COMPENDIUM OF OPINIONS

Volume XXX

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

Compendium of Opinions

(Volume XXX)

of the

Expert Advisory Committee

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

(This thirtieth volume contains opinions finalised between February 2010 and January 2011. The opinions finalised upto September 1981 are contained in Volume I. The opinions finalised thereafter upto January 2010, are contained in Volumes II to XXIX)

Published in 2012

Price	:	₹ 175/-(Including CD)
Committee/ Department	:	Expert Advisory Committee
ISBN	:	**978-81-8441-570-4 (Vol. XXX)**
ISBN	:	**81-85868-05-0 (Set)**
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, New Delhi-110 002
Printed at	:	Sahitya Bhawan Publications, Hospital Road, Agra-282 003
		October/2012/1,000 Copies

Foreword

The accountancy profession, in a continuous strive to adapt itself with the changing economic situations and business transactions, is generally posed with a situation where difficulties arise in applying the accounting principles to those newer situations and transactions. It is for resolving such difficulties of the profession that the Expert Advisory Committee was established by the Council of the Institute in the year 1975. The Expert Advisory Committee assists the members of the Institute in the application of accounting and/or auditing principles 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 glad that the Expert Advisory Committee has brought out another volume in the series of Compendium of Opinions, which contains opinions finalised by the Committee during the Council Year 2010-11.

I firmly believe that this volume of the Compendium of Opinions would be as useful and beneficial to the members and others interested as the other volumes.

New Delhi
February 9, 2011

CA. Amarjit Chopra
President

Preface

I am pleased to present this thirtieth volume of the Compendium of Opinions containing opinions finalised by the Expert Advisory Committee during this Council Year 2010-11. During the period, the Committee finalised and issued opinions on diverse subjects, such as, basis of calculation of future cash flows, treatment of capital expenditure on assets not owned by the company, segment reporting, accounting for expenditure during construction period, accounting for foreign currency transactions, accounting treatment of overlift/underlift quantity of crude oil, revenue recognition, depreciation accounting, etc.

Keeping the view the significance of information technology and the requirements of the users, this volume also contains a Compact Disk (CD), which incorporates all the opinions published not only in this volume but also published in earlier volumes of the Compendium of Opinions (viz., Volume I to Volume XXX). 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 given facts and circumstances, as provided by the querist, as well as on the basis of the applicable accounting/auditing principles and the relevant laws and regulations applicable under the circumstances of the query on the date of finalisation of the opinion. The date of finalisation of the opinion is indicated in respect of each opinion. The opinions must be read and applied in the light of any subsequent developments and/or amendments in the applicable legal position and accounting/auditing principles.

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. Anuj Goyal, Vice-Chairman, CA. Amarjit Chopra, President, CA. G. Ramaswamy, Vice-President, CA. Bhavna Doshi, CA. Jayant Gokhale, CA. Atul C. Bheda, CA. Dhinal A. Shah, CA. Madhukar N. Hiregange, CA. Abhijit Bandyopadhyay, CA. Naveen N.D. Gupta, CA. Charanjot Singh Nanda, Ms. Usha Sankar, Shri Ashutosh Dikshit, Shri Deepak Narain, CA. Nalin M. Shah, CA. Charanjit S. Attra, CA. Jigyasa Chopra, CA. Archana Bhutani, CA. Chandrashekhar V. Chitale, CA. Manoj Fadnis and CA. Vikas Thapar for their invaluable support and contribution in finalisation of the opinions.

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 9, 2011

CA. Sanjeev K. Maheshwari
Chairman
Expert Advisory Committee

Contents

Foreword

Preface

1. Treatment of capital expenditure on assets not owned by the company. 1

2. Treatment of capital expenditure on assets not owned by the company. 10

3. Treatment of liquidated damages payable for delay in commissioning of plant. 21

4. Treatment of loss arising on sale of under-performing assets and associated liabilities to a group company of the supplier of the assets. 26

5. Accounting treatment of success fee paid to financial advisors. 30

6. Accounting treatment of success fee paid to financial advisors. 37

7. Basis of calculation of future cash flows. 44

8. Accounting for expenditure incurred during construction period of project. 49

9. Accounting treatment of overlift/underlift quantity of crude oil. 54

10. Depreciation on facilities/assets engaged in processing of crude oil. 62

11. Treatment of minimum level of heel metal required to be maintained in the pots in Smelter Plant. 71

12. Revenue recognition in respect of F.O.R. destination sales. 76

13. Treatment of some of the units of one segment as a part of another segment – whether appropriate. 82

14. Accounting treatment of advance to subsidiary pending finalisation of modalities of issue of the shares. 87

15. Deferred tax asset/liability in respect of Held to Maturity Investments and provision for bad and doubtful debts in the case of banks. 93

16. Disclosure of income tax expense/assets, interest expense and borrowings, etc. in the segment report prepared under consolidated financial statements. 100

17. Authentication of the financial statements and attached schedules by the auditors. 111

18. Revenue recognition where sale value in foreign currency is covered by a forward contract. 112

19. Revenue recognition in high sea sale contracts. 117

20. Accounting for expenditure incurred on roads, bridges, etc., constructed on land owned by the company or on land where the company has a right to use it, where such roads, bridges, etc. are also used by general public. 123

Advisory Service Rules 131

Query No. 1

Subject: Treatment of capital expenditure on assets not owned by the company.[1]

A. Facts of the Case

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

2. The company is functioning in the regulated environment. The querist has stated that the tariff for sale of energy from its stations is determined by the Central Electricity Regulatory Commission (CERC), following the cost-plus basis. Tariff for sale of energy in case of a thermal power generating station comprises two components, namely, annual capacity (fixed) charges and variable charges. The capacity charges mainly consist of interest on loan capital, depreciation, return on equity, normative operation and maintenance expenses, interest on working capital, etc. and to a large extent depend on the admissible capital cost of a generating station. The variable charges consist of primary fuel cost on normative basis.

3. The company is establishing a hydro power project (4 X 200MW). The project site is situated in a remote area which does not have basic infrastructure and communication facilities for setting up of a power plant at the time of taking up of the project. Before taking up the construction activity of the power project, the company has to construct or widen the existing approach roads to the project site, lay pipelines for water, arrange for power construction, etc. For executing the above-mentioned project, higher rated power was required which did not exist at the time of taking up of the project. The company requested the concerned State Electricity Board (SEB) that the nearby sub-stations of the SEB may be augmented by providing additional MVA transformers and constructing two additional 33 KV lines

[1] Opinion finalised by the Committee on 18.3.2010

from sub-station to the project site for drawl of the construction power. The SEB agreed to carry out the modification work at a cost of Rs. 5.03 crore on deposit works basis. The querist has explained that 'deposit works basis' is the execution of capital works, for example, construction of roads, canals, construction-power lines, laying of railway tracks, etc. by the government departments (contractors), viz., Public Works Department, State Electricity Boards, Water Resource Department, government companies, etc., on behalf of PSUs/other companies on the basis of actual cost of works plus an agreed percentage of profit over the actual cost. The querist has informed that under 'deposit works basis', on receipt of request from the company, the contractor prepares an estimate of the work required to be executed and forwards it to the company for taking internal approvals. Based on the agreed estimates of the work, advances are paid to the contractor for execution of the work. Normally, separate account for each work is maintained by the contractor and the amount received from the company is accounted for as receipts in that account and the corresponding expenditure incurred are also accounted in the same deposit account as expenditure. Based on the statement of account received from the contractor, advances are adjusted and accounted for as capital work-in-progress. On completion of work, fund utilisation certificate is provided by the contractor along with the agreed percentage of profit and the final payment is settled. Based on the above principles of 'deposit works', advances have been released to the SEB periodically in the present case. On these lines, payments/deposits have been made in instalments and adjusted on completion of work progressively. As per the querist, the SEB has informed that the ownership of the sub-station after the proposed modifications and the 33 KV lines shall remain with them. Copy of the Memorandurn of Understanding (MOU) signed by the company with the SEB has been supplied by the querist for the perusal of the Committee.

4. The querist has stated that the expenditure on such capital works, which is required for carrying out construction of the project and the ownership of which does not vest with the company, is being accounted for as 'capital expenditure on assets not owned by the company' and disclosed in the Schedule of 'Capital Work-in-Progress' distinctly during construction period and thereafter disclosed in the Schedule of 'Fixed Assets' on completion. Further, such capital expenditure is being amortised over a period of four years from the year in which the first unit of the project concerned came into commercial operation. The related accounting policies followed by the company in this regard are reproduced below:

"Capital expenditure on assets not owned by the company is reflected as a distinct item in capital work-in-progress till the period of completion and thereafter in the fixed assets".

"Capital expenditure on assets not owned by the company is amortised over a period of 4 years from the year in which the first unit of project concerned comes into commercial operation and thereafter from the year in which the relevant asset becomes available for use. However, such expenditure for community development in case of stations under operation is charged off to revenue".

The querist has stated that the above treatment is being followed keeping in view the requirements of the Guidance Note on Treatment of Expenditure during Construction Period[2], issued by the Institute of Chartered Accountants of India.

5. The querist has further stated that consequent to the withdrawal of the above-mentioned Guidance Note, accounting for such expenditure is to be done in line with the provisions of paragraphs 9.1 and 10.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which are reproduced below:

"9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any *directly attributable cost of bringing the asset to its working condition for its intended use*; any trade discounts and rebates are deducted in arriving at the purchase price. ..." (Emphasis supplied by the querist.)

"10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

According to the querist, in line with the above-mentioned provisions of AS 10, the expenditure on augmentation of the sub-station and laying of additional 33 KV lines, incurred by the company is directly related to the

---

[2] The Guidance Note on Treatment of Expenditure during Construction Period has been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision at its 280th meeting held on August 7-9, 2008.

construction of the power project. The company is of the view that the said expenditure may continue to be accounted for as 'capital expenditure on assets not owned by the company' and amortised over a period, i.e., four years from the date when the first unit of the project comes into commercial operation since this expenditure is of capital nature and the benefit will accrue to the company for more than one year. Further, as per the querist, the above expenditure has been incurred for bringing the project for its intended use and the ownership of this capital asset does not vest with the company.

6. The querist has further stated that in case the above expenditure is charged off to revenue consequent to the withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period, this expenditure will neither be serviced as a part of fixed charges nor it will be allowed as a part of operation and maintenance (O&M) charges as provided by the CERC in the tariff regulations. Accordingly, charging of the expenditure on augmentation of sub-station to the profit and loss account will not be in line with the true spirit of the tariff regulations notified by the CERC, which is based on cost-plus-return basis. Further, as per the querist, charging of such expenditure to the profit and loss account shall also not be in accordance with the provisions of AS 10.

B. Query

7. Keeping in view the withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period and the nature of the industry, where the tariff is decided on cost-plus-return basis, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the existing accounting treatment followed by the company, viz., capitalising expenditure incurred for augmentation of construction-power which is essentially required for construction of the power project as 'capital expenditure on assets not owned by the company' and amortising the same over a period of four years, is in order.

(ii) In case the answer to (i) above is in the negative, then

(a) what accounting treatment for such capital expenditure on assets not owned by the company should be followed considering the fact that the company is functioning in the regulated environment and return on investment is based on admitted capital cost of the project.

(b) what accounting treatment should be given in respect of 'capital expenditure on assets not owned by the company' appearing in the schedule of fixed assets and its written down value.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the expenditure incurred by the company on augmenting of sub-stations and construction of transmission lines (hereinafter referred to as 'strengthening of power transmission system'), for construction of power projects during the construction period. Therefore, the Committee has examined only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, expenditure incurred on community development, etc. Further, in the absence of any information to the contrary, the Committee presumes that the expenditure incurred by the company on strengthening of the power transmission system is not adjustable against any payment to be made by the company towards future use of the transmission system.

9. 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 expenditure on strengthening of transmission system. For this purpose, the Committee has examined whether the expenditure results into recognition of a tangible asset or an intangible asset.

10. The Committee is of the view that the above-mentioned expenditure can be considered to result into a tangible asset, i.e., sub-station or transmission line, 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 fixed asset would be that the entity can restrict the access of others to the benefits derived from that asset. This view is also supported by the principles enunciated in paragraph 14 of Accounting Standard (AS) 26, 'Intangible Assets', as reproduced in paragraph 12 below.

11. The Committee notes from the Facts of the Case that the ownership of sub-station after the modifications and the augmented transmission lines shall remain with the SEB. The company is entitled to its allotted quantum of power supply. It has no say on the distribution of power supply to others. Thus, none of the factors mentioned in paragraph 10 above indicating control of the company is evident. Thus, sub-station or transmission line is not the resource controlled by the company and therefore, the expenditure incurred by the company on strengthening of transmission system cannot be capitalised as a separate tangible asset.

12. The Committee now examines whether the above-said expenditure results into an intangible asset for the company. In this context, the Committee notes the following paragraphs from AS 26:

> ***"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.***
>
> ***An <u>asset</u> is a resource:***
>
> > ***(a) controlled by an enterprise as a result of past events; and***

> ***(b) from which future economic benefits are expected to flow to the enterprise."***
>
> "14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. ..."

From the above, the Committee is of the view that the expenditure incurred by the company on strengthening of transmission system not owned by the company does not meet the definitions of the terms 'asset' and 'intangible asset' as, even though the economic benefits are expected to flow to the enterprise from such facilities, the company does not have control over such facilities. Accordingly, such expenditure cannot also be capitalised as a separate intangible asset.

13. Now, the question arises as to whether the expenditure incurred on sub-stations and transmission lines that are not owned by the company, could be considered as a component of the cost of a fixed asset/project. In this context, the Committee further notes paragraphs 9.1 and 10.1 of AS 10, which are reproduced in paragraph 5 above. The Committee is of the view that the basic principle to be applied while capitalising an item of cost to the cost of a fixed asset/project under construction/expansion is that it should be directly attributable to the construction of the project/fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are those costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by Accounting Standard (AS) 16, 'Borrowing Costs'. From the above, the Committee is of the view that expenditure incurred on strengthening of power transmission system, cannot be considered as directly attributable cost and accordingly, the same cannot also be capitalised as a component of fixed asset.

14. The Committee further notes that paragraph 56 of AS 26 provides as below:

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

From the above, the Committee is of the view that the expenditure incurred on strengthening of power transmission system should be expensed and charged to the profit and loss account of the period in which these are incurred.

15. As far as accounting treatment given by the company in respect of 'capital expenditure on assets not owned by the company' constituting the expenditure on strengthening of power transmission system is concerned, the Committee notes that as per the Announcement on Clarification on Status of Accounting Standards and Guidance Notes, issued by the Institute of Chartered Accountants of India, "In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard. ..." Accordingly, the Committee is of the view that the recommendations of a Guidance Note would be applicable only to the extent these are not contrary to an Accounting Standard. Hence, the recommendations of the 'Guidance Note on Treatment of Expenditure during Construction Period', after AS 26 becoming applicable to the company (even before the withdrawal of the said Guidance Note) were applicable only to the extent these were not contrary to the provisions of AS 26. Therefore, since, after AS 26 became applicable to the company, the expenditure incurred on strengthening of transmission lines was not expensed by the company as per the requirements of AS 26, as discussed above, the same is an error committed in the prior years which should be rectified in the financial statements and disclosed as a 'prior period item' of the period in which such rectification is carried out in accordance with the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

16. As far as the impact of accounting treatment of the expenditure on strengthening of power transmission system on tariff as per the tariff

regulations is concerned, the Committee is of the view that the accounting treatment of an expenditure is to be determined on the basis of the nature of the expenditure as per the generally accepted accounting principles. It is on this basis that the treatment to be accorded by the company in the present case to the expenditure on strengthening of the power transmission system has been arrived at in the above paragraphs. Whether or not this expenditure should be made a part of fixed charges or O&M charges for tariff fixation as per the tariff regulations is a matter to be considered by the relevant authority/company.

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) No, the existing accounting treatment followed by the company of capitalising the expenditure which, as per the querist, is essentially required for construction of power plants or making it available for its intended use, as 'capital expenditure on assets not owned by the company' and amortising the same over a period of four years, is not in order.

(ii)(a) The capital expenditure on strengthening of power transmission system not owned by the company should be expensed by way of charge to the profit and loss account of the period in which these are incurred.

(b) 'Capital expenditure on assets not owned by the company' appearing in the schedule of fixed assets at its written down value, being an error should be rectified and disclosed as a 'prior period item' as per the requirements of AS 5 in the financial statements of the period in which such rectification is carried out as discussed in paragraph 15 above.

Query No. 2

Subject: Treatment of capital expenditure on assets not owned by the company.[1]

A. Facts of the Case

1. A public sector undertaking registered under the Companies Act, 1956, is engaged in refining and marketing of petroleum products.

2. The querist has stated that sometimes when a new project, for example, setting up of a new refinery is undertaken by the company, it has to incur expenditure on the construction/development of certain assets, like electricity transmission lines, railway siding, roads, culverts, bridges, etc., in order to facilitate construction of project and subsequently to facilitate its operations. The ownership of such assets (hereinafter referred to as 'enabling assets') as well as the land on which these assets are situated does not vest with the company. The existing accounting policy of the company with respect to such 'enabling assets' is as under:

> "Capital expenditure on items like electricity transmission lines, railway siding, roads, culverts,* etc. the ownership of which is not with the company are charged off to revenue. Such expenditure incurred during construction period of projects is accounted as unallocated capital expenditure and is charged to revenue in the year of capitalisation of such projects."
>
> (* "Oil Jetty" may be added in the year 2009-10.)

According to the querist, the 'unallocated capital expenditure' is presented in the balance sheet as capital work-in-progress (CWIP).

3. The querist has further stated that the existing accounting policy is being followed based on the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), expressed on the treatment of such expenditure as contained in Volume IX, Query No.1.32 and Volume XII, Query No.1.3 of the Compendium of Opinions. In both the opinions, EAC has referred to paragraph 10 of the Guidance Note

[1] Opinion finalised by the Committee on 18.3.2010

on Treatment of Expenditure during Construction Period[2]. The conclusion of the said opinions, as per the querist, is as under:

(a) Fixed assets which, though having been built on land not belonging to the company, but are owned by the company, should form part of the relevant head of fixed assets belonging to the company and treated accordingly.

(b) Regarding fixed assets created on land not belonging to the company, which are also not owned by the company, the expenditure incurred on the construction of such assets should be classified as 'Capital Expenditure' in the balance sheet indicating appropriately, the nature of the expenditure including the fact that the assets are not owned by the company. Also, after the commencement of commercial operations, the same should be written off to the profit and loss account.

Both the above opinions, in the view of the querist, clearly state that till the commencement of commercial operations, such expenses should be classified as capital expenditure and after the commencement of commercial operations, the same should be written off to the profit and loss account. Accordingly, as per the querist, the company is uniformly following the above accounting policy since 1999-2000.

4. According to the querist, the statutory auditors of the company hold the opinion that the existing accounting treatment of such enabling assets followed by the company does not appear to be correct. The views of the statutory auditors regarding treatment of expenditure of such nature are stated by the querist as under:

S.No.	Nature of expenditure	Accounting treatment
1.	Fixed assets created on land not belonging to the company but the fixed assets are owned by the company.	Capital expenditure shall form part of the fixed assets belonging to the company and treated accordingly.
2.	(a) Fixed assets created on land where neither the assets, nor	(a) Expenditure to be debited to CWIP till the enabling asset is

[2] The Guidance Note on Treatment of Expenditure during Construction Period has since been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision taken at its 280th meeting held on August 7-9, 2008.

	the land, belongs to the company, or (b) The expenditure is incurred by way of payment to the government / private agencies for construction of bridge, roads, etc. and the company uses such enabling assets etc. for the purpose of completing its own project and subsequently for operational purposes. Such enabling assets are available for general public use also.	ready for use. (b) On completion of the enabling asset, the same to be capitalised. (c) Such capital expenditure to be reflected as "Capital expenditure on assets not owned by the company". (d) Such capital expenditure to be amortised over the period of its utility but not exceeding 5 years. (e) Amount amortised to be treated as expenditure during construction period till the completion of the project for which the enabling asset was originally created. After the completion of the project, the amortised amount is to be charged to the profit and loss account every year for the balance period of its utility.
3.	(a) Upgrading, widening of certain portions / stretches of the road, culverts etc. on land not owned by the company to enable the movement of heavy construction equipment during the course of putting up of project.	To be accounted for as incidental expenditure during construction period.
	b) Upgrading, widening, renovating, repairing, re-laying of certain portion / stretches of the road, culverts etc. after the completion of the project to enable the movement of vehicles / employees / general public.	To be charged to profit and loss account in the year of incurrence.

