine the nature of relationship ..."

In view of above, the Committee is of the view that though the holding company is the legal employer of the employee but in substance the employees are rendering service to the subsidiary company, hence, the latter should be considered as the employer of such employees.

12. As regards the disclosure requirements for defined benefit plans, the Committee notes the following paragraphs of AS 15, notified under the Companies (Accounting Standards) Rules, 2006:

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

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

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

From the above-reproduced paragraphs of AS 15, the Committee is of the view that the multi-employer and group administration plans are completely different from each other. In case of group administration plan, it is merely an aggregation of individual employer plans and therefore, the Standard itself states that the accounting related information is readily available with the participating enterprises as any other single employer. Further, the Committee notes from the Facts of the Case that in the extant case, the holding company gets the actuarial valuation done, at the year-end, for all of its employees, including those deputed to its subsidiary companies. The amount being proportionate share of expenses (for the year under consideration) is determined by the actuary and allocated to the subsidiary companies for accounting purpose. It is assumed that amount allocated is derived considering current service cost plus increase or decrease in total defined benefit obligation arising on account of other reasons like the actuarial gains and losses on entire obligation (irrespective of whether the obligation relates to period during which employee was with service with subsidiary or not). This indicates that there is a contractual agreement or stated policy based on which the proportionate share of expenses is being allocated to the subsidiary company. Further, since there is a common scheme for the employees of the holding company and the subsidiary company, keeping in view the Facts of the Case, it appears to the Committee that in substance, the holding company is running a group administration plan. The Committee is further of the view that the existence of such contractual agreement or stated policy through which the current service costs and obligations of defined benefit plans for employees of subsidiary company are being allocated to it clearly provides a basis for allocating the

assets and obligation of the plan too. The Committee is also of the view that in case there is no such contractual agreement or stated policy to bear entire obligation relating to that employee, as per paragraph 35 of AS 15, the net defined benefit cost should be recognised in the financial statements of the enterprise which is legally the sponsor employer (holding company in the extant case) for the plan and the other group enterprises (subsidiary company in the extant case) should recognise a cost equal to their contribution payable for the period.

13. With regard to accounting for contribution being made to provident fund trust, administered by the holding company, the Committee notes paragraphs 25 to 27 of AS 15 and Issue No. 9 of 'ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)', issued by the Accounting Standards Board of the ICAI, which provide as follows:

AS 15

> "25. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions. Under defined contribution plans:
>
> (a) the enterprise's obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an enterprise (and also by the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and
>
> (b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.
>
> 26. Examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:
>
> (a) a plan benefit formula that is not linked solely to the amount of contributions; or

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

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

27. Under defined benefit plans:

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

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise's obligation may be increased."

ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)

"9. Whether a provident fund which guarantees a specified rate of return is a defined benefit plan or a defined contribution plan.

Section 17 of the Employees Provident Funds (EPF) Act, 1952 empowers the Government to exempt any establishment from the provisions of the Employees' Provident Scheme, 1952 provided that the rules of the provident fund set up by the establishment are not less favourable than those specified in section 6 of the EPF Act and the employees are also in enjoyment of other provident fund benefits which on the whole are not less favourable to the employees than the benefits provided under the Act. The rules of the provident funds set up by such establishments (referred to as exempt provident funds) generally provide for the deficiency in the rate of interest on the contributions based on its return on investment as compared to the rate declared for Employees' Provident Fund by the Government under paragraph 60 of the Employees' Provident Fund Scheme, 1952 to be met by the employer. Such provision in the rules of the provident fund would tantamount to a guarantee of a specified rate of return. As per AS 15, where in terms of any plan the enterprise's obligation is to provide the agreed benefits to current and former employees and the actuarial risk (that benefits will cost more than expected) and investment risk fall, in

> substance, on the enterprise, the plan would be a defined benefit plan. Accordingly, provident funds set up by employers which require interest shortfall to be met by the employer would be in effect defined benefit plans in accordance with the requirements of paragraph 26(b) of AS 15."

From the above, the Committee is of the view that in the extant case, the actuarial risk (that benefits will cost more than expected) and investment risk of provident fund, in substance, falls on the employer, and as such, the provident fund plan would be a defined benefit plan. Accounting for such a benefit by the subsidiary should be as suggested in paragraph 12 above.

D. Opinion

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

(i) The contention of the company that it is not liable to make complete disclosures in its separate financial statements, in view of the fact that the same have been done by the holding company, is not correct. Refer to paragraph 12 above.

(ii) The provident fund plan in the extant case should be accounted for as a defined benefit plan as discussed in paragraph 13 above. For appropriateness of company's accounting policy, refer paragraphs 12 and 13 above.

Query No. 23

Subject: Provision for warranty under construction contract and corresponding revenue recognition.[1]

A. Facts of the Case

1. A public sector company (hereinafter referred to as 'the company') is engaged in the field of engineering, manufacture of equipment, erection and commissioning of power projects. In addition, the company is also in the

[1] Opinion finalised by the Committee on 6.2.2012.

business of transportation, transmission, defence, etc. The normal execution period of a contract ranges between 3 to 5 years. The normal warrantee/ guarantee period of a contract is between 18 to 24 months, which starts from the date of completion of trial operation of the project. The company has 15 manufacturing units, 4 power sector regions, service centers and regional offices besides project sites spread all over India and abroad. The company is listed with NSE and BSE. The turnover of the company was Rs. 43,337 crore in the year 2010-11.