5. The querist has stated that after the withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period, no direct reference to expenses of such nature is found either in Accounting Standard (AS) 10, 'Accounting for Fixed Assets', or in Accounting Standard (AS) 26, 'Intangible Assets'. However, to understand the accounting treatment of enabling assets, the querist has drawn attention to the following definitions:

Definition of Asset:

Paragraph 49(a) of the Framework for the Preparation and Presentation of Financial Statements, issued by ICAI, defines an asset as under:

> "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 (emphasis supplied by the querist)."

Paragraph 6 of AS 26 defines, inter alia, an asset as under:

"An <u>asset</u> is a resource:

> ***(a) controlled by an enterprise as a result of past events; and***
>
> ***(b) from which future economic benefits are expected to flow to the enterprise."***

6. According to the querist, as is clear from the above definitions, in order to recognise the expenditure as an asset, the following two conditions must be satisfied:

(i) The company must have c*ontrol over the asset*, and

(ii) *Future economic benefits* must flow to the company from these assets. (Emphasis supplied by the querist.)

7. With respect to 'control over the asset', the querist has stated that 'control' has been defined/referred as under:

- Paragraph 56 of the Framework for the Preparation and Presentation of Financial Statements issued by the ICAI, states as under:

> "56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is

> not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may *nonetheless satisfy the definition of an asset even when there is no legal control*. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it." (Emphasis supplied by the querist.)

- Paragraph 14 of AS 26 states as under:

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

The querist has stated that since in most of the cases of enabling assets, *the company cannot restrict the access of others to the benefits* arising from them, it can be concluded that the company does not have control over the assets (emphasis supplied by the querist).

8. With respect to 'future economic benefits', the querist has stated that future economic benefits are ensured from the enabling assets since they would facilitate operations of the company. Hence, as per the querist, even though the expenditure has been incurred for obtaining future economic benefits, the criteria for recognition as an asset are not met because the company cannot restrict the access of others to enabling assets.

9. The querist has also stated that paragraph 56 of AS 26 which deals with such expenses states, inter alia, as under:

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

Therefore, the querist has stated that, in the view of the company, the accounting treatment followed by the company of treating such expenditure incurred during construction of projects as unallocated capital expenditure and charging off the same to revenue in the year of capitalisation of such projects is in order.

B. Query

10. Due to divergence of opinion between the company and the statutory auditors and keeping in view the querist's view that subsequent to the withdrawal of the 'Guidance Note on Treatment of Expenditure during Construction Period', these issues have neither been covered in any of the Accounting Standards, nor the issue has been a subject matter of any query to the Expert Advisory Committee, the querist has sought the opinion of the Committee on the following issues:

(i) Whether the current accounting treatment of considering the expenditure incurred on 'enabling assets' as CWIP during construction period of the project and charging off the same to revenue in the year of completion of the project is correct.

(ii) Whether the accounting treatment suggested by the auditors in paragraph 4 above is correct.

(iii) Whether such expenditure can be charged off to revenue;

(a) If yes, the accounting period in which such expenditure should be charged off to revenue, i.e., whether

– in the accounting period of incurrence of such expenditure; or

– in the accounting period in which the enabling asset is complete and ready for use; or

– in the accounting period of completion of the main project for which such expenditure was incurred.

(b) If yes, what should be the treatment for such expenditure which is still lying as CWIP as on date.

(iv) If the answer to all or any of the above queries at (i) to (iii) is in the negative, what is the suggested accounting treatment for such expenditure.

C. Points considered by the Committee

11. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to accounting for construction/development of electricity transmission lines, railway sidings, roads, etc. in order to facilitate construction of the project and subsequently to facilitate its operations and the ownership of which does not vest with the company, collectively referred to by the querist as 'enabling assets'. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, fixed assets owned by the company but created on land not belonging to the company, etc. The Committee further notes from the Facts of the Case that the expenditure on 'enabling assets' includes payment to the government / private agencies for construction of the 'enabling assets' which will be available for general public use also. In the absence of any information to the contrary, the Committee presumes that the expenditure on 'enabling assets' is not adjustable against any payment to be made by the company towards future use of such assets.

12. 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 expenditure on 'enabling assets'. For this purpose, the Committee has examined whether the expenditure results into recognition of a tangible asset or an intangible asset.

13. The Committee is of the view that the above-mentioned expenditure can be considered to result into a tangible asset, 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 fixed asset would be that the entity can restrict the access of others to the benefits derived from that asset. This view is also supported by the principles enunciated in paragraph 14 of AS 26, as reproduced in paragraph 15 below.

14. The Committee notes from the Facts of the Case that the ownership of the 'enabling assets' does not vest with the company. The assets are available for general public use. Although the company is entitled to use these assets for the purpose of completing its own projects and subsequently for operational purposes, it has no say on the use of such assets by others. Thus, none of the factors mentioned in paragraph 13 above indicating control of the company is evident. Thus, 'enabling assets' are not resources controlled by the company and, therefore, the expenditure incurred by the company on such 'enabling assets' cannot be capitalised as a separate tangible asset.

15. The Committee now examines whether the above-said expenditure results into an intangible asset for the company. In this context, the Committee notes the following paragraphs from AS 26:

> ***"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.***
>
> ***An <u>asset</u> is a resource:***
>
> > ***(a) controlled by an enterprise as a result of past events; and***

> ***(b) from which future economic benefits are expected to flow to the enterprise."***

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

From the above, the Committee is of the view that the expenditure incurred by the company on 'enabling assets' not owned by the company does not meet the definitions of the terms 'asset' and 'intangible asset' as, even though the economic benefits are expected to flow to the enterprise from such facilities, the company does not have control over such facilities. Accordingly, such expenditure cannot also be capitalised as a separate intangible asset.

16. Now, the question arises as to whether the expenditure incurred on 'enabling assets' could be considered as a component of the cost of a fixed asset/project. In this context, the Committee further notes paragraphs 9.1 and 10.1 of AS 10, which are reproduced below:

> "9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. ..."

> "10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

From the above, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to the cost of a fixed asset/project under construction is that it should be directly attributable to the construction of the project/fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are those costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by Accounting Standard (AS) 16, 'Borrowing Costs'. From the above, the Committee is of the view that the expenditure incurred on 'enabling assets' cannot be considered as directly attributable cost and accordingly, the same cannot also be capitalised as a component of fixed asset.

17. The Committee further notes that paragraph 56 of AS 26 provides as below:

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

From the above, the Committee is of the view that the expenditure incurred on 'enabling assets' should be expensed and charged to the profit and loss account of the period in which these are incurred.

18. As far as accounting treatment given by the company in respect of such 'enabling assets' which are still lying as capital work-in-progress as on the date is concerned, the Committee notes that as per the Announcement on Clarification on Status of Accounting Standards and Guidance Notes, issued by the Institute of Chartered Accountants of India, "In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard. ..." Accordingly, the Committee is of the view that the recommendations of a Guidance Note would be applicable only to the extent these are not contrary to an Accounting Standard. Hence, the recommendations of the 'Guidance Note on Treatment of Expenditure during Construction Period', after AS 26 becoming applicable to the company (even before the withdrawal of the said Guidance Note) were applicable only to the extent these were not contrary to the provisions of AS 26. Therefore, since, after AS 26 became applicable to the company, the expenditure incurred on 'enabling assets' was not expensed by the company as per the requirements of AS 26, as discussed above, the same

is an error committed in the prior years which should be rectified in the financial statements and disclosed as a 'prior period item' of the period in which such rectification is carried out in accordance with the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

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) No, the existing accounting treatment followed by the company of considering the expenditure incurred on 'enabling assets' as capital work-in-progress during construction period of the project and charging off the same to revenue in the year of completion of the project is not correct.

(ii) No, the accounting treatment suggested by the auditors with regard to the 'enabling assets' is also not correct.

(iii)(a) Yes, the expenditure incurred on enabling assets not owned by the company should be charged off to revenue in the accounting period of incurrence of such expenditure.

(b) Expenditure on such assets not owned by the company appearing as CWIP, being an error should be rectified and disclosed as a 'prior period item' as per the requirements of AS 5 in the financial statements of the period in which such rectification is carried out as discussed in paragraph 18 above.

(iv) The expenditure on 'enabling assets' should be expensed by way of charge to the profit and loss account of the period in which the same is incurred.

Query No. 3

Subject: Treatment of liquidated damages payable for delay in commissioning of plant.[1]

A. Facts of the Case

1. A limited company having its registered office in India is a group member of a transnational player in the global gases and engineering industry. The company's gases division is engaged in the manufacture and sale of industrial, medical and special gases to customers across industries. The company also has a Project Engineering Division which executes turnkey projects for both in-house and third parties.

2. The querist has stated that the company has an established customer base in steel industry as oxygen is required in large quantities for steel making. Based on Long Term Agreements (LTAs), typically of 15 to 20 years' duration, entered into with such steel companies, plants owned by the company, are built within the customer's premises for 'across the fence' supplies of gases to them as well as to other customers in the merchant market in the region. Such Build-Own-Operate (BOO) schemes for gas supplies to major customers, particularly in the steel industry, is an established business model for the company. Time being the essence of such schemes where any delay by the company in building and commissioning of its plants to commence supplies of gases to its customers on dates as mentioned in the LTAs could cause substantial financial losses to them and vice-versa, stringent liquidated damage clauses for delays by either party feature prominently in LTAs.

3. The company has entered into one such LTA dated 31st May, 2006 for supply of industrial gases to a customer by installing an air separation plant (the plant) at the customer's steel works premises on Build–Own-Operate (BOO) basis. As per one of the clauses of the 'general conditions' of the agreement, the company is liable to pay 'late start liquidated damages' to the customer if there is a delay in the commencement of gas supply from the plant after the target commencement date due to the company's fault and the customer is ready to consume gas at its expanded steel making facility.

[1] Opinion finalised by the Committee on 18.3.2010

4. As per the agreement, the target commencement date was 31st March, 2008, being the date on which the company estimated that it would be able to start fulfilling its obligation to supply gas from the plant. However, as per the querist, due to delay by the main equipment supplier of the plant and other related problems at site, the company was not ready to commission the plant and commence supplies on the target commencement date and instead, was ready for supply of gases only in November 2008. At this stage, due to the economic downturn, the customer requested to further delay the start-up of the plant which was finally commissioned in February 2009.

5. The company capitalised the total cost of the project in its books of account in March 2009 after trial runs of the plant were successful. The company follows the calendar year as its financial year. The querist has stated that the company is now in the process of negotiating a settlement with the customer for the delays in plant commissioning on both its own as well as on the customer's part. As a result of such negotiation, the company will have to pay late start liquidated damages to the customer for the delayed commissioning of the plant due to its inability to have the plant ready for supply of gases on the appointed target commencement date of 31st March, 2008.

6. The querist has drawn the attention of the Committee to paragraph 20 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which states as under:

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

As per the querist, the plant was brought to its working condition for its intended use, i.e., for supply of gas to the customer in November 2008. The point for consideration is whether liquidated damages payable for delay in commissioning the plant should be treated as cost attributable for bringing the plant to its working condition for its intended use (supply of gas to the customer) within the ambit of paragraph 20 of AS 10.

B. Query

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

(a) Whether the amount to be paid by the company on account of liquidated damages due to delay in commencement of supply of gases to the customer consequent upon delay in bringing the plant to its working condition on the appointed target commencement date can be capitalised in its books of account as additional cost attributable to the project (capitalised in March 2009) in accordance with the provisions of AS 10 and any other related Accounting Standard or statute.

(b) If the answer to (a) above is in the negative, whether the liquidated damages payable can be treated as deferred revenue expenditure to be amortised over a period of 3 to 5 years after the commencement of commercial production.

(c) If the answer to (b) above is also in the negative, whether the only option available to the company will then be to charge off the amount of liquidated damages as an expense in the profit and loss account.

(d) Generally, on any other issue related to the subject.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to the treatment of liquidated damages payable by the company for delay in commissioning of the plant. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, appropriateness of capitalisation of the plant by the company in March 2009, compensation receivable by the company, if any, on account of request by the customer to delay the start-up of the plant, compensation receivable by the company, if any, for the delay by the main equipment supplier of the plant, expenses incurred during the period the plant is ready to commence production and the actual date of commencement of production, etc.

9. The Committee notes from the Facts of the Case that the plant has been constructed by the company under BOO scheme. Therefore, in the

view of the Committee, the provisions related to self-constructed assets would apply in the present case. In this context, the Committee notes paragraph 20 of AS 10 as reproduced by the querist in paragraph 6 above, and paragraph 21 of AS 10 which is reproduced below:

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

The Committee further notes that paragraph 10.1 of AS 10 provides that in arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5. The Committee notes that paragraph 9.1 is relevant to the case under consideration which states as below:

> "9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:
>
> (i) site preparation;
>
> (ii) initial delivery and handling costs;
>
> (iii) installation cost, such as special foundations for plant; and
>
> (iv) professional fees, for example fees of architects and engineers.
>
> The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors."

10. The Committee notes from the Facts of the Case that the 'late start liquidated damages' are payable by the company on account of delay in the commencement of gas supply from the plant on the target commencement date. The Committee is of the view that such expenditure cannot be said to be attributable to bringing the plant to its working condition for its intended use. Such expenditure is not attributable to the construction activity. It is

also not in the nature of price adjustment on account of which cost of a fixed asset may undergo a change subsequent to its construction. The Committee is of the view that the liquidated damages are of the nature of a penalty resulting from non-fulfillment of the terms of the agreement, in this case, the target date of commencement of gas supply. The amount of liquidated damages is a compensation to the customer for loss of revenue on account of non-supply of gas by the company. Accordingly, the Committee is of the view that such expenditure cannot be capitalised and should be expensed by way of charge to the profit and loss account as no future benefit is expected from the same.

D. Opinion

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

(a) The amount to be paid by the company on account of liquidated damages due to delay in commencement of supply of gases to the customer consequent upon delay in bringing the plant to its working condition on the appointed target commencement date cannot be capitalised in its books of account as additional cost attributable to the project (capitalised in March 2009) in accordance with the provisions of AS 10 or any other Accounting Standard or statute.

(b) The liquidated damages payable cannot be treated as deferred revenue expenditure to be amortised over a period of 3 to 5 years after commencement of commercial production as explained in paragraph 10 above.

(c) The company should charge off the amount of liquidated damages as an expense in the profit and loss account.

(d) The Committee, as per its Advisory Service Rules, answers only specific queries raised by the querist on accounting and/or auditing principles and allied matters and as a general rule, the Committee does not answer open-ended general queries. See paragraph 8 above.

Query No. 4

Subject: Treatment of loss arising on sale of under-performing assets and associated liabilities to a group company of the supplier of the assets.[1]

A. Facts of the Case

1. A listed company had given a Letter of Intent (LOI) for 40 Windmills Model 250T Wind Electric Generator (WEG) of 250/80 KW on turnkey basis including land to a company dealing in wind mills (hereinafter referred to as the 'supplier'). The company had finally scaled down to 20 windmills instead of the 40 windmills for which LOI was given. These 20 windmills were installed at the site of the company. The supplier was paid in full @ Rs. 128 lakh per machine amounting to Rs. 2,560 lakh at a debt:equity ratio of 75:25. The debts were funded by two nationalised banks. The machines installed were under operations and maintenance (O&M) for 2 years free of charge. The supplier had also executed a bond of performance guarantee of power generation of 5 lakh units per machine annually and individually with effect from the date of commissioning, and to compensate the shortfalls in the power generation at the prevailing State Electricity Board's rate.

2. The querist has stated that right from the inception, there were several problems in the power generation, land title, encroachment thereof and services. The company intimated the supplier regarding poor revenue generation and performance in respect of the 20 Windmills. As per the querist, the supplier admitted and affirmed about the non-performance and low performance of the machines and settlement thereof, but the settlement amount was not acceptable to the company. In view of the disparity, the company served a legal notice against the supplier stating the aforesaid facts and suggested arbitration recourse to resolve the matter. There was no response to the said notice from the supplier.

3. The querist has stated that in view of the foregoing, the company invoked section 9 of the Arbitration and Conciliation Act, 1996 with prayer to set aside the money to be realised from the forthcoming public issue of the said supplier and till then maintain the machines to generate the guaranteed generation of power. When the matter came up for hearing, the supplier gave an undertaking to the Court to maintain the machines to the guaranteed

[1] Opinion finalised by the Committee on 18.3.2010

level of generation and requested time to file counter with regard to the settlement of the matter.

4. After subsequent discussions between the company and the supplier, a Memorandum of Understanding (MOU) dated 10.07.08 was entered into for out-of-court settlement. The main points of the MOU (copy furnished by the querist for the perusal of the Committee) have been supplied by the querist as under:

- Net consideration was finalised for Rs. 1,966 lakh for entire 20 machines as on 01.04.2008.
- Out of the net consideration finalised at Rs. 1,966 lakh, Rs. 1,596 lakh was to be paid to the term lending bankers of the company and balance Rs. 370 lakh was paid to the company.
- The supplier or its nominee will take over the loan liabilities of the company relating to 20 machines and relieve from all liabilities and obligations, whatsoever, including personal guarantee, charge on other assets of the company and its promoters and directors.
- The supplier or its nominee will service interest / principal to bankers in a timely manner w.e.f 01.04.08 till the takeover of the loan and ensure that the loan accounts are maintained as standard asset.
- In case takeover of loan does not fructify by the end of 6 months or such further extended period agreed by the parties, the supplier will pay the balance of loan outstanding with bankers, take over the assets and relieve the company from all liabilities with bankers.

5. Consequent to the MOU, the following entries were passed in the books of the company:

- For the electricity generation on accrual basis: The amount is credited to the ‘Wind mill generation account’ and debited to ‘Wind mill generation receivable account’.
- For the interest accrued on term loan: The interest is debited to ‘Interest account’ and credited to ‘Term loan account’.

- When interest is paid by supplier to the bank: The amount is debited to 'Term loan account' and credited to supplier account.
- For the principal repayment: The amount is debited to respective loan account and credited to supplier account.
- Amount received from the State Electricity Board for the electricity supplied: The amount is credited to Wind mill generation receivable account.
- Amount directly collected by the supplier from the State Electricity Board for electricity supplied: The amount is credited to 'Wind mill generation receivable account' and debited to supplier account.

6. One of the group companies of the supplier has recently got the sanction of term loan for the takeover of the assets and liabilities. When the company transfers the assets, there will be no cash flows, but the aforesaid accounts, namely, Wind mill generation receivable account, Supplier account, Term loan account and Windmill assets account (WDV) will be squared off. This process of squaring off will result in a net loss of Rs. 444 lakh (excess debit balance) to the company.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the said loss of Rs. 444 lakh arising out of the abovesaid windmill transaction can be amortised over a period of time or whether the said loss should be fully charged off in the year in which the wind mills are sold by the company.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to the manner of recognition of loss arising out of the wind mill transaction in the instant case, i.e., whether the loss should be charged to the profit and loss account of the period in which such loss is incurred or whether it should be amortised over a period of time. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, computation of net consideration or computation of loss arising from the windmill transaction, interpretation of the terms of the MOU, propriety of journal entries passed

by the company consequent to MOU, timing of recognition of loss arising from the said transaction, i.e., whether the loss could be said to have been incurred by the company before entering into the MOU, after entering into the MOU or at the time of transfer of assets and related liabilities, accounting to be done at the time MOU is entered into, compensation received, if any, for shortfall in power generation, etc. The Committee notes that there are certain discrepancies between the Facts of the Case supplied by the querist and the MOU, for example, amount to be paid to the term lending bankers as per MOU is Rs. 1590 lakh, whereas the amount is stated in the Facts of the Case to be Rs. 1596 lakh, no mention in the Facts of the Case about the interest to be paid to the company by the supplier but stated in the MOU, etc. However, the discrepancies do not have a bearing on the issue under consideration for opinion.

9. The Committee notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, inter alia, provides that "losses represent decreases in economic benefits and as such they are no different in nature from other expenses" (paragraph 78). With respect to recognition of expenses, the Committee notes that the Framework, inter alia, provides in paragraph 96 that "an expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits". From the Facts of the Case, the Committee is of the view that the loss incurred by the company does not produce any future economic benefit to the company. Accordingly, in the view of the Committee, such loss should be fully charged off to the profit and loss account when incurred.

10. In the context of the proposed amortisation of the loss by the company, the Committee notes that amortisation over a period of time is possible only when the item is recognised as an asset. The Committee notes that the term 'asset' has been defined in the Framework 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." (Paragraph 49(a))

From the above, the Committee is of the view that an expenditure can be recognised as an asset only if it results into a resource controlled by the entity and some future economic benefits are expected to flow to the enterprise as a result of such expenditure. Since neither of the conditions is met in the case of the loss under consideration, it cannot be recognised as an asset and, therefore, there is no question of amortisation thereof.

D. Opinion

11. On the basis of the above, subject to paragraph 8 above, the Committee is of the opinion on the issue raised by the querist in paragraph 7 above, that the loss arising out of the windmill transaction in the instant case should be fully charged off to the profit and loss account of the year in which such loss is incurred. Such loss cannot be amortised over a period of time.

Query No. 5

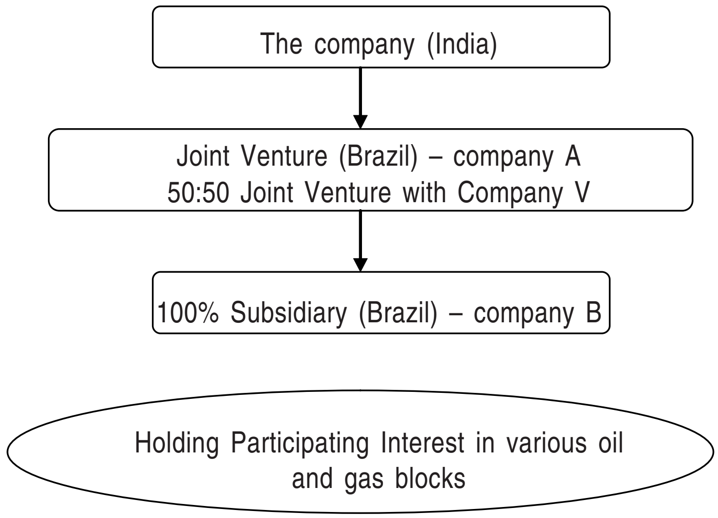
Subject: Accounting treatment of success fee paid to financial advisors.[1]

A. Facts of the Case

1. A government company (hereinafter referred to as 'the company') registered under the Companies Act, 1956, is a wholly owned subsidiary of a listed government company. The shares of the company are not listed with any stock exchange.

2. The company is engaged in activities relating to exploration and production of oil and gas. The company follows the 'Full Cost' method of accounting for its oil and natural gas exploration and production activities. The company is holding participating interest (PI) in various oil and gas blocks. The company along with another company (company V) has acquired through joint venture company – company A, shares in company B which holds the PI in oil and gas blocks in Brazil. The structure of the Group in respect of acquisitions of participating interest is as under:

[1] Opinion finalised by the Committee on 11.5.2010



3. The steps followed for this acquisition, as stated by the querist, are as under:

- On 22nd December, 2005, the holding company of 'the company' entered into MOU with company V for cooperation in oil and gas exploration in India and worldwide.
- On 6th June, 2007, proposal came from a foreign company, M/s E Corporation (which was holding the shares of company B) for divesture of deep-water offshore exploration portfolio of assets in Brazil.
- On 13th June, 2007, Joint Study and Bid Participation Agreement (JSBPA) was signed between the company and company V, with the following terms and conditions:
    - ❖ Participating Interest shall be through a joint venture 50:50 partnership.
    - ❖ Bidding companies shall jointly appoint an investment bank, management consultant and/or a petroleum expert (collectively referred to as consultants/financial advisors).
    - ❖ Costs for these consultants shall be shared equally by the two Indian parties.
    - ❖ The payment will be released from India.

- On 14th June, 2007, appointment of financial advisors was made whose scope of work was defined as under:
  - Carry out detailed financial due diligence.
  - Develop a detailed financial model and other methodologies to determine the transaction value.
  - Analyse various risks associated with the projects.
  - Valuation of company / project.
  - Assisting in appointment of technical, legal and taxation consultants.
  - Listing out various financial options available to the company.
  - Preparing the bidding strategy to acquire the proposed equity interest or participating interest by the seller.
- The fees payable was as under:
  - A drop dead fee of US $ 2,50,000 if for any reason, the transaction does not consummate.
  - A success fee of 0.70% of the bid price, payable on successful closure of the transaction.

  The querist has pointed out that the Fixed Drop Dead Fee, however, shall not be payable if engagement is commenced but the financial advisors are unable to continue or complete the transaction for reasons attributable to them. Notwithstanding this, payment of Fixed Drop Dead Fee shall become due and payable only after 90 days from the date of the signing of the agreement with them.
- On 27th July, 2007, the financial advisors submitted the report along with presentation and the same was deliberated upon by the company and company 'V'. On 30th July, 2007, after the internal deliberations, the strategy meeting between the company and company 'V' for acquiring company B was held, wherein it was decided to bid for 3 basins out of 4 held by company B. Accordingly, bid letter was submitted on 30th July, 2007.

The querist has pointed out that the bidding could have been possible even without relying on financial advisors' report.

- Later, negotiations took place with E Corporation and during the meeting, it clarified its intention that it wishes to exit from the Brazil project and therefore, offered the 4th basin at a nominal price of US $1.

- After negotiations/discussions, application was made to Agencia Nacional do Petroleo Gas Natural Biocombustiveis (ANP) - Government of Brazil for granting permission.

- On 7th December, 2007, a local Special Purpose Vehicle (SPV), viz., A Ltd. (50:50 Joint Venture) was incorporated with one thousand Rials as share capital. Later, on 18th March, 2008, the share capital was increased to Rials 2.09 million to meet ANP's requirement.

- On 29th July, 2008, ANP granted conditional approval subject to fulfilling conditions related to performance guarantees and to have local SPV with one million Brazilian Rials as share capital, etc.

- After a lot of follow-ups, on 12th September, 2008, ANP granted approval for the acquisition.

- On 18th September, 2008, the payment for acquisition was made to E Corporation and subsequently acquired its subsidiary company B.

- The merger of company B and company A is also under process. The assets at present are existing in the books of company B.

- On 15th July, 2009, an amount of Rs. 2,40,95,418.00 (being 0.7% of bid price of USD 82.5 million converted into Indian Rupee (INR) @ 47.055) after TDS was paid to the financial advisors against the bill of financial due diligence.

4. The querist has stated that the above-mentioned success fee has been treated as revenue expenditure in the books of the company for the following reasons:

(a) The underlying assets (PI) are not in the books of the company.

The value of equity shares together with share premium subscribed by the company in company A are shown as investment in the books of the company. The PI in Brazilian blocks is in the books of company B. Hence, it is felt that the expenditure on success fee incurred in relation to PI cannot be capitalised in the books of the company.

(b) The expenditure on account of success fee is incurred at the bidding process stage before the formation/incorporation of company A (whose 100% subsidiary held the PI in Brazilian blocks). The success fee has relation to bidding process for PI and has no relation to the acquisition of equity shares in company A.

(c) Though the advisory services of the financial advisors have helped the bidding process, the bidding could have been possible even without these services, i.e., it need not necessarily be an integral part of the acquisition. Hence, as per the querist, relying on one of the recent opinions issued by the Expert Advisory Committee (published as Query No. 19 of Volume XXVI of the Compendium of Opinions) on the subject 'Capitalisation of certain expenses related to acquisition of an investment', the success fee has been treated as revenue expenditure. The querist has reproduced the following portion of the opinion for reference:

> "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 and duties and levies by regulatory agencies and stock exchanges. The expenses incurred 'before' acquisition, even though directly attributable to acquisition should not be added to the cost of acquisition of shares as these do not represent the worth of shares acquired."

5. As per the querist, the government auditors while reviewing the accounts had examined the above treatment given by the company and have decided that this matter be taken up with the Expert Advisory Committee of the Institute of Chartered Accountants of India for specific opinion on the matter.

B. Query

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

(i) Whether the accounting treatment followed by the company is correct.

(ii) If no, then what is the correct accounting treatment.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting treatment of fee, i.e., Fixed Drop Dead Fee and success fee, paid by the company to financial advisors in connection with acquisition of investment in the subsidiary company B which held the participating interest in oil and gas blocks. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, accounting in the books of the holding company, company A, company V or company B with respect to any expenditure in connection with the acquisition of shares or participating interest, etc.

8. The Committee notes from the Facts of the Case that the company in the instant case has incurred the expenditure on fee to financial advisors for a commercial advantage which is to be availed through its joint venture company A, in whose books, the investment in company B would appear. The Committee examines whether this expenditure can be added to the cost of investment in the joint venture company A as appearing in the books of the company. In this context, the Committee notes paragraphs 28, 29 and 32 of Accounting Standard (AS) 13, 'Accounting for Investments', which provide as follows:

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

29. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of

> ***the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident."***
>
> ***"32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually."***

From the above, the Committee is of the view that in the present case, the expenditure on fee paid to financial advisors, cannot be included in the 'cost of investment' at the time of initial recognition. Such expenditure also does not become part of the carrying amount of the investment in the shares of company A as the investment is to be carried at cost with only diminution being recognised under certain circumstances.

9. The Committee now examines whether the expenditure on fee to financial advisors can be capitalised as a separate asset. The Committee notes that the term 'asset' has been defined in the Framework for the Preparation and Presentation of Financial Statements (the Framework), issued by the Institute of Chartered Accountants of India as "a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise" (paragraph 49(a)). The Committee is of the view that the expenditure on fixed drop dead fee and success fee does not result into a resource controlled by the company and accordingly, it cannot be capitalised as an asset.

10. The Committee further notes paragraph 96 of the Framework issued by the Institute of Chartered Accountants of India, which provides as follows:

> "96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

From the above, the Committee is of the view that the expenditure on fixed drop dead fee and success fee incurred by the company, which does not meet the definition of an asset as discussed in paragraph 9 above, should be expensed in the statement of profit and loss.

D. Opinion

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

(i) The accounting treatment followed by the company to treat the expenditure incurred on success fee as revenue expenditure is correct.

(ii) Since the answer to (i) above is in the positive, this issue does not arise.

Query No. 6

Subject: Accounting treatment of success fee paid to financial advisors.[1]

A. Facts of the Case

1. A Government company (hereinafter referred to as 'the company') registered under the Companies Act, 1956, is a wholly owned subsidiary of a listed government company. The shares of the company are not listed with any stock exchange.

2. The company is engaged in activities relating to exploration and production of oil and gas. The company follows the 'Full Cost' method of accounting for its oil and natural gas exploration and production activities. The company is holding participating interest (PI) in various oil and gas blocks. The company along with another company (company V) bids to have PI in oil and gas blocks at Mozambique. Company A, which is a 100% subsidiary of the company has acquired through its 100% step-down subsidiary, company B, the PI in oil and gas block in Mozambique. The structure of the Group in respect of acquisitions of participating interest is as under:

[1] Opinion finalised by the Committee on 11.5.2010

The company – India

↓

Company A
(100% Subsidiary of the company) – The Netherlands

↓

Company B
(100% Subsidiary) – The Netherlands

↓

Holding Participating Interest in Mozambique Block
10.00% - Company V
10.00% - The company
80% - Other enterprises

3. The steps followed for the acquisition of PI, as stated by the querist, are as under:

- On 22nd December, 2005, the holding company of 'the company' entered into a Memorandum of Understanding (MOU) with company V for cooperation in oil and gas exploration in India and worldwide.

- On 2nd April, 2008, proposal for farm-in opportunity in offshore exploration block in Mozambique Area was received from M/s N Corporation (Operator).

- Joint Study and Bidding Participating Agreement was signed in April 2008 by the company and company V, both Indian parties. The Agreement states that the expenditure incurred on the due diligence would be shared equally by these two Indian parties.

- The bids were invited from four parties for the appointment of financial consultant/advisor. After commercial evaluation, the job was awarded to M/s E. The letter of award was issued on 17th April, 2008 and the scope of work includes the following:

  - Facilitating in bidding process.

- Assist in appointing legal and taxation consultants in this regard.
- Carry out financial due diligence.
- Fees agreed upon:
  - Fixed Drop Dead Fees of Rs. 36.00 lakh if for any reason, the transaction does not consummate.
  - Success Fees of Rs. 1.50 crore, payable on successful closure of the transaction.

- The commitment (LOI) is made in India by the Indian parties and payment for services was also agreed to be made in India by the Indian parties.
- M/s E made presentation to management on 24th April, 2008, which was considered by the managements of the company and its holding company. The company obtained the internal approvals for bidding.
- The strategy meet between the company and company V for discussing the strategy for bidding and to acquire a participating interest in oil and gas block in Mozambique currently with M/s N Corporation took place on 25th April, 2008.
- In this meeting decision to bid and commercial terms were discussed and decided. The querist has pointed out that the bidding could have been possible even without relying on financial advisor's report.
- The bid letter was submitted on 30th April, 2008.
- Negotiations/discussions took place during May to July, 2008. During this period, it was decided that both the parties would acquire 10% each, participating interest in the oil and gas block in Mozambique and sign separate agreements with M/s N Corporation.
- At this stage, it was also decided that the agreement would be signed through a subsidiary abroad. Hence, the company created a new subsidiary, company B at the Netherlands, which

is a step-down subsidiary of the then existing subsidiary of the company, company A. Similarly, company V signed the agreement through its subsidiary company. For creation of company B, the remittance of Euro 18,500, which was required as the minimum share capital, was made from India.

- The Participating Agreement between company B and M/s N Corporation was signed on 11th August, 2008.

- The Government of Mozambique (Republic De Mocambique – Ministerio Dos Recurson Minerils Gabinete D Ministro) accorded approval on 19th December, 2008.

- Amount paid to M/s E (being success fee – the company's share) was Rs. 74,72,221 (after deducting tax) and the same was released on 31st March, 2009.

4. The querist has stated that the above-mentioned success fee has been treated as revenue expenditure in the books of the company for the following reasons:

(a) The underlying assets (PI) are not in the books of the company. The value of equity shares together with share premium subscribed by the company in its subsidiary, company A, are shown as investment in the books of the company. The PI in Mozambique block is in the books of company B. Hence, it is felt that the success fee incurred in relation to PI cannot be capitalised in the books of the Indian company, viz., the company.

(b) The expenditure on account of success fee is incurred at the bidding process stage before the formation/incorporation of company B (which acquired the PI in Mozambique block). The success fee has relation to bidding process for PI and has no relation to the acquisition of equity shares in company A.

(c) Though the advisory services of the financial advisers have helped the bidding process, the bidding could have been possible even without these services, i.e., it need not necessarily be an integral part of the acquisition. Hence, as per the querist, relying on one of the recent opinions issued by the Expert Advisory Committee (published as Query No. 19 of Volume XXVI of the

Compendium of Opinions) on the subject 'Capitalisation of certain expenses related to acquisition of an investment', the success fee has been treated as revenue expenditure. The querist has reproduced the following portion of the opinion for reference:

> "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 and duties and levies by regulatory agencies and stock exchanges. The expenses incurred 'before' acquisition, even though directly attributable to acquisition should not be added to the cost of acquisition of shares as these do not represent the worth of shares acquired."

5. As per the querist, the government auditors while reviewing the accounts had examined the above treatment given by the company and have decided that this matter be taken up with the Expert Advisory Committee of the Institute of Chartered Accountants of India for specific opinion on the matter.

B. Query

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

(i) Whether the accounting treatment followed by the company is correct.

(ii) If no, then what is the correct accounting treatment.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting treatment of fee, i.e., Fixed Drop Dead Fee and success fee, paid by the company to financial advisors in connection with acquisition of participating interest in oil and gas blocks by the step-down subsidiary company B. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, accounting in the books of the holding company, company A, company V or company B with respect to any expenditure in connection with the acquisition of shares or participating interest, etc.

8. The Committee notes from the Facts of the Case that the company in the instant case has incurred the expenditure on fee to financial advisors for a commercial advantage which is to be availed through its subsidiary company A, in whose books, the investment in company B (which is acquiring the participating interest in oil and gas blocks) would appear. The Committee examines whether this expenditure can be added to the cost of investment in the subsidiary company A as appearing in the books of the company. In this context, the Committee notes paragraphs 28, 29 and 32 of Accounting Standard (AS) 13, 'Accounting for Investments', which provide as follows:

> ***"28. The cost of an investment should include acquisition charges such as brokerage, fees and duties.***
>
> ***29. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident."***
>
> ***"32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually."***

From the above, the Committee is of the view that in the present case, the expenditure on fee paid to financial advisors, cannot be included in the 'cost of investment' at the time of initial recognition. Such expenditure also does not become part of the carrying amount of the investment in the shares of company A as the investment is to be carried at cost with only diminution being recognised under certain circumstances.

9. The Committee now examines whether the expenditure on fee to financial advisors can be capitalised as a separate asset. The Committee notes that the term 'asset' has been defined in the Framework for the

Preparation and Presentation of Financial Statements (the Framework), issued by the Institute of Chartered Accountants of India as "a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise" (paragraph 49(a)). The Committee is of the view that the expenditure on fixed drop dead fee and success fee does not result into a resource controlled by the company and accordingly, it cannot be capitalised as an asset.

10. The Committee further notes paragraph 96 of the Framework issued by the Institute of Chartered Accountants of India, which provides as follows:

> "96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

From the above, the Committee is of the view that the expenditure on fixed drop dead fee and success fee incurred by the company, which does not meet the definition of an asset as discussed in paragraph 9 above, should be expensed in the statement of profit and loss.

D. Opinion

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

(i) The accounting treatment followed by the company to treat the expenditure incurred on success fee as revenue expenditure is correct.

(ii) Since the answer to (i) above is in the positive, this issue does not arise.

Query No. 7

Subject: Basis of calculation of future cash flows.[1]

A. Facts of the Case

1. A company is a public sector enterprise under the administrative control of the Ministry of Mines, Government of India and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power at captive power plant for use in Smelter Plant. The saleable products derived out of the manufacturing process are alumina and aluminium which are sold in domestic and international markets. The company has four production units (i) A fully mechanised open cast Bauxite Mine having excavation capacity of 48,00,000 tonnes per annum, (ii) Alumina Refinery having production capacity of 15,75,000 tonnes per annum, (iii) Captive Power Plant having 8 units of 120 MW each to generate power and (iv) Smelter Plant of 3,45,000 M.T. per annum capacity.

2. Mines division serves feed-stock to the Alumina Refinery, located at 16 KM downhill. The Refinery provides alumina to the company's Smelter Plant which is about 600 KM away, in a specially designed alumina wagon by rail transport. For production of 1 M.T. of aluminium metal at Smelter, 13600 KWH of power is required, which is met by generation of power at Captive Power Plant situated at a distance of 4 KM. Cost of power constitutes about 30% of the cost of production of aluminium. Captive Power Plant is set up exclusively to supply un-interrupted power to Smelter. It is also connected to State grid, to take care of the supply of emergency power to Smelter in case of any break-down or failure at the Captive Power Plant. Any surplus power after meeting the requirement of Smelter is automatically transmitted to State grid and treated as sale.

3. The company has identified the following three reportable segments on the basis of type of products:

(i)	Chemical Segment	-	For Bauxite Mining and Alumina Plant.
(ii)	Power Segment	-	For Captive Power Plant.
(iii)	Aluminium	-	For Smelter Plant.

[1] Opinion finalised by the Committee on 11.5.2010

4. At Alumina Refinery, the company has set up two value added plants for (i) special grade hydrate and (ii) special grade alumina (SGA). Both the units have been identified as cash-generating units for the purpose of Accounting Standard (AS) 28, 'Impairment of Assets'.

5. The installed capacity of the SGA plant is 19400 MT per annum. On its way to stabilisation and entering into the new market, the capacity utilisation during the period from the financial year 2005-06 to 2007-08 ranged from 8.23% to 21.65% only. During the course of audit for the financial year 2008-09, the Comptroller and Auditor General of India (C&AG) auditors advised for calculating recoverable amount of SGA plant for the purpose of testing impairment.