2. The querist has stated that revenue recognition in respect of long term construction contracts is done based on percentage of completion method in line with the requirements of Accounting Standard (AS) 7, 'Construction Contracts', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'Rules'). The accounting policies in respect of revenue recognition and provision for contractual obligation (warranty/ guarantee) are as under. The warranty obligation is created at 2.5% of the contract value based on past trends.

Revenue recognition

"Revenue is recognised on percentage completion method based on the percentage of actual cost incurred upto the reporting date to the total estimated cost of the contract."

Provision for warranties

From 01.04.2010

"The company provides warranty cost at 2.5% of the revenue progressively as and when it recognises the revenue and maintain the same throughout the warranty period."

Earlier policy (upto 31.03.2010)

"Provision for contractual obligations is maintained at 2.5% of the contract value on completion of trial operation."

3. The querist has stated that the accounting practice in respect of provision for warranty obligation while working out percentage of completion for revenue recognition is as follows:

From 01.04.2010

Provision is created towards warranty obligation at 2.5% of the revenue progressively as and when the revenue is recognised and the same is added to 'actual cost incurred' upto reporting period for working out percentage of completion under AS 7 contracts. 2.5% of the contract value is also added towards warranty obligation to the 'total estimated cost' to complete the work for percentage completion method.

Earlier Practice

While working out the total cost to complete the contract, contractual obligation at 2.5% of the value of the contract was added, to work out the percentage of completion and to recognise the revenue. On completion of trial operation, 2.5% of contract value is added in the actual cost incurred to bring the cost incurred to 100% and also to recognise 100% revenue. Provision for warranty obligation is also created for the same amount.

4. The querist has further stated the following issues and grounds for change of accounting policy:

(i) The recognition of turnover of 2.5% value of each despatch/ activity completion was deferred till the completion of trial operation by adding 2.5% of the contract value to 'estimated cost to complete' but not in 'actual cost incurred' upto the reporting period in ascertaining the percentage completion.

(ii) Further, there was a mismatch in recognition of turnover and creation of provision for contractual obligation in the year of completion of trial operation. In case of profitable projects, revenue recognised before the trial operation was lower than 97.5% of the contract revenue and in case of loss making projects, it was more than 97.5%.

(iii) There was a deferment of revenue till completion of trial operation and recognising revenue on trial operation without any despatch/ activity completion was against the spirit of revenue recognition and AS 7 . This may be construed against the revenue recognition principle as per which, the revenue has to be recognised at 100% of the value of the activities completed or services rendered in line with AS 7.

(iv) Paragraph 11 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the 'Rules' states, "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." From this, it is very clear that the obligation could be a statutory requirement from a binding contract or normal business practice, custom and desire to maintain good business relations etc. In all the contracts of the company, the contract provides for warranty for periods ranging between 12 months to 24 months which is a binding contract. However, while executing the contract ranging over a period of 3 to 4 years, the company is always bound to rectify, rework, compensate any defects, short supplies, operational problems of the individual equipment already supplied in respect of which turnover has been recognised even before the warranty period. In fact, it can be concluded that the contractual obligation coexists right from the date the first supply is made irrespective of the fact whether the trial operation has been completed or not. The company is always to incur additional expenditure to rectify the problem with equipment supplied, work performed etc. and in respect of which turnover has been recognised.

(v) Further, as per AS 7, the normal principle of revenue recognition is substituted by the percentage of completion method and the revenue itself is progressively recognised on consideration of the substance of the transaction. It is, therefore, appropriate that to the extent the revenue has been recognised, the related warranty cost should also be recognised. Whatever has been recognised as contract revenue under percentage of completion method (PoCM) is subject matter of warranty and to that extent, warranty has become a present obligation even though period of warranty may commence at a later date.

(vi) As per revenue recognition principle, 100% revenue needs to be recognised on completion of corresponding supplies/work performed with matching cost.

(vii) This issue was also referred for opinion to an accounting expert and to a leading Chartered Accountant firm who is assisting the company in IFRS implementation. The changed policy is in line with the opinion given by them.

(viii) Further, the company has also reviewed the practices of similar companies in the industry which are reproduced below:

X Ltd.

"The company provides for anticipated costs for warranties when it recognises revenue on the related products or contracts. Warranty costs include calculated costs arising from imperfections in design, material and workmanship in the company's products. ..."

Y Ltd.

"Product-related expenses and losses from onerous contracts, provisions for estimated costs related to product warranties are recorded in cost of goods sold and services rendered at the time the related sale is recognised. ..."

Z Ltd.

"Production costs include direct costs (such as material, labour and warranty costs) and indirect costs. Warranty costs are estimated on the basis of contractual agreement, available statistical data and weighting of all possible outcomes against their associated probabilities. Warranty periods may extend upto five years. ..."