6. The querist has stated that estimate of future cash flows over the useful life of the SGA plant, i.e., upto the financial year 2022-23 was made in line with the provisions of paragraphs 26(a), 26(b), 26(c), 27, 28, 29, 30, 31(a), 31(b), and 31(c) of AS 28. Present value of the cash flows worked out to be positive as compared to the carrying cost of the assets. For SGA plant, calcined alumina, which is internally transferred, is the only raw-material. While calculating the cash flows, cost of production of calcined alumina was considered as the cost of raw-material. The querist has further stated that calcined alumina which is internally transferred to Smelter Plant for production of aluminium metal is valued at cost although about 50% of production of alumina is sold.

7. As per the querist, during the course of scrutiny/checking of cash flow statement, C&AG auditors agreed to each and every assumption taken, except the cost of raw-materials. In support of their views, C&AG auditors relied upon the following provisions of paragraph 68 of AS 28:

> ***"68. If an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash-generating unit, even if some or all of the output is used internally. If this is the case, management's best estimate of future market prices for the output should be used:***
>
> ***(a) in determining the value in use of this cash-generating unit, when estimating the future cash inflows that relate to the internal use of the output ; and***

> ***(b) in determining the value in use of other cash-generating units of the reporting enterprise, when estimating the future cash outflows that relate to the internal use of the output."***

In the opinion of the C&AG auditors, market price of calcined alumina should have been taken as the cost of raw-material instead of cost of production. This resulted into negative cash flows necessitating making provision for impairment loss.

8. The querist has stated that in reply to the C&AG's query, as stated in paragraph 7 above, the management justified its calculation as per paragraph 31(b) of AS 28, which reads as follows:

> ***"31. Estimates of future cash flows should include:***
>
> ***(a) projections of cash inflows from the continuing use of the asset;***
>
> ***(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and***
>
> ***(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life."***

9. According to the querist, C&AG auditors were of the view that there seems to be a contradiction between the provisions of paragraph 31 and paragraph 68 of AS 28 and advised to seek opinion from the Expert Advisory Committee of the Institute of Chartered Accountants of India.

B. Query

10. Based on the facts stated above, the opinion of the Expert Advisory Committee has been sought by the querist on the issue as to whether the raw-materials' cost (internally transferred) should be taken at 'cost of production' or at 'market price' for the purpose of calculating future cash flows for ascertaining impairment as per AS 28.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist is that whether, for the purpose of calculating future cash flows while testing for impairment, the price of the raw-material which is transferred internally, should be taken at 'cost of production' or 'market price'. The Committee has, therefore, examined only this issue, and has not examined any other issue that may arise from the Facts of the Case, such as, whether the cash generating units are properly identified by the company, etc. The Committee presumes that all other factors for determining future cash flows/value in use of the CGU have been duly considered by the company in accordance with AS 28. The Committee notes from the Facts of the Case that it is not clear whether 'calcined alumina' is the raw-material for the SGA plant or for Smelter Plant. However, since the opinion of the Committee contained hereinafter is based on the principles of pricing of internally transferred raw-materials, it does not affect the opinion.

12. The Committee notes paragraph 31 of AS 28 reproduced in paragraph 8 above and paragraph 68 of AS 28 reproduced in paragraph 7 above. The Committee further notes paragraph 69 of AS 28 which states as below:

> "69. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise (for example, products at an intermediate stage of a production process), this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or group of assets. ..."

13. From the above, the Committee is of the view that paragraph 31 of AS 28 lays down the composition of the estimates of future cash flows. Paragraph 31(b) of AS 28 only lays down that the projections of cash flows for an asset should include cash outflows required to generate cash inflows. This paragraph further requires that cash outflows should include among other expenses, overheads and other related charges that can be directly attributed or allocated on a reasonable and consistent basis to the asset.

14. The Committee is of the view that, on the other hand, paragraph 68 of AS 28 lays down the parameters for identification of the cash-generating

unit in case when an active market exists for the output produced by the asset or a group of assets even if the output is used internally. This paragraph requires that in such a situation, that is, when an active market exists for the output of an asset or a group of assets which is used internally, that asset or group of assets should be identified as a separate cash generating unit. This paragraph further requires that in such a situation, it is the management's best estimate of future market prices of the output that should be used for determining the cash inflows even from internal use of the output. Similarly, for determining the cash outflows of the cash generating unit that uses the output of this CGU as its raw material, it is the management's best estimate of future market prices of the product that should be used for determining cash outflows.

15. From paragraphs 13 and 14 above, the Committee is of the view that paragraph 31(b) is a general paragraph which deals with what cash outflows should be taken into account while determining future cash flows; whereas, paragraph 68 of AS 28 contains specific requirement with respect to, inter alia, the price at which the raw material which is transferred internally, should be taken for the purpose of determining cash outflows. Thus, in the view of the Committee, there is no contradiction between paragraphs 31 and 68 of AS 28.

D. Opinion

16. On the basis of the above and subject to paragraph 11 above, the Committee is of the opinion that for the purpose of calculating future cash flows for determining impairment as per AS 28, the cost of the internally transferred raw-material should be taken at the management's best estimate of future market prices of the output (raw material).

Query No. 8

Subject: Accounting for expenditure incurred during construction period of project.[1]

A. Facts of the Case

1. A company manufactures automobile parts, particularly, it is in the business of processing steel for auto component manufacturing units. The company was incorporated on 5.10.2007 and started activities to establish the project to process prime steel for auto component manufacturing units. The project was completed and the commercial production was started on 13.12.2008. Total cost of the project was Rs. 113.83 crore, which was capitalised on completion of the project. The company has also incurred administrative expenses/expenses which are not specifically related to any particular fixed asset, amounting to Rs. 2.28 crore during the period of establishment of the project after getting the certificate of commencement of business till the date of start of commercial production (apart from preliminary expenses, which were incurred during incorporation of the company).

2. During the period of construction stage upto 12.12.2008 (i.e., the date of commencement of commercial production), the company has expended Rs. 2,27,72,267 as indirect expenses which are not specifically related to any particular fixed asset /administrative expenses as per details mentioned below:

Expense Head	**Amount (Rs.)**
Financial Expenses	29,244
Vehicle Running & Maintenance Cost	6,36,085
Travelling & Conveyance	47,44,645
Professional Expenses	7,74,439
Rent , Rates & Taxes	10,33,025
Communication Expenses	5,21,873
Salary & Wages –Workers & Staff	69,39,752
Working Directors Remuneration	51,09,346
Other Personnel Expenses	15,10,539
General & Administrative Expenses	14,73,319
Total	**2,27,72,267**

[1] Opinion finalised by the Committee on 11.5.2010

3. The statutory auditor of the company is of the view that as these expenses are not related to any specific fixed asset of the company, the same should be charged to the profit and loss account and should not be capitalised as pre-operative expenditure to the project cost as per paragraph 9.3 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India (ICAI) (Paragraph 9.2 of AS 10, notified under the Companies (Accounting Standards) Rules, 2006), which, inter alia, states that a*dministration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset*. The querist has stated that the management of the company is of the view that these expenditures can be capitalised in view of paragraph 9.3 of AS 10, issued by the ICAI, which, inter alia, states that *in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project.* However, as per the querist, the statutory auditor does not agree with the same. (Emphasis supplied by the querist.)

B. Query

4. The querist has sought the opinion of the Expert Advisory Committee of the ICAI on the following issues in respect of the accounting treatment of the said administrative expenses/expenses which are not specifically related to any particular fixed asset, in view of AS 10 and other accounting standards, if applicable in this particular case:

(i) Whether the expenses incurred during the construction of the project can be capitalised with the cost of fixed assets.

(ii) Whether the expenses incurred during the construction of the project should be charged off to the profit and loss account. If yes, then whether the same should be charged every year, if the gestation period of the project is more than one year, though no commercial activity has been carried on by the company except that it was engaged in construction of the project only. (In this case, the profit and loss account will only show losses related to these expenditures.)

(iii) If these expenses can not be capitalised, then whether the expenses incurred during construction of the project can be treated as pre-operative expenses and written off in installments or otherwise in future years, after start of commercial production instead of charging it to the profit and loss account in the same year in which the expenditure has been incurred.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to the accounting treatment of administration expenses / indirect expenses not specifically related to any particular fixed asset, incurred during the construction of the project upto the date of commencement of commercial production. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for preliminary expenses incurred during incorporation of the company, accounting for individual items of various expense heads as provided by the querist in paragraph 2 above, etc. The Committee presumes that the 'financial expenses' mentioned in paragraph 2 above, do not refer to 'borrowing costs' covered under Accounting Standard (AS) 16, 'Borrowing Costs', as the querist has referred to only AS 10 in the context of expenses mentioned in paragraph 2 above. The Committee's opinion contained hereinafter is based on the general principles to be followed while accounting for such expenditure incurred during construction of the project. The exact expenditures that are to be capitalised/expensed will have to be determined on the basis of the said principles.

6. The Committee notes that the accounting principles for determination of the cost of a self-constructed fixed asset, have been laid down, inter alia, in paragraph 10.1 of AS 10, notified under the Companies (Accounting Standards) Rules, 2006, which provides as follows:

> "10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5[2]. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

[2] To be read as 9.4.

The Committee further notes paragraphs 9.1 and 9.2 of the notified AS 10 as reproduced below:

> "9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:
>
> (i) site preparation;
>
> (ii) initial delivery and handling costs;
>
> (iii) installation cost, such as special foundations for plant; and
>
> (iv) professional fees, for example fees of architects and engineers.
>
> …
>
> 9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset."

From a combined reading of the above paragraphs of AS 10, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to a fixed asset/project under construction is that it should be directly attributable to the construction of the project/fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are those costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The above-discussed principle of avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by AS 16. In the extant case, the Committee is of the view that it should be seen that whether the expenses incurred are directly attributable to construction as discussed above. Accordingly, if the expenses incurred are directly attributable to construction, these can be capitalised with the cost of the concerned fixed asset(s)/ project. However, if these expenses cannot be said to be directly attributable to the construction of project/fixed asset(s), these should be expensed by way of a charge to the profit and loss account in the period in which these are incurred as no future economic benefit is expected from the same. The Committee is of the view that for this purpose, profit and loss account will have to be prepared by the company even before the commencement of commercial operations.

7. The Committee also wishes to point out that there may be an intervening period between the date the asset/project is ready for commercial production and the date when commercial production actually begins. The Committee is of the view that only those costs directly attributable to the construction incurred upto the stage of bringing the asset/project to its working condition for its intended use, i.e., for getting the asset/project ready for commercial production, can be capitalised with the cost of the asset/project. The costs incurred thereafter are to be expensed immediately.

D. Opinion

8. On the basis of the above, in respect of the administrative expenses/ expenses which are not speficially related to any particular fixed asset, as given by the querist in paragraph 2 above, and subject to the considerations contained in paragraph 5 above, the Committee is of the following opinion on the issues raised in paragraph 4 above:

(i) The expenses incurred during the construction of the project should be capitalised provided the expenses are considered to be directly attributable to the construction of the project/fixed asset(s) for bringing it(them) to its(their) working condition for its(their) intended use as discussed in paragraph 6 above.

(ii) If the expenses incurred during the construction of the project cannot be said to be directly attributable to the construction of the project/fixed asset(s) for bringing it(them) to its(their) working condition for its(their) intended use and, therefore, not capitalised under (i) above, these should be expensed by way of charge to the profit and loss account in the period in which these are incurred. Refer paragraph 6 above.

(iii) If the expenses incurred during the construction of the project cannot be said to be directly attributable to the construction of the project/fixed asset(s) for bringing it(them) to its(their) working condition for its(their) intended use and, therefore, not capitalised under (i) above, these cannot be written off in installments or otherwise in future years. Such expenses should be expensed in the period in which the same are incurred as per (ii) above.

Query No. 9

Subject: Accounting treatment of overlift/underlift quantity of crude oil.[1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as the 'company'), which is a 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. Usually, the legal regimes applicable in most of the countries provide that the ownership of mineral resources (hydrocarbons) is with respective governments. Accordingly, the host governments grant the rights to explore, develop and produce hydrocarbons in certain specified geographical areas within their territories (hereinafter referred to as the 'Rights') to the companies on some equitable consideration under various regimes. The activities of the company, thus, include securing such Rights and then to explore, develop and produce hydrocarbons. Such Rights are secured either on a 100% basis, wherein the company or its affiliates themselves take the entire risks and rewards of such Rights or in consortium with other participants (such consortia usually being unincorporated joint ventures) wherein the joint venture participants

[1] Opinion finalised by the Committee on 11.5.2010

share the risks and rewards in certain agreed proportions. Such Rights are granted by the host governments in accordance with the applicable legal and fiscal regime in the host country which are incorporated into binding contractual arrangements entered into with the host governments.

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

3. The company is a participant in one such PSA along with other companies (hereinafter referred to as the 'consortium') with the government of a foreign country (hereinafter referred to as the 'State') in respect of certain geographical area specified in the PSA (hereinafter referred to as the 'area'). Under the PSA, the State granted the exclusive Rights to the consortium to conduct hydrocarbon operations in the area subject to the terms and conditions of the PSA. The joint venture arrangements among the consortium partners are governed by the Joint Operating Agreement (hereinafter referred to as the 'JOA') entered into by the consortium participants.

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

5. The querist has stated that relevant article of the PSA provides that the title to hydrocarbon to which consortium is entitled to shall, unless an earlier separation point is agreed upon between the State and the consortium, pass to consortium at the delivery point. Further, according to the querist, relevant article of the JOA provides that each participant shall have the right and obligation to offtake (i.e., of crude oil) in kind and separately dispose of

its participating interest share of total production due to the participants pursuant to the PSA. JOA contains provisions enabling participants to enter into an 'Offtake Agreement for Crude Oil' (hereinafter referred to as the 'COA') to cover the offtake of crude oil produced under PSA and lays down the following principles (among others) on which the COA is to be based:

(A) Title and risk of loss of each participant's participating interest share of crude oil shall pass to that participant at the delivery point.

(B) As between the participants, each participant shall have the right to offtake in each period a volume equal to its participating interest share of the total participating production of crude oil for the period (such volume is hereinafter referred to as a participant's 'basic entitlement'). A participant shall have the right to request either a deferral of lifting of a portion of such participant's basic entitlement or an overlift of such participant's basic entitlement, provided such deferral or overlift does not adversely affect the production and/or lifting schedule. The operator shall have the right to approve or disapprove such underlift or overlift; provided, however, approval shall not be unreasonably withheld.

(C) To the extent that distribution of basic entitlement on such basis is impracticable due to unavailability of facilities or minimum cargo sizes, a method of making period adjustments shall be determined which provides substantially equivalent economic benefits to all the participants.

6. Accordingly, as per the querist, 'Crude Offtake Agreement (COA)' has been entered into by the participants. COA contains provisions (among others) for lifting schedule determination, cargo allocation and overlift/underlift.

7. 'Allocation Rules of the COA', inter alia, provide for the following:

(a) In developing each lifting schedule, the operator shall take into consideration the type and rate of production from the area, storage capacity at the terminal, the total number of the liftings from the terminal, the cumulative overlift and underlift of each party, and other operational and technical details pertinent to avoiding a shutdown or reduction of production.

(b) The operator shall have the discretion to allow the lifting of a cargo of a size less than, or more than, a standard cargo, provided that such lifting would not affect or unreasonably risk the lifting of another party, unless any party that would be affected by such lifting has notified the operator that such party does not disapprove such lifting.

(c) Overlift/Underlift:

(i) Each party may be designated to lift quantities, which would cause such party to overlift for the month when the operator has assigned the party a lifting of a standard cargo and the party's entitlement is not sufficient to load a full standard cargo plus any allowable upward operational tolerance.

(ii) Each party may be designated to lift quantities which would cause such party to underlift for the month when the final lifting schedule developed according to relevant article of the COA has the party not lifting its full entitlement for the month.

(iii) Any arrangements with other parties which violate the overlift/underlift restrictions set forth in this agreement shall be rejected by the operator, unless in the reasonable judgment of the operator, such arrangements will not affect the lifting of another party, or unless each party, that in the reasonable judgment of the operator, will be affected by such overlift or underlift has notified the operator that it does not disapprove of such overlift or underlift.

(iv) The operator shall be authorised to reject any arrangement with other parties, which results in an overlift or underlift position of one or more parties, if in the reasonable judgment of the operator, rejecting such nomination is necessary in order to avoid shutting down or reducing production from the Area or exceeding the storage capacity tolerance of the Terminal.

8. Thus, according to the querist, given the fact that title and risk of loss of each participant's participating interest share of crude oil shall pass to that participant at the delivery point, the participants are entitled to overlift/

underlift crude oil in accordance with the provisions of JOA and COA. The underlift/overlift of a participant is adjusted in lifting schedule for the next month.

9. The querist has stated that in view of the above provisions of the PSA, JOA and COA, the company is accounting for the overlift/underlift quantity of its basic entitlement as per its declared accounting policy reproduced below:

> "15. Revenue Recognition:
>
> 15.1 Revenue from sale of products is recognised on transfer of custody to customers. Any difference as of the reporting date between the entitlement quantity minus the quantities sold in respect of crude oil (including condensate), if positive is treated as inventory and, if negative, is adjusted to revenue by recording the same as liability."

10. The querist has further stated that as on 31st March, 2009, the company overlifted quantity over and above its basic entitlement. Following the above-stated accounting policy, the company reduced the sales arrived at by multiplying overlift quantity by the sale price of crude oil realised by the company for its last sold cargo during March 2009 and created liability for the same.

11. The querist has also stated that had there been a case of underlift as on the balance sheet date, the company would have treated the underlift quantity as inventory of the company and would have valued it in accordance with the requirements of Accounting Standard (AS) 2, 'Valuation of Inventories' at cost or net realisable value, whichever is lower.

12. The above treatment, as per the querist, did not attract any adverse comment/ observations either from the statutory auditors or the Comptroller and Auditor General of India (C&AG) till the financial year 2007-08. However, C&AG auditors while carrying out their review under section 619(3)(b) of the Companies Act, 1956 for the financial year 2008-09 objected to the accounting for overlift quantity as liability and contested that the company should treat overlift quantity as its own share of production and should have booked sales of Rs. 789 million for the overlift quantity simultaneously recognising expenditure (cost of hydrocarbon, transportation charges and royalty etc.) amounting to Rs. 248 million on the basis of its recent cost figures, i.e., for fourth quarter (Q4) of the financial year 2008-09 in the

extant case. Further, the C&AG auditors contended that government's take of profit oil should have also been reduced from the sales on the basis of applicable percentage of government's share of profit oil (i.e., for Q4 2008-09) as was recognised for normal sales of the company in accordance with its practice of showing sales 'net of government share of profit oil', as stated by way of footnote in Schedule-15, Sales to the company's final accounts.

B. Query

13. The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the appropriate accounting treatment of overlift/underlift quantity of crude oil by the company, i.e., whether

(i) the accounting policy of the company in recognising overlift quantity as liability and underlift quantity as inventory is appropriate and whether the accounting treatment carried out by the company in respect of overlift quantity of crude oil by recognising the same as liability at recent sales price of the crude oil realised by the company is appropriate; or

(ii) the production quantity related to overlift quantity should be treated as the company's share and accounted for in the manner specified by the C&AG auditors; or

(iii) there is any other appropriate accounting treatment / disclosure of such overlift/underlift quantity.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised in the query relates to the accounting for overlift and underlift quantity of crude oil. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for government's share of profit oil, interpreting the terms of the PSA, JOA and COA, accounting for the joint operations, propriety of recognition of revenue on the transfer of custody of oil to customers, etc. In the absence of any information to the contrary, the Committee presumes that the company is being charged for its proportionate share in the production cost of the oil as per its basic entitlement and not as per the quantity lifted during the period.

15. As far as accounting for overlift quantity of crude oil is concerned, the Committee notes that the definition of the term 'revenue', as provided by Accounting Standard (AS) 9, 'Revenue Recognition' states that ***"Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and …".*** Accordingly, in the view of the Committee, the total amount of consideration arising from the sale of crude oil (including the sold quantity from the overlift of crude oil) should be recognised as revenue.

16. The Committee further notes the definition of the term 'liability', as provided in paragraph 10 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', which states as follows:

> ***"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 notes from the Facts of the Case that the underlift/overlift of a participant is adjusted in the lifting schedule for the next month. Thus, the Committee is of the view that the overlift of crude oil gives rise to an obligation on the company to transfer future economic benefits (by foregoing the right to receive equivalent future entitlement in the crude oil). Accordingly, a liability should be provided for by the company by way of charge to the profit and loss account for overlift quantity keeping in view the presumption stated in paragraph 14 above that the company is charged only for the proportionate share of production cost as per its basic entitlement and not for the actual quantity lifted. The above treatment is based on the fundamental accounting principle of 'accrual' as contained in paragraph 10(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', which provides as below:

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

17. The amount of provision for the liability in respect of overlift quantity should be determined on the basis of the best estimate of the expenditure required to settle the present obligation at the balance sheet date as per the requirements of paragraph 35 of AS 29. In the extant case, it would be the best estimate of the company's proportionate share of production expenses as per the JOA/PSA in respect of the quantity of crude oil foregone in future period towards settlement of the overlift quantity of crude oil.

18. As regards underlift situation, the Committee is of the view that to the extent it is the settlement of an overlift situation of the earlier periods, it should be recognised by debiting the liability provided for under the overlift situation and crediting/reducing the company's proportionate share in the production cost. In respect of other underlift situations (i.e., not arising due to settlement of an overlift of crude oil in an earlier period), the Committee notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, provides that "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 an enterprise". Accordingly, the Committee is of the view that an underlift represents a right to future economic benefit through entitlement to receive equivalent production in the future and is therefore, an asset. In respect of the nature of that asset, the Committee notes the definition of the term 'pre-paid expense', as provided under the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India, which states as follows:

> **"13.07 Pre-paid Expense**
>
> Payment for *expense* in an accounting period, the benefit for which will accrue in the subsequent accounting period(s)."

Since in the present case, the company is charged for the proportionate share of production cost as per its basic entitlement, but the quantity of crude oil lifted is less than its basic entitlement, the amount paid in excess is 'prepaid expense'. The Committee is of the view that under the underlift situation, the company should recognise a pre-paid expense by crediting its proportionate share of production cost as per the joint operating agreement/ production sharing agreement.

19. In situations where an overlift situation has arisen due to settlement of an earlier underlift, the Committee is of the view that the same should be

recognised by crediting the earlier recognised 'pre-paid expense' for the underlift and debiting the share of production cost for the current period.

D. Opinion

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

(i) The accounting policy of the company in recognising overlift quantity as liability is appropriate, however, recognition of liability by reversing the sales/revenue of the company at the recent sales price of the crude oil is not appropriate. The accounting policy of recognising the underlift quantity as inventory is also not appropriate.

(ii)&(iii) Refer to paragraphs 15 to 19 above.

Query No. 10

Subject: Depreciation on facilities/assets engaged in processing of crude oil.[1]

A. Facts of the Case

1. A company is engaged in the exploration, development and production of oil and gas in various oil and gas fields across the country and has recently commenced commercial production in its Rajasthan block. The company has set up processing facilities at the oil and gas blocks, which are required to do an initial processing of the crude oil so as to separate water content from it, before transporting the crude oil to the refineries.

2. The various assets of the company, as per the querist, are broadly classified as under:

[1] Opinion finalised by the Committee on 11.5.2010

A. Well related assets

Well related assets consist of the following costs and assets:

- Costs incurred to gain access to and prepare well locations for drilling, including surveying well locations for the purpose of determining specific exploration/development drilling sites, clearing ground, draining including road building and relocating public roads, gas lines and power lines to the extent necessary in developing the proved oil and gas reserves; and
- Costs incurred to drill and equip exploration/development wells, development-type stratigraphic test wells and service wells including the cost of platforms and of well equipment such as casing, tubing, pumping equipment and the wellhead assembly.

B. Processing facilities

Includes cost to acquire, construct and install production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems.

C. Support facilities and equipments

- Includes cost of equipment and facilities in the nature of service units, camp facilities, godowns (for stores and spares), workshops (for equipment repairs), transport services (trucks and helicopters), catering facilities and drilling and seismic equipment.

3. The querist has stated that paragraph 3(ii) of Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and paragraph 1(ii) of Accounting Standard (AS) 6, 'Depreciation Accounting', specifically state that these Standards do not deal with the accounting for wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources. According to the querist, in the absence of specific Accounting Standard for oil and gas accounting, the company is guided by the Guidance Note on Accounting for

Oil and Gas Producing Activities, (hereinafter referred to as the 'Guidance Note') issued by the Institute of Chartered Accountants of India (ICAI).

4. The querist has further stated that as per the above Guidance Note, development costs cover all the direct and allocated indirect expenditure incurred in respect of the development activities, including *inter alia*, costs incurred to acquire, construct, and install production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems. Further, the Guidance Note requires that depletion should be calculated using the Unit of Production (UoP) method and provided on all the oil and gas assets except support assets as defined above in (C) category.

5. The querist has also stated that sections 205, 349 and 350 of the Companies Act, 1956 ('the Act') require that depreciation should be provided as per the rates and manner given in Schedule XIV to the Act. Clause II(B)(7), II(D)(7) and footnote 8 of Schedule XIV have prescribed rates of depreciation for certain tangible assets used by a mineral oil concern which would be different from those arrived under the UoP method. The company believes that the requirement to provide depreciation as per the Act is only for the purpose of arriving at the profits under section 205, 349 and 350 of the Act, which in turn relates to profits available for distribution of dividend, managerial remuneration, etc. As per the querist, there is no other requirement in the Act which mandates charging off the minimum depreciation to the profit and loss account as per Schedule XIV rates.

6. The querist has also mentioned that the erstwhile Department of Company Affairs (DCA) (now known as Ministry of Corporate Affairs), vide its circular dated February 21, 2003, had disapproved the use of UoP method for providing depreciation under section 205 for companies engaged in the production of steel.

7. As regards the queries raised in paragraph 8 below, the company has provided its views as follows:

(i) The exclusion provided under paragraphs 3(ii) and 1(ii) of AS 10 and AS 6, respectively, deal with expenditure incurred for extraction of mineral oil. It would be a narrow interpretation to restrict the expenditure till the point the oil is brought to the surface of the earth. Once oil has been extracted, these would be required to be stored in tanks and processed, all of which precede the activity of distribution. In such a case, the company believes that the exclusion given under paragraph 3(ii) and 1(ii) of AS 10 and AS 6, respectively, encompass the entire activity which is related to or is incidental to the extraction of crude oil. Accordingly, incidental activities, like storage of crude oil and water separation processing should be excluded from the scope of AS 6 and AS 10 by virtue of paragraphs 3(ii) and 1(ii), respectively.

(ii) The requirement to provide depreciation under the Companies Act, 1956 is only for the purpose of arriving at profits to be computed under section 205, 349 and 350 of the Act. Hence, from an accounting standpoint, the company should abide by the provisions of the Guidance Note, which specifies that depletion on these assets is to be provided based on UoP method. From a regulatory compliance standpoint, the company should re-compute profits for the limited purposes of sections 205, 349 and 350 of the Act and disclose the same suitably in the financial statements. The intention of the DCA circular, according to the querist, also appears to be restricted to the limited purpose of calculation of profits under section 205 of the Act. Distribution of profit, managerial remuneration, etc., which are associated with the profits computed under section 205, 349 and 350 would be done in accordance with the re-computed profits and not book profits computed based on the UoP method of depreciation. Hence, there would be no violation of the Companies Act, 1956 in case depreciation is recomputed in the manner provided under Schedule XIV to the Act for the purpose of calculation of distribution of profit, managerial remuneration, etc., and the said treatment is disclosed in the financial statements.

B. Query

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

(i) Whether the assets/facilities described under paragraph 2B above would be covered under the exclusion scope given under paragraph 3(ii) of AS 10 and paragraph 1(ii) of AS 6 keeping in view that these are essential and built at any oil and gas exploration field and without these assets/facilities, crude oil cannot be processed and sold and transported to the refineries.

(ii) Whether the company can provide depreciation based on the UoP method on assets described under paragraph 2B above and charge the same to the profit and loss account. For the limited purpose of computation of profits for sections 205, 349 and 350 of the Companies Act, 1956, whether the company can re-compute depreciation in accordance with Schedule XIV to the Act.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to depreciation on assets/facilities as described under paragraph 2B above (hereinafter referred to as the 'processing facilities'). The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, depreciation on other assets and facilities, viz., well related assets, support facilities and equipments, etc.

10. The Committee is of the view that the accounting for processing facilities in the instant case would depend on whether the processing carried out by such processing facilities is a part of production process during the extraction of crude oil or after its extraction for the purpose of transportation and distribution thereof. In this context, the Committee notes paragraph 12 of the Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the Institute of Chartered Accountants of India, which provides as follows:

> "12. Production activities consist of pre-wellhead (e.g., lifting the oil and gas to the surface, operation and maintenance of wells, extraction rights, etc.,) and post-wellhead (e.g., gathering, treating, field transportation, *field processing, etc., upto the outlet valve on the lease or field production storage tank,* etc.,) activities for producing oil and/or gas."

The Committee notes from the Facts of the Case that the processing facilities in the instant case are required to do an initial processing (separation of water content from crude oil) before transporting and distributing the crude oil. However, it is not clear from the Facts of the Case as to whether such processing is a part of production process (i.e., processing upto the outlet valve on the lease or field production storage tank as per the above-reproduced paragraph 12 of the Guidance Note) or whether such processing is carried out thereafter.

11. The Committee further notes paragraph 3(ii) of AS 10, notified under the Companies (Accounting Standards) Rules, 2006 and paragraph 1(ii) of the notified AS 6, which provide as below:

> *AS 10*
>
> "3. This standard does not deal with accounting for the following items to which special considerations apply:
>
> (i) …
>
> (ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources;
>
> …
>
> Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this Standard."
>
> *AS 6*
>
> "1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:–
>
> (i) …
>
> (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
>
> …"

The Committee notes from the above that the exclusions under AS 6 and AS 10 have been made in respect of expenditure on the exploration for and extraction of oil and gas and not in respect of processing after the extraction of oil and gas. Accordingly, in case processing in the extant case is done after extraction, the Committee is of the view that these Standards shall apply in respect of accounting for the 'processing facilities'. With respect to charging of depreciation, the Committee notes that AS 6 requires in paragraph 20 that depreciation on an asset should be charged on a systematic basis during the useful life of the asset. The Committee also notes that paragraph 13 of AS 6 provides as below:

> "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."

Accordingly, the Committee is of the view that in case the processing in the extant case is done after extraction of crude oil, depreciation should be provided at the rates prescribed under Schedule XIV to the Companies Act, 1956.

12. In case the processing in the extant case is a part of the production process, the Committee is of the view that the 'processing facilities' would be covered under the exclusion paragraphs of AS 6 and AS 10 as reproduced in paragraph 11 above. Therefore, the accounting treatment recommended under the Guidance Note on Accounting for Oil and Gas Producing Activities would be applicable to the company. However, the Committee is of the view that since the provisions of a statute prevail over the pronouncements issued by the Institute of Chartered Accountants of India, requirements of Schedule XIV to the Companies Act, 1956 shall prevail over the provisions of the Guidance Note. Accordingly, the company should charge deprecition on the 'processing facilities' on the basis of the rates prescribed under Schedule XIV instead of on the basis of the UoP method of charging depreciation recommended under the Guidance Note.

13. As regards re-computation of depreciation in accordance with Schedule XIV to the Companies Act, 1956 for the limited purpose of computation of

profits for sections 205, 349 and 350 of the Act, the Committee notes paragraphs 7, 8, 9 and 10 of the Guidance Note on Accounting for Depreciation in Companies, issued by the Institute of Chartered Accountants of India, which provide as follows:

> "7. Section 205 of the Companies Act requires that no dividend shall be declared or paid by a company except out of the profits of the company arrived at after providing for depreciation in accordance with the provisions of sub-section 2 of that Section. This sub-section allows the company to provide for depreciation either in the manner specified in Section 350 of the Act or in the alternative manners specified in that sub-section itself. Part II of Schedule VI further provides that if no provision for depreciation is made, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act shall be disclosed by way of a note.
>
> 8. A question may arise as to whether it is obligatory on a company to provide for depreciation only on the basis mentioned in Section 205(2) read with section 350 and Schedule XIV of the Act or whether these bases can be considered as indicating the minimum depreciation which must be provided by the company, insofar as the accounts of the company are concerned and insofar as it is required to exhibit a true and fair view of the state of affairs of the company as on a given date and of the profit or loss for the year.
>
> 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.

10. This view is supported by the Department of Company Affairs and it has clarified that "the rates as contained in Schedule XIV should be viewed as the minimum rates, and, therefore, a company will not be permitted to charge depreciation at rates lower than those specified in the Schedule in relation to assets purchased after the date of applicability of the Schedule. If, however, on the basis of bona fide technological evaluation, higher rates of depreciation are justified, they may be provided with proper disclosure by way of a note forming part of annual accounts"[2]."

From the above, the Committee is of the view that in order to provide true and fair view of the state of affairs of the company and of the profit or loss for the year, depreciation should be provided as per the rates given 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

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

(i) Whether the assets/facilities as described under paragraph 2B above would be covered under the exclusion scope given under paragraph 3(ii) of AS 10 and paragraph 1(ii) of AS 6 would depend upon whether the processing performed by these assets/facilities is a part of production process during the extraction of oil or whether such processing is carried out thereafter as discussed in paragraphs 10, 11 and 12 above.

(ii) In order to provide true and fair view of the state of affairs of the company and of the profit or loss for the year, under both the situations described in (i) above, depreciation should be provided at the rates given under Schedule XIV to the Companies Act,

[2] Circular No. 2/89, dated March 7, 1989.

1956, which prescribes the minimum rates of depreciation instead of on the basis of the UoP method of charging depreciation recommended under the Guidance Note on Accounting for Oil and Gas Producing Activities. 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. Refer paragraphs 11, 12 and 13 above. The question of re-computation of depreciation in accordance with Schedule XIV to the Companies Act, 1956, for the purpose of computation of profits for sections 205, 349 and 350 of the Act, therefore, does not arise.

Query No. 11

Subject: Treatment of minimum level of heel metal required to be maintained in the pots in Smelter Plant.[1]

A. Facts of the Case

1. A company is a public sector company under the administrative control of the Ministry of Mines, Government of India and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power in captive power plant for use in Smelter Plant and selling alumina and aluminium both in domestic and international markets. It has a capacity to produce 15,75,000 M.T. of calcined alumina, 3,45,000 M.T. of aluminium ingots per annum, and 960 M.U. of power.

2. For production of 3.45 lakh M.T. of aluminium per annum, the company has installed a smelting plant having 720 pots. According to the querist, the pots are nothing but aluminium reduction cells in which metallic aluminium is produced commercially by the electrolysis of alumina in a liquid bath cryolite. Each pot consists of a steel shell set up on substantial foundation

[1] Opinion finalised by the Committee on 11.5.2010

and a carbon lining. The space within the lining is usually about half a metre deep. For electrolytic process, electric current is passed through anodes suspended from above and partly dipped in the liquid bath of cryolite. The pot cells act as cathode.

3. The querist has stated that 480 pots were capitalised in a phased manner during the period 1987-88 to 1995-96. In line with the provisions of the Guidance Note on Treatment of Expenditure during Construction period[2], issued by the Institute of Chartered Accountant of India, the expenses incurred on start-up and commissioning of the pots including the expenditure incurred on trial runs and revenue earned out of sale of metal produced during the trial run were accumulated under 'Incidental Expenditure During Construction (IEDC) Account'. Once the process started giving stabilised production, the net of expenses/income under IEDC were capitalised along with the cost of plant. It has been further clarified by the querist that the debit to the IEDC on account of trial production are of two types, i.e., the cost of raw-materials incurred one time and the cost of raw materials which is recurring. Similarly, the credit to IEDC Account are of two types, i.e., sale and accretion of stock of metal produced out of trial run. However, the in-process materials available inside the pot on the date of declaration of commercial production were neither valued nor credited to IEDC Account. In other words, the cost of in-process materials (i.e., heel metal) formed part of capital cost.

4. In the process of electrolysis, alumina (AL 203) is decomposed and reduced to molten aluminium which is known as hot metal. During the course of pot start–up, either molten metal is poured into new pots or the pots are directly heated to enable decomposition of dry alumina.

5. The contents within the lining of a pot can be divided into three layers. The bottom (approx. 20 cm.) contains the hot metal which is required to be maintained in the pot for maintaining the temperature and other technical balances. This may be called as minimum level of hot metal. The middle layer consists of metal which can be tapped and taken out. In other words, when the hot metal exceeds the minimum level in the production process, the excess quantity is the metal produced and tapped. The third and top

[2] The Guidance Note on Treatment of Expenditure during Construction Period has been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision taken at its 280th meeting held on August 7-9, 2008.

layer consists of cryolite bath which is approximately 20 cm. The approximate quantity of hot metal per cm depth is 0.5 M.T. Hence, approximately 10 M.T. of hot metal is the minimum level always lying in the pot for its lifetime.

6. The querist has stated that the metal in the pot is assessed by dip measurement process by technical team as on 31st March each year for the purpose of valuation of in-process stock.

7. The accounting policy followed by the company in respect of hot metal prior to financial year 1995-96 is given below:

> "In-process materials are not valued in view of the fact that the entire initial fill for the process has already been capitalised, the quantum thereof at the opening and closing date of the year remaining more or less at the same level and such stocks are not measurable accurately."

8. During the audit of accounts for the financial year 1995-96, Comptroller and Auditor General of India (C&AG) auditors differed and observed that "It is not a fact that quantum of in-process material at the opening and closing date of the year remain at the same level and that such stock are not measurable. The quantum of in-process material varies with fluctuations in the number of pots actually in operation".

9. The querist has stated that in response to the aforesaid observation of the C&AG auditors, the company undertook to seek an opinion from the Expert Advisory Committee of the Institute of Chartered Accountants of India, and the Committee opined as below:

> "(i) The accounting policy on valuation of work-in-progress followed by the company is not proper.
>
> (ii) The work-in-progress has to be valued at the end of a financial year irrespective of the fluctuations in the opening and closing number of pots."

10. Accordingly, as per the querist, for pots capitalised after 1995-96, the value of entire in-process material (heel metal) lying in pots at the time of capitalisation were not capitalised on the basis of the aforesaid opinion.

11. The querist has further stated that the life of a pot is taken as 18 years and depreciation @ 5.28% on straight-line method is provided each year. Pot relining is a regular maintenance activity carried out every 4-5 years

(2500 days). For relining, the closing heel metal available in the pot is evacuated (known as pot de-lining) and poured into the other live pot, where it is converted into finished goods and subsequently sold. Similarly, during relined pot start-up, molten metal is poured into the relined pot.

12. As per the querist, in the financial year 2008-09, 120 pots of 2nd phase expansion of Smelter Plants have been capitalised and the entire in-process material available in the pots has been considered as in-process stock. The statutory auditors are differing to such accounting treatment and are of the opinion that the minimum level of hot metal in the bottom layer of pot (approximately 10 M.T.) which is required to be maintained in the pot to manufacture aluminium from alumina till delining and acting as part of plant and machinery should form part of the capital cost and any stock beyond that only should form part of inventory.

B. Query

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

(i) Whether the accounting policy adopted by the company, based on the earlier opinion of the Expert Advisory Committee (published as Query No. 1.12 of Volume XVII of the Compendium of Opinions) on non-capitalisation of minimum level of heel metal required for producing aluminium from alumina (acting as part of plant and machinery) and considering it as stock in-process is correct.

(ii) Whether a separate treatment is required for the minimum level of heel metal during re-lining of pots in case the same is capitalised.

C. Points considered by the Committee

14. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to the manner of recognition of the minimum quantity of hot metal (i.e., heel metal) which is required to be maintained in the pot due to technical reasons during the process of production of aluminium, i.e., whether such metal should be capitalised with the plant and machinery or should be considered as in-process material (inventory). The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, valuation

of the in-process heel metal at the close of the financial year, accounting treatment followed by the company in respect of pots capitalised upto the financial year 1995-96, depreciation of pots, accounting for other materials, such as, cryolite, etc. used during production, etc.