(ix) According to the querist, the change has definitely resulted in better presentation of the financial statements and it is well within the principles of conservatism and prudence. The present change in accounting policy is exactly in line with the revenue recognition requirements of AS 7 and at the same time improves the presentation of financial statements.

B. Query

5. Considering the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the present policy and practice of the

company on ‘provision for warranties’, viz., creation of provision towards warranty obligation progressively during construction period and considering the same as “cost incurred” to determine the percentage of completion for revenue recognition under AS 7 is in line with the requirements of accounting standards.

C. Points considered by the Committee

6. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to recognition of provision for warranty costs under a construction contract and its treatment for determining the percentage of completion for recognition of contract revenue. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, measurement of amount of provision for warranty obligation, accounting for construction costs and revenue in general, appropriateness of method selected for determination of stage of completion of a contract, accounting for change in accounting policy, etc. The opinion expressed hereinafter only lays down the general principles to be followed in the extant case and has not gone into calculations of contract costs and contract revenue during various accounting periods. Further, the Committee has presumed from the Facts of the Case that the warranty service in the extant case is the normal quality-assurance type warranty, which is neither separately priced nor separately sold as per the business practice in case of construction contracts.

7. As regards recognition of provision for warranty costs, the Committee notes paragraphs 11 and 14 of AS 29, notified under the ‘Rules’ as follows:

> “11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.”
>
> ***“14. A provision should be recognised when:***
>
> ***(a) an enterprise has a present obligation as a result of a past event;***
>
> ***(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***

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

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

From the above, the Committee is of the view that a provision should be recognised when there exists present obligation to act or perform in a certain way and other conditions for its recognition under AS 29 are satisfied. Obligations may arise from a binding contract or statutory requirement and may also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. The Committee notes from the Facts of the Case that all the contracts of the company provide for warranty for periods ranging between 12 to 24 months and while executing the contract over a period of 3 to 4 years, the company is always bound to rectify, rework and compensate any defects, short supplies, operational problems of the individual equipment *already supplied* under construction contracts. Thus, there exists a contractual/customary present obligation in respect of warranty service which will require outflow of resources embodying economic benefits to settle the obligation. Further, the Committee notes that, in the extant case, the company can reliably estimate the amount of obligation on the basis of past trend. Accordingly, the Committee is of the view that a provision in respect of warranty service should be recognised in the extant case.

8. As far as timing of recognition of provision is concerned, the Committee notes paragraphs 15, 16 and 21 of AS 7, as reproduced below:

"15. Contract costs should comprise:

(a) costs that relate directly to the specific contract;

...

16. Costs that relate directly to a specific contract include:

...

(g) the estimated costs of rectification and guarantee work, including *expected warranty costs*; and

..." (Emphasis supplied by the Committee.)

> ***"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. ..."***

From the above, the Committee is of the view that the expected warranty cost is a contract cost which is directly related to a specific contract. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. In the instant case, the company follows the percentage of completion method for recognising its revenue which indicates that the outcome of a construction contract can be estimated reliably. Accordingly, following the percentage of completion method, the contract costs, including provision for expected warranty costs, should be recognised by reference to stage of completion of the contract activity at the reporting date. In this regard, the Committee also notes from the Facts of the Case that the querist has stated that even during the execution of the projects, the company is bound to rectify, rework and compensate any defects, short supplies, operational problems of the individual equipment already supplied and that the contractual obligation in respect of warranty coexists from the date of first supply. Thus, the Committee is of the view that in the extant case, present obligation in respect of contractual warranty as per the provisions of AS 29 arises from the performance of a contract activity in respect of which contract cost is recognised even during the progress of the contract and as such, the proportionate warranty cost should be provided for during the contract period. The Committee is of the view that such provision for expected warranty costs would also be 'contract cost incurred' and therefore, should be considered for determining the stage of completion for recognition of revenue as per the principles of AS 7.

D. Opinion

9. On the basis of the above and subject to paragraph 6 above, the Committee is of the opinion that the provision for warranty costs should be recognised progressively during the construction on performance of contract activity and in respect of which contract cost is recognised. Since such

provision for expected warranty costs would also be 'contract cost incurred', the proportionate warranty cost should be considered for determining the stage of completion for recognition of revenue as per the principles of AS 7, as discussed in paragraphs 7 and 8 above.

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. 50,000/- 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. 25,000/- 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.in

9. The Committee reserves its right to decline to answer any query on an appropriate consideration of facts. If the Committee feels that it would not be in a position to, or should not reply to a query, the amount will be refunded to the querist.

10. The right of reproduction of the query and the opinion of the Committee thereon will rest with the Committee. The Committee reserves the right to publish the query together with its opinion thereon in such form as it may deem proper. The identity of the querist and/or the client will, however, not be disclosed, as far as possible.

11. It should be understood clearly that although the Committee has been appointed by the Council, an opinion given or a view expressed by the Committee would represent nothing more than the opinion or view of the members of the Committee and not the official opinion of the Council.

12. It must be appreciated that sufficient time is necessary for the Committee to formulate its opinion.

13. The queries conforming to above Rules should be addressed to the Secretary, Expert Advisory Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi-110 002.