15. The Committee notes from the Facts of the Case that a minimum quantity of hot metal (heel metal) is always required to be maintained in a pot during the process of production for technical reasons (to maintain the desired temperature and other technical balances) in order to produce aluminium and the excess quantity of hot metal in the pot is the metal produced and tapped. Further, the Committee notes that during delining (which is a regular maintenance activity), such metal is evacuated and poured into another live pot where it is converted into finished goods and sold. Thus, it is not the same metal which stays in the pot for the life time, it is only the *quantity* of the metal which is to be maintained in the pot. Therefore, the initial level of heel metal poured into the pot may have been converted into finished goods and sold. The Committee also notes that during the course of pot start-up, either molten metal is poured into new pots or the pots are directly heated to enable decomposition of alumina (paragraph 4 above). Thus, in the view of the Committee, this minimum level of heel metal in the pot facilitates production. Although it is used in the production of aluminium, it cannot be considered of the nature of a plant and machinery, through which the raw material is converted into finished product. In this context, the Committee notes the definition of the term 'inventories' given in paragraph 3 of Accounting Standard (AS) 2, 'Valuation of inventories', and paragraph 4 thereof, which provide as follows:

> **"*<u>Inventories</u> are assets*:**
>
> ***(a) held for sale in the ordinary course of business;***
>
> ***(b) in the process of production for such sale; or***
>
> ***(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."***
>
> "4. …Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise…"

From the above, the Committee is of the view that the minimum quantity of heel metal in the extant case is the material-in-progress which is being produced by the enterprise and accordingly, it should be shown and treated as 'inventory' in the books of account of the company.

D. Opinion

16. On the basis of the above and subject to paragraph 14 above, the Committee is of the following opinion on the issues raised in paragraph 13 above:

(i) The accounting policy of the company of non-capitalisation of minimum level of heel metal required for producing aluminium from alumina and considering it as stock-in-process is correct.

(ii) Answer to this question does not arise as the minimum level of heel metal is not to be capitalised in the extant case.

Query No. 12

Subject: Revenue recognition in respect of F.O.R. destination sales.[1]

A. Facts of the Case

1. A company in the field of telecommunications, is engaged in manufacturing and supply of various telecom products, providing network solutions, manufacturing of mobile infrastructure equipment, etc. The company is having manufacturing facilities at various locations, viz., Mankapur, Raebareli, Bangalore, Palakkad, Naini, Srinagar and has various regional and area offices in all major cities besides a Network System Unit for extending various service support to customers. The supplies and services of the company are mainly to customers, like, public sector telecommunication enterprises, Defence, Railways, etc. All the supplies and services are executed through purchase orders received from the above customers, which

[1] Opinion finalised by the Committee on 11.5.2010

are generally based on tenders. Most of the tenders call for quotes which are all inclusive (inclusive of freight, insurance, etc.). In respect of orders from public sector telecommunication enterprises, equipment undergoes quality check by the customer at the manufacturing unit before the same is handed over to carrier for despatch to the destination as per the customer's requirement.

2. The querist has stated that upto the financial year 2007-08, the company was consistently following the practice of accounting for such sales and services as per its accounting policy for revenue recognition which reads as under:

> *"Significant Accounting Policy No. 9*
>
> Revenue from customer accepted sale of goods/other sale of goods is recognised on the date of despatch of goods from the company's premises to the customer. Goods ready for despatch but held in the company's premises at the customers' specific requests are also recognised as sale of goods."

3. As per the querist, based on the said accounting policy, sales were accounted if the materials were handed over to carriers on or before 31st March. This is evident from the date of Lorry Receipt (L/R) or Railway Receipt (R/R). Even though materials reach the customer after the end of the accounting period, sales were accounted for based on the date of carrier receipt, viz., lorry receipt date or railway receipt date. This practice of accounting for sales was not acceptable to the Comptroller and Auditor General of India (C&AG) for F.O.R. destination contracts. During the audit of accounts for the financial year 2007-08, C&AG raised an audit query stating that since such contracts are F.O.R. destination, it is necessary that materials should reach the customer before the closure of accounting period if these are to be accounted for as sales. Their contention was that as materials have not reached the customer before 31st March, such despatches cannot be considered for revenue recognition as sales, since the risks and rewards of ownership are not passed on to the customer on the date of such despatches. As per the auditor, such despatches which are not likely to reach the customer before the end of the accounting period should not be accounted for as sales and should be treated as finished goods inventory (stock- in-transit). During the audit, the company gave an assurance to C&AG that the accounting policy on revenue recognition will be reviewed during the financial year 2008-09 and suitable modification in the accounting

policy will be made. In view of the said assurance, during the financial year 2008-09, the company has modified its accounting policy as follows:

> "Revenue from customer accepted sale of goods/other sale of goods is recognised on the date of despatch of goods from the company's premises to the customer. In the case of F.O.R. destination contracts, if there is a reasonable expectation of the goods reaching destination within the accounting period, revenue is recognised. Goods ready for despatch but held in the company's premises at the customer's specific request are also recognised as sale of goods".

4. According to the querist, in view of the said modification, revenue is recognised based on reasonable estimation of the materials reaching the destination. This process of assessing the reasonable expectation of goods reaching the destination is creating a practical difficulty. Besides, since goods have already moved out of the manufacturing area before 31^{st} March, excise duty has to be paid and many states insist for payment of sales tax also. Hence, paying these amounts and not accounting for as sales may create issues concerned with sales tax assessment. The querist has also pointed out that in his opinion, the requirements as to performance (reproduced below) as set out in paragraph 11 of Accounting Standard (AS) 9, 'Revenue Recognition', were satisfied in the earlier accounting policy itself:

> ***"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."***

5. The querist has also referred to an earlier opinion given by the Expert Advisory Committee (Query No. 1.21 of Volume VIII of the Compendium of

Opinions) wherein, the Committee has opined that the company can book sales as soon as the goods are delivered to transporters if the entity does not retain significant risks and rewards of ownership in the goods. In the instant case, according to the querist, even though the company has taken the responsibility for transit insurance, it does not retain any significant risks and rewards of ownership in the goods.

B. Query

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

(i) Whether the present (modified) accounting policy of the company is in order and if so, how assessment of the reasonable expectation of materials reaching the destination can be made.

(ii) Whether the company can revert to the earlier accounting policy of recognition of revenue based on the date of despatch of materials to the carrier.

C. Points considered by the Committee

7. The Committee notes that the querist has raised the query in respect of its accounting policy in case of F.O.R. destination contracts with respect to which the auditor has raised a query during the audit of accounts for the financial year 2007-08. The Committee has therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for goods ready for despatch but held in the company's premises at the customer's specific request, revenue recognition in case of customer accepted sale of goods/other sale of goods, etc. Further, the Committee's opinion contained herein is only from the accounting point of view and not from the point of view of interpreting any provisions of law or statute, e.g., those relating to excise duty or sales tax, etc. The Committee also notes that there is no specific contract or case referred to by the querist in the extant case, for instance, it is stated in the Facts that *most of the tenders* call for quotes which are all inclusive (inclusive of freight, insurance, etc.). It is also stated that all the supplies and services are executed through purchase orders received from the customers, which are *generally based on tenders.* Further, *in respect of orders from public sector telecommunication enterprises*, equipment undergoes quality check by the customer at the manufacturing unit before the same is handed over

to carrier for despatch to the destination as per the customer's requirement. Thus, from the Facts of the Case, all contracts *do not seem to be identical.* Accordingly, the opinion expressed hereinafter is based on the general principles to be followed while recognising revenue in respect of F.O.R. destination contracts.

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

> "6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. *However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.* Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes." (Emphasis supplied by the Committee.)
>
> ***"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.***
>
> ***11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:***
>
> > ***(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and***

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

9. The Committee notes from the above that the time of transfer of all significant risks and rewards of ownership may be different from the time of transfer of legal ownership, and that for accounting purposes, revenue in such cases should be recognised at the time of transfer of significant risks and rewards of ownership to the buyer. The Committee is of the view that the question when the transfer of significant risks and rewards of ownership takes place depends on particular facts and circumstances of the case, including the terms of the contract, express and/or implied, and the conduct of the parties. Various factors should be considered for ascertaining the timing of passing of significant risks and rewards of ownership. For example, factors like, who bears the risk of damage during transit, whether the goods produced are substantially complete, whether the company can sell the goods to another party or pledge the same after handing over of the goods to the carrier, etc., will have to be taken into account in determining the timing of transfer of significant risks and rewards of ownership. Accordingly, the Committee is of the view that revenue should be recognised as soon as the significant risks and rewards of ownership of goods have been passed on to the buyer and other conditions as stipulated in AS 9 have been fulfilled. In the view of the Committee, for recognising revenue, the date of despatch of materials to the carrier or receipt of the material by the customer are not relevant, as being argued in the Facts of the Case.

D. Opinion

10. On the basis of the above and subject to the considerations stated in paragraph 7 above, the Committee is of the following opinion on the issues raised in paragraph 6 above:

(i) Revenue should be recognised as soon as the significant risks and rewards of ownership of goods have been passed on to the buyer and other conditions as stipulated in AS 9 have been fulfilled. For recognising revenue, the date of despatch of materials to the carrier or receipt of the material by the customer are not relevant as discussed in paragraph 9 above. Accordingly, the wording of the present (modified) accounting policy of the company is not in order in respect of F.O.R. destination contracts. In view of the above, the question of making assessment of the reasonable expectation of materials reaching the destination does not arise.

(ii) The company can revert to the earlier accounting policy of the company, provided on the date of despatch of materials to the carrier, the significant risks and rewards of ownership in respect of materials are transferred to the buyer. See paragraph 9 above.

Query No. 13

Subject: Treatment of some of the units of one segment as a part of another segment – whether appropriate.[1]

A. Facts of the Case

1. A company is a public sector enterprise under the administrative control of the Ministry of Mines, Government of India, and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power at captive power plant for use in Smelter, and selling of alumina and aluminium both in domestic and international markets. The company has four production units (i) a fully mechanised open cast Bauxite Mine having excavation capacity of 48,00,000 tonnes per annum (ii) Aluminium Refinery having production capacity of 15,75,000 tonnes per annum (iii) Captive Power Plant having 8 units of 120 MW each to generate power and (iv) Smelter Plant of 3,45,000 M.T. per annum capacity.

2. Mines Division, which is located on hills, serves feed-stock to the Alumina Refinery located 16 KM downhill. The Refinery provides alumina to the company's Smelter Plant which is about 600 KM away by a specially designed alumina wagon by rail transport. For production of 1 MT of Alumina at Smelter, 13,600 KWH of power is required, which is met by generation of power at Captive Power Plant situated at a distance of 4 KM. Cost of power constitutes about 30% of cost of production of aluminium. Captive Power

[1] Opinion finalised by the Committee on 23.7.2010

Plant is set up exclusively to supply uninterrupted power to Smelter. It is also connected to State Grid to take care of the supply of emergency power to Smelter in case of any break-down or failure at Captive Power Plant. Any surplus power after meeting the requirement of Smelter is automatically transmitted to State Grid and treated as sale, as per agreement with company 'G', which is a State Government undertaking.

3. The company has identified the following three reportable segments on the basis of the type of products:

(i) Chemical Segment – For Bauxite Mining and Alumina Plant

(ii) Power Segment – For Captive Power Plant

(iii) Aluminium – For Smelter Plant

4. The querist has stated that the company has identified the reportable segments in line with the provisions of paragraph 27 (a), (b) and (c) of Accounting Standard (AS) 17, 'Segment Reporting'.

5. The querist has referred to an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the subject, 'Transfer price for the purpose of segment reporting' (published as Query No. 16 of Volume XXIX of the Compendium of Opinions), issued to the querist. Paragraph 15 of the said opinion, inter alia, states as below:

> "The Committee is of the view that as per AS 17, an enterprise is free to choose any appropriate pricing policy for inter-segment transfers, for example, at cost, or cost plus a fixed return, or market price of the product, etc."

6. The querist has further stated that the Captive Power Plant segment of the enterprise is on the verge of completion of its second phase expansion consisting of two more units (9^{th} & 10^{th}) of 120 MW. On completion of 9^{th} and 10^{th} units, the company will have surplus power of 100 MW. Though third party sale of power is legally permitted, the State Government generally discourages sale of power to third parties. However, in the instant case, as per formal discussion, company G has agreed not to raise any objection in case the company agrees to sell minimum fixed 40 MW of surplus power to company G. Accordingly, balance 60 MW can be sold to third parties at a higher rate.

B. Query

7. In the light of the above facts and the fact that as regards power segment, it has already been opined that the management is free to choose any appropriate pricing policy for inter-segment transfer, the querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the issue as to whether, after completion of 2nd phase expansion, i.e., 9th and 10th units of Captive Power Plant, the company can identify and treat some of the units of Captive Power Plant (Power Segment) as part of Smelter Plant and the remaining units as part of independent power producer company so that the transfer price of power to aluminium Smelter can be at cost price of Captive Power Plant units attached to Smelter. If yes, whether the segment report will be prepared only for the units treated as part of independent power producer company. The querist has clarified that the company does not have the intent of creating a separate legal entity for units identified as part of independent power producer company.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to treatment of some of the units of Captive Power Plant which supply power to Smelter plant as part of the Segment relating to Smelter Plant so that the transfer price of power to Smelter Plant can be at cost, and treatment of remaining units as a separate segment (power segment) so as to use market price of power for those units for the purpose of segment reporting. 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, any issue that may arise from the Facts of the Case of the earlier opinion referred by the querist, etc.

9. The Committee notes the definition of the term 'business segment' as contained in AS 17, notified under the Companies (Accounting Standards) Rules, 2006, which is reproduced below:

> ***"A <u>business segment</u> 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."***

The Committee notes that according to the definition of the term 'busienss segment' as per AS 17 reproduced above, if the various products of the company are subject to different risks and returns, these would constitute different business segments. However, if the products are not subject to different risks and returns, they would not constitute different business segments. The Committee notes from the Facts of the Case that the company has identified three reportable segments, viz., (i) Chemical Segment (for Bauxite Mining and Alumina Plant), (ii) Power Segment (for Captive Power Plant), and (iii) Aluminium (for Smelter Plant), on the basis of the type of products and in line with the provisions of paragraph 27(a), (b) and (c) of AS 17. Thus, the company itself recognises that the above are three separate segments for the purpose of reporting under AS 17. Accordingly, in the absence of any information to the contrary, the Committee presumes that the company has correctly determined the business segments, and, therefore, the three segments represent different risks and returns.

10. The Committee further notes from the Facts of the Case that it is upon completion of additional units of Captive Power Plant when the company will have surplus power for sale to external parties, that the company wishes to treat only some of the units whose product (i.e., power) will be sold to external parties as a separate segment, i.e., Power; and treat the units whose product (i.e. power) is being used for captive consumption for Smelter Plant as part of the segment constituting Smelter Plant, i.e., Aluminium. The Committee is of the view that determination of business segments depends on the different risks and returns associated with the different products produced by a company. The sale of a portion of a particular product to the external customers or the use of a portion of a particular

product for captive consumption, does not alter the risks and rewards associated with that product. In this context, the Committee notes that paragraph 40 of AS 17 requires, inter alia, disclosure of the following for each reportable segment:

> ***"(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments".***

Accordingly, the Committee is of the view that in the case of the company, power segment should constitute all the units producing power irrespective of whether power is being used for captive consumption or being sold to external customers.

11. In respect of reporting of the segment result, the Committee notes the definitions of the terms 'segment revenue', 'enterprise revenue' and paragraph 53 of AS 17 which provide as follows:

> ***"Segment revenue is the aggregate of***
>
> ***(i) the portion of enterprise revenue that is directly attributable to a segment,***
>
> ***(ii) the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and***
>
> ***(iii) revenue from transactions with other segments of the enterprise".***
>
> ***"Enterprise revenue is revenue from sales to external customers as reported in the statement of profit and loss."***
>
> ***"53. In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements."***

From the above, the Committee is of the view that in the case of the company, the segment revenue for power segment would comprise the revenue earned from sale of power to external customers and the revenue on account of inter-segment transfer of power at the price actually used to price those transfers. As far as the Smelter Plant is concerned, i.e., the segment which is receiving the product from the power segment, the price actually used to price the transfer of power consumed, would constitute cost for Smelter Plant segment (i.e., Aluminium segment).

D. Opinion

12. On the basis of the above, the Committee is of the opinion that in the case of the company, power segment should constitute all the units producing power irrespective of whether power is being used for captive consumption or being sold to external customers and accordingly, the company cannot identify and treat some of its units of Captive Power Plant as part of Smelter and remaining units as a separate segment. While reporting segment results under AS 17, the actual price that is charged from external customers (viz., sale price) and the actual price that is used for inter-segment transfers should be used.

Query No. 14

Subject: Accounting treatment of advance to subsidiary pending finalisation of modalities of issue of the shares.[1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as the 'company'), which is a 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 acquired 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 a right in the properties/blocks.

2. A Cyprus based company (hereinafter referred to as 'ABC'), has been acquired (100% of share capital) by the company. During the same year,

[1] Opinion finalised by the Committee on 23.7.2010

ABC acquired the 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 the intention to treat it as share application money without entering into any formal agreement at the time of remittances. Further, the company has advanced USD 53 million equivalent to Rs. 2,635 million to ABC for XYZ's business requirements.

3. Subsequently, the company entered into a 'Shareholders' Investment Agreement' with ABC. As per the terms of Shareholders' Investment Agreement, ABC will issue preference/equity shares at a mutually agreed premium rate. The agreement makes 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 of the shares like, nature of shares (i.e., equity/preference shares), number of shares, face value and premium, etc., are firmed up till the balance sheet date. No written agreement is in place regarding settlement of advance of USD 53 million given for meeting XYZ's business requirements. However, the company intends to convert this advance also into equity/preference shares and the advance is not likely to be refunded in near future.

4. As the shares are yet to be issued, the amount paid by the company to ABC has been shown as 'Advance to ABC' in the Schedule, 'Loans and Advances' in the stand-alone financial statements of the company.

5. The company intends to convert the advances of USD 1,975 million (USD 1,922 million for financing acquisition of XYZ as well as USD 53 million for financing business requirements of XYZ) into equity/preference shares. Thus, as per the querist, the advance given to ABC, was considered as an extension to the company's net investment in ABC, which is a non-integral foreign operation and, therefore, the net investments in ABC were revalued and accounted for in accordance with the requirements of paragraphs 15 and 16 of Accounting Standard (AS) 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates'. The company revalued the advance of USD 1,975 million at the foreign exchange rate at the year-end rate, increasing advances by Rs. 442 crore consisting of Rs. 434 crore due to revaluation of advance amounting to USD 1,922 million towards financing acquisition cost of XYZ and Rs. 8 crore due to revaluation of advance amount of USD 53 million towards financing business requirements of XYZ.

The credit for the same amount was given to 'Foreign Exchange Translation Reserve'.

6. The querist has stated that the C&AG auditors, while carrying out their review under section 619(3)(b) of the Companies Act, 1956, objected to the above accounting treatment of showing the amount of USD 1,922 million paid to ABC towards financing acquisition cost of XYZ as 'Advance', as, in their view, the amount should be shown as 'Investment (Share Application Money pending allotment)' and, therefore, should not be revalued in accordance with Accounting Standard (AS) 13, 'Accounting for Investments'.

7. Further, as stated by the querist, the C&AG auditors questioned the credit of Rs. 8 crore arising on revaluation of amount of advance of USD 53 million towards financing business requirements of XYZ to 'Foreign Exchange Translation Reserve' instead of taking it to the profit and loss account as, in their view, the foreign exchange revaluation gain is of revenue nature.

B. Query

8. In view of the above stated facts, the querist has sought the opinion of the Expert Advisory Committee on the appropriate accounting treatment of advances so paid and treatment of foreign exchange gain/loss arising on revaluation thereof, i.e.,

(a) Whether the accounting treatment followed by the company in treating payment of USD 1,975 million as 'Advance to ABC', revaluation of advances and credit of foreign exchange revaluation gains to 'Foreign Exchange Translation Reserve' is appropriate; or

(b) Whether views of the C&AG auditors that (i) the advance of USD 1,922 million should be shown as Investment, (ii) it should not be revalued and (iii) that the foreign exchange gain arising on revaluation of advance of USD 53 million given for meeting business requirements of XYZ is a revenue gain, is appropriate; or

(c) Whether there is any other appropriate accounting treatment / disclosure of the sum paid to ABC and revaluation thereof.

C. Points considered by the Committee

9. The Committee, while answering the query, has considered only the

issues raised by the querist in paragraph 8 above and has not touched upon 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, 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 (revised 2003).

10. The Committee is of the view that the accounting treatment in the extant case would depend upon whether the funds advanced to ABC for acquisition of shares in XYZ and for meeting XYZ's business requirements can be regarded as a monetary item or as a non-monetary item. The Committee notes the following paragraphs from Accounting Standard (AS) 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates':

> ***"7.11 <u>Monetary items</u> are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money."***
>
> ***"7.14 <u>Non-monetary items</u> are assets and liabilities other than monetary items."***
>
> "12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non- monetary items. ..."

11. The Committee notes from the Facts of the Case that in respect of the advance of USD 1922 million, 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. The Committee notes in respect of advance of USD 53 million made by the company to ABC that the company intends to convert this advance also into equity/preference shares, however, no agreement in respect thereof has been entered into or any modality for such conversion has been decided till the balance sheet date. Accordingly, the Committee is of the view that both the advances are of the nature of monetary items.

12. For determining the treatment of 'monetary items', the Committee notes the following paragraphs of AS 11 (revised 2003):

> ***"11. At each balance sheet date:***
>
> ***(a) foreign currency monetary items should be reported using the closing rate. ..."***
>
> ***"13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15."***
>
> **Net Investment in a Non-integral Foreign Operation**
>
> ***"15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expense in accordance with paragraph 31.***
>
> 16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables."

From the above, the Committee is of the view that the two advances of USD 1922 million and USD 53 million, should be reported using the closing rate. The Committee presumes that since the intention of the company is to convert both the advances into equity/preference share capital, settlement of the advances is neither planned nor likely to occur in the foreseeable future (as envisaged in paragraph 16 of AS 11 (revised 2003) reproduced above). In such a case, keeping in view that ABC is a non-integral operation of the company, in substance, the advances 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 (revised 2003) reproduced above. 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 (revised 2003).

13. With respect to the disclosure of the advances in the financial statements of the company, the Committee is of the view that these advances should be disclosed under the head which most appropriately reflects their nature. Accordingly, the advances should be disclosed under the head 'loans and advances' with appropriate disclosure regarding their nature.

D. Opinion

14. On the basis of the above, and subject to the presumptions stated in paragraph 9 above, the Committee is of the following opinion on the issues raised in paragraph 8 above:

(a) Accounting treatment followed by the company in treating payment of USD 1975 million as advance to ABC, revaluation of advances and credit of foreign exchange revaluation gains to 'Foreign Exchange Translation Reserve' is appropriate subject to the presumption stated in paragraph 12 with respect to the settlement of advances. See paragraph 12 above.

(b) The views of the C&AG auditors that the advance of USD 1922 million should be shown under the head 'investment', and should not be revalued, is not appropriate. The view of the C&AG auditors that the foreign exchange gain arising on revaluation of advance of USD 53 million should be treated as a revenue gain, would be appropriate only if the presumption stated in paragraph 12 above with respect to the settlement of advance does not hold good. See paragraph 12 above.

(c) For appropriate accounting treatment/disclosure of the advance of USD 1975 million, see paragraphs 11, 12, and 13 above.

Query No. 15

Subject: Deferred tax asset/liability in respect of Held to Maturity Investments and provision for bad and doubtful debts in the case of banks.[1]

A. Facts of the Case

1. The querist has quoted the following paragraphs from Accounting Standard (AS) 22, 'Accounting for Taxes on Income':

> "5. Taxable income is calculated in accordance with tax laws. In some circumstances, the requirements of these laws to compute taxable income differ from the accounting policies applied to determine accounting income. The effect of this difference is that the taxable income and accounting income may not be the same.
>
> 6. The differences between taxable income and accounting income can be classified into permanent differences and timing differences. Permanent differences are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference.
>
> 7. Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. Another

[1] Opinion finalised by the Committee on 23.7.2010

> example of timing difference is a situation where, for the purpose of computing taxable income, tax laws allow depreciation on the basis of the written down value method, whereas for accounting purposes, straight line method is used. ..."

2. According to the querist, although the principles laid down in AS 22 are spelt out, the application of these principles in practice has posed certain issues for banks. It is observed that in banking companies, there have been large variations in the application of AS 22. The querist has observed that the treatment for deferred tax calculation differs particularly in deferred tax on investments classified as Held to Maturity and deferred tax on provision for bad and doubtful debts.

Deferred tax on Investments (Held to Maturity)

3. The querist has stated that as per RBI Regulations, all the banks are allowed to maintain 25% of its total investment as "Held to Maturity" and the quantum of 25% should not be more than the DTL (Demand and Time Liability).

4. The treatment of investments in the books of account of a banking company is primarily governed by the RBI Guidelines. The querist has summarised the RBI guidelines for long term investments (Held to Maturity) as follows:

> Investments classified under the held to maturity category need not be marked to market. They should be carried at acquisition cost, unless it is more than face value, in which case the premium is amortised over the unexpired period till maturity. Diminution in value of investments under 'held to maturity category' is to be provided only if such diminution is other than temporary in nature.

5. The querist has stated that tax considerations for depreciation on investments were initially governed by the CBDT Circular No. 665 dated 5th October, 1993. In the said circular, it was stated that "...the Assessing Officers should determine on the facts and circumstances of each case as to whether any particular security constitutes stock-in-trade or investment taking into account the guidelines issued by the Reserve Bank of India in this regard from time to time". Therefore, Assessing Officers had the power to segregate the securities into investments and stock in trade based on the guidelines issued by the RBI. Consequently, the banks did not have an

option to take the mark to market benefit on investments held under the Held to Maturity (HTM) category.

6. However, as per the querist, the guidelines and clarifications issued by the above circular seem to have been diluted by the Supreme Court decision in United Commercial Bank vs. Commissioner of Income Tax (1999) 240 ITR 355 (SC). In the said decision, the Supreme Court has held that "Preparation of the balance-sheet in accordance with the statutory provision would not disentitle the assessee in submitting the income-tax return on the real taxable income in accordance with a method of accounting adopted by the assessee consistently and regularly. That cannot be discarded by the departmental authorities on the ground that the assessee was maintaining the balance-sheet in the statutory form on the basis of the cost of the investments. In such cases, there is no question of following two different methods for valuing its stock-in-trade (investments) because the bank was required to prepare the balance-sheet in the prescribed form and it had no option to change it. For the purpose of income-tax as stated earlier, what is to be taxed is the real income which is to be deduced on the basis of the accounting system regularly maintained by the assessee and that was done by the assessee in the present case."

7. Therefore, as per the querist, based on the rationale laid down by the Supreme Court, if a bank is consistently valuing its stock in trade (investments) at lower of the cost and market price, then it would be entitled to claim the same as deduction, notwithstanding the fact that the same is shown at cost in the balance sheet as per statutory requirements.

8. According to the querist, the difference in the treatment of HTM securities as per books of account and for tax purposes results in a difference between book profits and tax profits till the securities are disposed off. At the time of disposal of such securities, the profit/loss on disposal as recorded in the books of account as well as that offered for tax will be equal to the difference between the cost of acquisition and the sale value of the investment. Therefore, the differences as indicated above will automatically reverse at the time of disposal of the securities. According to the querist, as per AS 22, such a difference will be classified as a timing difference and, thus, will require creation of a deferred tax asset/liability.

Deferred tax on Provision for bad and doubtful debts

9. The querist has further stated that the creation of provision for bad

debts in the books of account of banking companies is governed by the Reserve Bank of India Regulations. As per the relevant RBI Regulations, banking companies have to appropriately classify their advances into four categories as under:

1. Standard Assets
2. Sub-Standard Assets
3. Doubtful Assets
4. Loss Assets

10. Based on the above grouping, RBI has prescribed the rates at which the provision has to be created in the books of banks. This ranges from 10% to 100% (for item 2, 3 and 4) depending upon the various conditions laid down for the advance. These provisions are known as Provision for Non-Performing Assets (NPA). Even for debts which are considered to be not recoverable, a 100% provision is created in the books of account before writing them off as bad. A small percentage provision is also created for all the Standard Assets as per the norms of the RBI.

11. The querist has stated that section 36(1)(viia) of the Income-tax Act, 1961 lays down limits to the extent of which provision for doubtful debts will be allowed as a deduction. Any other bad debts (other than the provision for the year) are allowed as a deduction under section 36 (1)(vii) to a banking company only if the total amount of bad debts written off exceeds the total amount of provision already allowed as a deduction under section 36 (1)(viia).

12. Owing to the above accounting treatment of Provision for Non Performing Advances, there exists a difference in the income as per records maintained for income-tax purposes and income as per the books of account. According to the querist, this is a timing difference that will match in future by way of either recovery or write-off.

B. Query

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

(i) Whether the difference between the value of investment as per the books of account and as per the records created for income tax purposes, which will get cleared when the relevant security is disposed off by the bank, in respect of Held to Maturity investments should be considered for the purpose of deferred tax asset/ liability as per the provisions of timing difference in accordance with AS 22.

(ii) Whether the difference in the provision for bad debts (provision for Non Performing Assets) as per the books of account and as per income-tax is a timing difference and therefore, whether it requires creation of deferred tax asset/liability in accordance with AS 22.

C. Points considered by the Committee

14. The Committee notes that the basic issues raised by the querist are related to deferred tax implications of difference in value of HTM investments for accounting and tax purposes and difference in provision for bad and doubtful debts for accounting and tax purposes, in the situations as specified in the facts of the case. 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, appropriateness of treatment of HTM investments as stock-in-trade for tax purposes. Further, the Committee refrains from expressing any view on the correctness of interpretation of tax treatment by the querist, including present status of CBDT Circular No. 665 dated 5th October, 1993.

15. As per the querist, there is difference between taxable income and accounting income due to difference in valuation of HTM investments for tax purposes and accounting purposes. If such differential valuation is accepted by the Income-tax department, a question arises as to whether the difference is a timing difference or a permanent difference.

16. The Committee notes paragraphs 5, 6 and 7 of AS 22 quoted by the querist in paragraph 1 above. Further, the Committee notes the following definitions given in AS 22:

> ***"4.6 Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.***

> ***4.7 <u>Permanent differences</u> are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.”***

17. From the above, the Committee is of the view that there are two essentialities for timing differences to arise:

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

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

The Committee notes that as per the definitions quoted above, the reversal of the difference can take place at any time in future, i.e., without any time limit.

18. The Committee notes that in case HTM investments are treated as stock-in-trade for tax purposes, though there may be differences between valuation of the investments for tax purposes and accounting purposes at relevant dates, the cumulative effect on profit and loss account from the time of acquisition to the disposal of the investment is same both for accounting and tax purposes. Thus, the difference originating in one period is bound to reverse in one or more subsequent period(s). Therefore, the Committee is of the view that the difference between taxable income and accounting income attributable to the difference in valuation of the HTM securities is a timing difference. Accordingly, the Committee is of the view that the said timing difference should be considered for creation of deferred tax asset/liability in accordance with the provisions of AS 22.

19. As regards provision for bad and doubtful debts, the Committee notes that the querist has stated in paragraph 10 above that before actual write-off, provision is created and that as stated by the querist in paragraph 12 above, there might be difference between provision made for accounting purposes and provision allowed for income-tax purposes, leading to difference between accounting income and taxable income. Further, the querist has stated in paragraph 11 above that any other bad debts (other than the provision for the year) are allowed as a deduction under section 36 (1)(vii) of the ‘Act’, only if the total amount of bad debts written off exceeds the total amount of provision already allowed as a deduction under section 36 (1)(viia). The Committee notes section 36(1)(vii) reads as below:

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

> *"(vii*) subject to the provisions of sub-section (2), the amount of any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year;
>
> **Provided** that in the case of an assessee to which clause (*viia*) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause;
>
> *Explanation:* For the purposes of this clause, any bad debt or part thereof written off as irrecoverable in the accounts of the assessee shall not include any provision for bad and doubtful debts made in the accounts of the assessee".

Without expressing any view on the querist's interpretation of the above provision of the 'Act', the Committee proceeds to examine the issue as per the information and interpretation given by the querist. Thus, provision for bad and doubtful debts precedes actual write-off in accounts and the said provision made in accounts is allowed as a deduction for tax purposes as a combination of provision and write-off over a period of time, if provision allowed as a deduction for tax purposes is less than the provision made in the accounts. In other words, the difference originating in one period is bound to reverse in one or more subsequent period(s). Withdrawal of excess provision, if any, also amounts to, in substance, reversal of timing difference. This may happen, for example, due to partial write-off and partial recovery of a loan. Therefore, the Committee is of the view that the difference between taxable income and accounting income attributable to provision for bad and doubtful debts is a timing difference. As noted in paragraph 17 above, there is no time limit for the reversal of timing differences. Accordingly, the Committee is of the view that the said timing difference should be considered for recognition of deferred tax implications in accordance with the provisions of AS 22. Further, AS 22 contains specific provisions on consideration of prudence for recognition of deferred tax asset, re-assessment of unrecognised deferred tax assets, review of deferred tax assets, write-off and reversal of the same in appropriate circumstances which should be considered while accounting for deferred taxes. In case a written-off loan/

advance is subsequently recovered, either in whole or part, the same will be offered as income for both tax and accounting purposes and hence, there is no deferred tax implication in this regard.

D. Opinion

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

(i) The difference between the value of investment as per the books of account and as per the records created for income tax purposes emerging for Held to Maturity investments should be considered for the purpose of deferred tax asset/ liability as per the provisions in respect of timing difference in accordance with AS 22.

(ii) The difference in the provision for bad debts (Provision for Non Performing Assets) as per the books and as per income-tax is a timing difference and, therefore, it requires recognition of deferred tax effect subject to the considerations of prudence in case of deferred tax asset, in accordance with AS 22, when the tax treatment is as explained by the querist.

Query No. 16

Subject: Disclosure of income tax expense/assets, interest expense and borrowings, etc. in the segment report prepared under consolidated financial statements.[1]

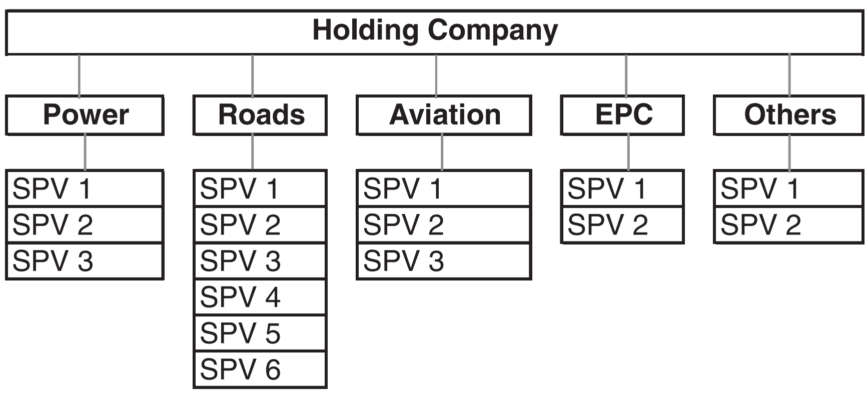
A. Facts of the Case

1. A company is engaged, through its subsidiaries, joint ventures and associates, in generation of power, development of expressways, airport infrastructure facilities and special economic zones. As per the concession

[1] Opinion finalised by the Committee on 23.7.2010

agreements with grantors, the company is required to carry out each of its infrastructure projects through a separately designated Special Purpose Vehicle (SPV) which is either a subsidiary, associate or a joint venture. These SPVs exclusively undertake the project for which these are respectively incorporated and they are not permitted to undertake any other activity. The company is a public company and is listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). The consolidated gross annual turnover of the company for the year ended March 31, 2009 was Rs. 4,476 crore and the networth was Rs. 6,471 crore.

2. As stated above, the company is engaged in the infrastructure business and its present activities are spread across various verticals, such as, Power, Roads, Airports, Engineering, Procurement & Construction (EPC) and other infrastructure projects. The querist has provided the following pictorial representation that depicts the company's structure:



SPVs incorporated for each project are classified/grouped under distinct business sectors and each of these sectors is headed by a Business Chairman assisted by a Chief Executive Officer (CEO) and Chief Financial Officer (CFO). These businesses are reviewed and monitored by the respective business chairmen who are on the boards of the respective SPVs and also on the board of the company (holding company).

3. At present, the company has about 100 subsidiaries/associates/JVs. It prepares its standalone financial statements and also consolidated financial statements. The consolidated financial statements (CFS) include the accounts of the company (standalone) and its subsidiaries, associates and joint ventures. According to the querist, the CFS are prepared in accordance with historical cost convention and comply in all material respects with the

applicable accounting principles in India, the accounting standards notified under section 211(3C) of the Companies Act, 1956 (hereinafter referred to as 'the Act') and other relevant provisions of the Act.

4. The querist has stated that under CFS, segment report of the company and its subsidiaries, associates and joint ventures is prepared considering business segment as the primary segment and geographic segment as the secondary segment. The company has identified the business segments as Power, Roads, Airport, Engineering, Procurement & Construction (EPC) and others. Others include the operations, like, real estate development, investment companies which do not qualify for separate disclosure as segments as per the threshold limits prescribed under Accounting Standard (AS) 17, 'Segment Reporting'. As explained above, each sector has many SPVs which are independently incorporated companies. The company merely holds all these companies by virtue of the equity holding/ownership control. However, each of these SPVs under respective sectors are separate and distinct legal entities.

5. The querist has further stated that each of the SPVs prepares its stand alone annual accounts and has specifically identifiable timing differences for the computation of deferred taxes and specific allowances and disallowances for the computation of current tax. Also, each of the SPVs is individually discharging its tax liability and the books of account of each of these entities also carries the tax assets/provisions (net) distinctly. Hence, for the preparation of consolidated financial statements, the company is of the view that the tax assets/expenses are part of the respective segments only, as the same are distinctly identifiable and directly attributable to those respective sectors/segments. The company has prepared the consolidated segment report accordingly by classifying the tax assets/expenses under each of the respective segments. However, the same is not acceptable to the auditors, who are of the view that the same should be disclosed as an unallocated item in the segment report included in the consolidated accounts.

6. Extending the above arguments, auditors are also of the opinion that interest expense relating to loans borrowed by the SPVs for their projects, overdrafts and other operating liabilities including loans identified with a particular segment should not be included in the segment expense of the consolidated financial statements since the operations of the company are primarily not of a financial nature.

Viewpoint of the Querist

7. The querist has stated that AS 17, as notified under the Companies (Accounting Standards) Rules, 2006 states the objective of the Standard as follows:

> "The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:
>
> (a) better understand the performance of the enterprise;
>
> (b) better assess the risks and returns of the enterprise; and
>
> (c) make more informed judgements about the enterprise as a whole."

The querist has further reproduced paragraphs 11 and 13 of AS 17 as follows:

> "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."

> "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."

(Emphasis supplied by the querist.)

8. The querist further states that paragraph 5.6 of AS 17 defines that segment expense does not include, among others, 'income tax expense', 'interest expense', etc. Paragraph 5.8 of the Standard specifies that ***"segment assets do not include income tax assets"***. Paragraph 5.8 also states that ***"If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets"***. However, the definition of the term "segment expense" also states as follows:

"5.6 <u>Segment expense</u> is the aggregate of

(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

..."

9. The querist has analysed the company's case as follows:

(i) As mentioned in the foregoing paragraphs, the underlying business of each segment is carried through several SPVs which are separate legal entities.

(ii) The performance of each of these segments and the performance of the companies comprised in the segment are internally monitored distinctly by a separate Business Chairman, CEO and CFO who are responsible to the respective Boards of the companies. In accordance with paragraph 13 of AS 17, segment reporting of the company is based on the internal reporting and monitoring framework.

(iii) Each of these companies underlying the segments enjoy different and distinct tax benefits applicable and specific to each such sector/company. Further, interest cost of each segment is directly attributable to the borrowings or operating liabilities of the SPVs falling under the specific sectors/segments. In CFS, the performance evaluation of a segment (which is a sum total of the performance of individual project SPVs) and analysis of segment risks and rewards would be incomplete without considering the tax expense / benefit, interest cost incurred distinct to such segment.

(iv) The tax exposure of each segment is significantly different and unique to the respective segment.

(v) Paragraph 13 of AS 17 states that segment expense/assets/ liabilities include "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"**.** As per the querist, the structure of the company is such that the SPVs under each sector are independently assessed as a legal entity under law and these SPVs carry on one single activity leaving no uncertainty in identifying the segment expenses/assets/liabilities. Accordingly, in the case of the company's consolidated financials, the tax expense/interest cost/asset/liability, can be directly linked/ allocated to a segment and the exclusions stipulated under paragraph 5 of AS 17 are not relevant.

(vi) As these are separate legal entities, the tax expenses are clearly distinguishable to each company/sectors and do not have/involve any presumptions or do not require any allocation/appropriation.

(vii) The essence of disclosing interest cost and tax expense under unallocated segment stems from the rationale that such expenses are common for various segments of a standalone company and cannot be attributable to individual segments at actuals and hence, the same may not be shown as part of any segment. However, this is not the case of a consolidated entity. In the case of a consolidated entity, these expenses are specific to individual SPVs and in the case of the company, such individual SPVs carry on one specified activity only and thus, such expenses are required to be shown under the specific segment to enable the user of the financial statements to assess the performance of the segment.

(viii) Reliance is to be placed on the objective of the Standard and its disclosure requirements for reporting purposes.

(ix) The company also considers the characteristics of relevance, reliability and comparability in presenting the segment report. Tax assets/expenses and interest cost being more directly attributable, are more relevant if the same are disclosed as part of the respective sectors. The same will also be consistent and comparable with the practice followed by the company in the past and makes the financial data more reliable to assess the risks and rewards of each business segment.

(x) Therefore, in order to present more realistic results of the respective segments, it is appropriate to include the interest and tax expense of each of the SPVs under their respective segments itself in case of consolidated accounts.

(xi) The related loans or borrowings corresponding to the interest expenses disclosed under respective segments, as argued by the company, should also be disclosed under the respective segments and the same will be in compliance with the requirements of paragraph 5.8 of AS 17.

In view of the above, the company is of the view that the tax assets/expenses and interest cost & related borrowings thereon should be considered under respective segments for the purposes of disclosure for consolidation purposes.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee as to:

(i) Whether the tax assets/expenses need to be disclosed under respective segments or to be disclosed as 'unallocated' in the segment report of consolidated financial statements.

(ii) Whether interest expense incurred by SPVs coming under individual sectors (which are treated as segments under CFS) needs to be disclosed under respective segments itself or to be disclosed under unallocated/corporate column.

(iii) What would be the position of borrowings/loans taken in each segment while preparing CFS.

C. Points considered by the Committee

11. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 10 above and has not examined any other issue that may arise from the Facts of the Case.

12. The Committee notes paragraph 4 and definitions of the terms 'segment expense', 'segment result', 'segment assets' and 'segment liabilities' as stated in paragraph 5 of AS 17, notified under the Companies (Accounting Standards) Rules, 2006, as follows:

"4. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Standard to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements."

"5.6 <u>Segment expense</u> is the aggregate of

(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

Explanation:

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment are not included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories. In case interest is included as a part of the cost of inventories where it is so required as per AS 16, Borrowing Costs, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest is considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest is disclosed by way of a note to the segment result.

(c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) income tax expense; and

(e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

5.7 <u>Segment result</u> is segment revenue less segment expense.

5.8 <u>Segment assets</u> are those operating assets that are employed by a segment in its operating activities and that either are directly

> ***attributable to the segment or can be allocated to the segment on a reasonable basis.***
>
> ***If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.***
>
> ***Segment assets do not include income tax assets.***
>
> ***…***
>
> ***5.9 Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.***
>
> ***If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.***
>
> ***Segment liabilities do not include income tax liabilities."***

The Committee notes from the above that interest and income tax expense are explicitly excluded from the definition of 'segment expense'. In view of the definition of 'segment result', interest and income tax expense are also excluded from the segment result. Similarly, the Standard specifically excludes income tax assets/liabilities from the segment assets/liabilities. Accordingly, the Committee is of the view that interest and income tax expense in the present case, though being specifically identifiable and related to particular segments cannot be included in the segment expense and accordingly, in the calculation of segment result. Similarly, income tax asset/ liability also cannot be included in the segment assets/liabilities in the segment report of the consolidated financial statements.

13. As far as the reporting of borrowings/loans specifically related to a segment in the consolidated segment report is concerned, the Committee notes from the definition of the term 'segment liabilities', as reproduced in paragraph 12 above, that if the segment result of a segment includes interest expense, its segment liabilities would include the related interest-bearing liabilities. Conversely, the Committee is of the view that if the interest expense is not included in the segment result, segment liabilities would also not include the related interest-bearing liabilities. Accordingly, the Committee is of the view that borrowings/loans, even though, specifically raised by each

segment, cannot be included in the calculation of segment liabilities.

14. The Committee further notes paragraphs 41 and 42 of AS 17 which provide as follows:

> "41. Paragraph 40(b) requires an enterprise to report segment result. If an enterprise can compute segment net profit or loss or some other measure of segment profitability other than segment result, without arbitrary allocations, reporting of such amount(s) in addition to segment result is encouraged. If that measure is prepared on a basis other than the accounting policies adopted for the financial statements of the enterprise, the enterprise will include in its financial statements a clear description of the basis of measurement.
>
> 42. An example of a measure of segment performance above segment result in the statement of profit and loss is gross margin on sales. Examples of measures of segment performance below segment result in the statement of profit and loss are profit or loss from ordinary activities (either before or after income taxes) and net profit or loss."

From the above, the Committee is of the view that the Standard itself encourages, in addition to disclosure of the segment result as discussed above, disclosure of other items relating to the performance of each segment. However, that disclosure should not affect the calculation of segment result. Thus, while the company in the extant case is required to disclose segment expense and segment result without including the interest and income tax expense as stated above, the company, if it so desires, may disclose the performance of each segment after interest and income tax expense. On the same analogy, the Committee is of the view that income tax asset/ liability and loans/borrowings related to the afore-mentioned interest specifically related to a segment, may be provided as additional information apart from segment assets and segment liabilities as per the provisions of AS 17 by way of separate disclosure.

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) The tax assets/expense cannot be included in the segment assets and segment expenses, respectively. However, if the company so desires, it may disclose the performance of each segment after income tax expense and income tax asset as additional information relating to these segments separately, as discussed in paragraph 14 above.

(ii) The interest expense incurred by SPVs coming under individual sectors (which are treated as segments under CFS) cannot be included in the segment expense. However, if the company so desires, it may disclose the performance of each segment after interest expense relating to these segments separately, as discussed in paragraph 14 above, without affecting the 'segment result'.

(iii) The borrowings/loans, even though, specifically raised by each segment, cannot be included in the calculation of segment liabilities, as discussed in paragraph 13 above. However, these may be shown by way of additional information separate from segment liabilities as discussed in paragraph 14 above.

Query No. 17

Subject: Authentication of the financial statements and attached schedules by the auditors.[1]

A. Facts of the Case

1. A development resource organisation is involved in the financial management, legal issues and governance of development organisations in South Asia. In the process of monitoring various projects, it assesses the organisations' financial systems, internal control procedures and other governance issues.

B. Query

2. The querist has sought the opinion of the Expert Advisory Committee

[1] Opinion finalised by the Committee on 23.7.2010

on the issue as to what is the position and responsibility of the auditor with regard to signatures on the financial statements and attached schedules both in the Indian context and internationally. In other words, whether it is obligatory for the auditor to sign on each page of the financial statements that are being certified by him.

C. Points considered by the Committee

3. The Committee notes that the basic issue raised by the querist relates to whether the auditor is obliged to authenticate each page of the financial statements and the attached schedules that are being reported upon or being certified by him. The Committee has, therefore, not touched upon any other issue that may relate to the responsibility of the auditor in any other respect. The Committee also notes that the issue raised in the international context is vague and, therefore, cannot be answered by the Committee.

D. Opinion

4. The Committee is of the opinion that in order to ensure that the financial statements and the attached schedules that are part of/annexed to the financial statements are the ones on which the auditor's report/certificate is being issued, it is necessary for the auditor to authenticate the said documents.

Query No. 18

Subject: Revenue recognition where sale value in foreign currency is covered by a forward contract.[1]

A. Facts of the Case

1. A Limited is a manufacturing company and is listed in Bombay Stock Exchange and National Stock Exchange as a public listed company. The

[1] Opinion finalised by the Committee on 10.1.2011

company has domestic sales as well as export sales (physical exports) and the company has the following forex hedging strategy for currency risk:

(a) The hedged exposures/forecasted cash flows are *highly probable* because these are always based on signed contracts, sales orders and purchase orders (and not on budgets, intentions, etc.).

(b) The *hedge documentation* (such as, the forex policy/procedure, the documentation for each individual hedge, selection of the hedge instruments, etc.) is in place.

(c) There is always a *one-to-one relation* between the hedged exposure and the hedge instrument (no netting, no clubbing together of hedged items).

(d) The relation of hedged item versus hedge instrument is *100% effective* and can be measured accordingly.

(Emphasis supplied by the querist.)

2. After entering into an export order, the company takes forward cover for the full amount of the sales invoice which is receivable in US Dollars normally after sixty days. The forward cover is also taken for sixty days.

B. Query

3. In the light of the above, the querist has sought the opinion of the Expert Advisory Committee regarding revenue recognition on the following issues:

(i) The rate at which the sales should be accounted:

(a) Whether it is the rate on the date of bill of lading, on which date the property in the goods has passed on to the customer as per the contract.

(b) Whether it is correct to apply the forward contract rate and account the sales at that rate as finally, the company will be realising from the customer at the forward rate on the due date.

(ii) It is assumed that the customer will not fail on the due date for the purpose of the above. If customer fails to pay on the due date what will be the opinion of the Committee.

(iii) Will the company be complying with following accounting standards, if it follows accounting for revenue (sales) at the forward contract rate:

(a) Accounting Standard (AS) 9, 'Revenue Recognition',

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

(c) Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement', AS 31, 'Financial Instruments: Presentation' and AS 32, 'Financial Instruments: Disclosure' dealing with hedge accounting.

C. Points considered by the Committee

4. The Committee notes from the Facts of the Case that the basic issues raised in the query relates to the rate at which sales should be recognised and the treatment to be followed if the customer fails to pay on due date. The Committee has, therefore, considered only these issues and has not touched upon any other issue that may arise from the Facts of the Case, such as, accounting treatment of forward exchange contract taken to hedge the foreign exchange exposure of the sale amount, treatment of changes in foreign exchange rates after initial recognition, etc.

5. The Committee notes paragraph 9 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', 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."***

From the above, the Committee is of the view that the sales in the instant case should be recorded by applying the exchange rate at the date of the transaction. The transaction date for the purposes of recognition of revenue would be the date on which the significant risks and rewards of ownership of goods are transferred to the buyer. In this regard, the Committee notes paragraph 6.1 of Accounting Standard (AS) 9, 'Revenue Recognition':

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

6. The Committee further notes paragraphs 9.1 to 9.3 of AS 9, which provide as follows:

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

From the above, the Committee is of the view that revenue should not be recognised unless it is reasonably certain that the ultimate collection of the revenue will be made. However, if the uncertainty relating to collectability arises subsequent to recognition of revenue, a separate provision for the uncertainty should be recognised. In this context, the Committee notes that the impairment of receivables is covered by Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', which, inter alia, provides as follows:

> "***10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:***
>
> ***(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and***
>
> ***(b) a reasonable estimate of the amount of the resulting loss can be made."***

The Committee notes that an event is regarded as 'probable' if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Thus in case, at the balance sheet date, it is probable that the receivables would not be recovered in future, a provision in that respect should be made as per the provisions of AS 4.

7. As regards the question raised by the querist relating to compliance with AS 9, AS 11, AS 30, AS 31 and AS 32 in case the company records revenue at the forward contract rate, the Committee clarifies that for accounting purposes, the issue of recognition of revenue is independent of the accounting for foreign exchange transactions including hedging. Accounting for sale, i.e., recognition of revenue in the present case would be governed by the provisions of AS 9 as stated in paragraphs 5 and 6 above. Accounting for foreign exchange transactions including hedging is governed by AS 11 and/or AS 30 depending upon the nature of transaction. In the instant case, since the transactions undertaken by the company have been stated by the querist to be highly probable forecast transactions, forward exchange contracts in respect of these transactions can be accounted for as a cash flow hedge considering the provisions of AS 30 as AS 11 does not deal with accounting for forward contracts for such transactions. AS 31 is not relevant in the present case. In case of highly probable forecast transactions, where forward exchange contract is considered as cash flow hedge, the company should make disclosures as per the requirements of AS 32.

D. Opinion

8. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 3 above:

(i) The sales should be recognised at the rate on the date of the transaction, i.e., the date on which the significant risks and rewards of ownership of goods have been transferred to the buyer and not at the rate of forward exchange contract, as discussed in paragraph 5 above.

(ii) The revenue should not be recognised unless it is reasonably certain that the ultimate collection of the revenue will be made. However, if the uncertainty relating to collectability arises subsequent to recognition of revenue, a separate provision for the uncertainty should be recognised. Refer to paragraph 6 above.

(iii) If the company accounts for revenue (sales) at forward contract rate, it will not be complying with the requirements of AS 9, AS 11, AS 30 and AS 32. AS 31 is not relevant in the present case. Refer to paragraph 7 above.

Query No. 19

Subject: Revenue recognition in high sea sale contracts.[1]

A. Facts of the Case

1. A company is a public sector undertaking in the field of telecommunications and is engaged in manufacturing and supply of various telecom products, providing network solutions, manufacturing of mobile infrastructure equipment, etc. The company is having manufacturing facilities

[1] Opinion finalised by the Committee on 10.1.2011

at various locations, viz., Mankapur, Raebareli, Bangalore, Palakkad, Naini and Srinagar and has various regional and area offices in all major cities besides a Network System Unit for extending various service support to customers. The supplies and services of the company are mainly to customers, like public sector telecommunication enterprises, Defence, Railways, etc. All the supplies and services to them are executed through purchase orders, which are generally based on tenders. Most of the tenders call for quotes which are all inclusive (inclusive of freight, insurance, etc.). In respect of orders from public sector telecommunication enterprises, equipment undergoes quality check by the customer at the respective manufacturing unit before the same is handed over to the carrier for despatch to the destination as per customer's requirement.

2. The querist has stated that the company received a Purchase Order (P.O.) from a public sector telecommunication enterprise for supply and installation, testing and commissioning of cellular mobile phone network for an amount of Rs. 6,57,68,57,955 (copy of which has been supplied by the querist for the perusal of the Committee). Customer P.O. price is inclusive of all levies and taxes, packing, forwarding, freight and insurance, etc. The scope of P.O. includes supply of equipments (which shall be imported and supplied on high sea sales basis), installation and commissioning of the equipment, maintenance during warranty period and Annual Maintenance Contracts (AMC) after warranty period. Customer's P.O. contains itemized rates for supply, testing, installation, etc.

3. The querist has further stated that before the materials reached Indian Territory, High Sea Sales agreement was entered into with the customer and the sale is effected in favour of the customer. The equipments are directly delivered to customer's designated sites. Based on the High Sea Sales agreement, the documents during the course of transit are endorsed in favour of customer. In this way, the main features of a High Sea Sales are ensured, viz.,

- (i) the sale is effected by a transfer of document,
- (ii) the document transferred is the document of title of goods,
- (iii) and such transfer is effected before the goods have crossed the customs frontier of India.

In this process, ownership of such equipment is transferred to the customer during the course of transit and the required customs duty is paid directly by the customer. The company coordinates all activities in delivering the equipment to their destination.

4. According to the querist, as soon as the High Sea Sales agreement is entered into, the company recognises revenue for the sale value of the equipment (as per separate value given in the customer's P.O.). During the financial year 2008-09, the company made supplies amounting to Rs. 73.84 crore and revenue was recognised in the accounts to that extent. However, this accounting treatment was not acceptable to the Government Audit on account of the following:

(a) Materials which were supplied on High Sea Sales basis on 30.03.2009 were received by customer after the accounting year 2008-09.

(b) As per P.O., delivery to the ultimate site in satisfactory condition will remain supplier's responsibility.

(c) Delivery of materials and services, its installation and commissioning shall be made by supplier in accordance with the terms and conditions specified in schedule of requirements and special conditions of the contract and the goods shall remain at the risk of the supplier until delivery of the network as a turnkey job has been completed even if there is a transfer of title of the goods earlier on account of High Sea Sales.

5. According to the querist, the company has not agreed to the auditors' views due to the following reasons:

(a) The ownership/title is already passed on to the customer by way of subsequent High Sea Sales agreement.

(b) Separate value is available in P.O. for sale value of equipment and other activities.

(c) With High Sea Sales agreement, the risks and rewards are getting transferred to the customer after endorsement of the documents and there is no uncertainty of realising the sale proceeds.

(d) The customer has paid the bills (as per payment terms) for the value of supplies made without linking to activity of completion of installation, commissioning and testing.

B. Query

6. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether accounting for the sale value of equipment immediately on entering into High Sea Sales Agreement and endorsement of the documents of title without linking to the date of receipt of equipment by customer and also before completion of the activity of installation and commissioning of the equipment is in order and in accordance with Accounting Standard (AS) 9, 'Revenue Recognition'.

C. Points considered by the Committee.

7. The Committee notes that the basic issue raised in the query relates to timing of recognition of revenue in respect of supply of equipments under High Sea Sales Agreement in accordance with the principles of AS 9. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, recognition of revenue in respect of services rendered by the company, such as, installation, testing, commissioning, etc., accounting for maintenance during warranty period and AMC after warranty period, etc. Further, while expressing its opinion, the Committee has not examined whether the principles of Accounting Standard (AS) 7, 'Construction Contracts' are applicable in the present case as this issue has not been raised and accordingly, the opinion of the Committee is based on the presumption that the principles of AS 9 are applicable in the extant case. Also, the Committee's opinion contained hereinafter is only from the accounting point of view and not from the point of view of interpreting any provisions of law or statute, e.g., those relating to customs duty or sales tax, etc.

8. As far as timing of recognition of revenue in case of sale of goods, the Committee notes the following paragraphs from AS 9 which provide as below:

> "6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the

transfer of significant risks and rewards of ownership to the buyer. *However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.* Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes." (Emphasis supplied by the Committee.)

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

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

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

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

9. The Committee notes from the above that the time of transfer of all significant risks and rewards of ownership may be different from the time of transfer of legal ownership, and that for accounting purposes, revenue in such cases should be recognised at the time of transfer of significant risks and rewards of ownership to the buyer. The Committee is of the view that the question when the transfer of significant risks and rewards of ownership takes place depends on particular facts and circumstances of the case,

including the terms of the contract, express and/or implied, and the conduct of the parties. Various factors should be considered for ascertaining the timing of passing of significant risks and rewards of ownership. For example, factors like, who bears the risk of damage during transit, whether the goods supplied are substantially complete, etc., will have to be taken into account in determining the timing of transfer of significant risks and rewards of ownership. Accordingly, the Committee is of the view that revenue should be recognised as soon as the significant risks and rewards of ownership of goods have been passed on to the buyer and other conditions as stipulated in AS 9 have been fulfilled. In the view of the Committee, for recognising revenue, mere availability of separate value in the P.O. for sale value of equipment or even receipt of payment from the customer does not indicate the transfer of significant risks and rewards of ownership of the goods supplied, as being argued in the Facts of the Case.

10. The Committee notes from the Facts of the Case that the company recognises revenue for the sale value of the equipment immediately on entering into the High Sea Sales Agreement and endorsement of the documents of title. It is also noted that as per clause 16.2 of the customer's P.O., " Delivery of the goods and services, its installation and commissioning shall be made by the supplier in accordance with the terms and conditions specified in the schedule of requirements and special conditions of the contract and the goods shall remain at the risk of the supplier until delivery of the network as a turn-key job has been completed, even if there is transfer of title of the goods/materials earlier on account of high sea sales". Thus, the Committee is of the view that risks and rewards of ownership of the goods under High Sea Sales are not transferred at the time of entering into such an agreement or endorsement of the documents of title. Accordingly, the accounting policy followed by the company in this respect is not appropriate.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that accounting for the sale value of equipment immediately on entering into High Sea Sales Agreement and endorsement of the documents of title as revenue is not in order and in accordance with AS 9. Refer to paragraph 10 above.

Query No. 20

Subject: Accounting for expenditure incurred on roads, bridges, etc., constructed on land owned by the company or on land where the company has a right to use it, where such roads, bridges, etc. are also used by general public.[1]

A. Facts of the Case

1. A public sector company registered under the Companies Act, 1956 is engaged in construction and operation of hydro-electric power projects. The components of a hydro-electric project, such as, power house, dam, tunnel, and colony are generally spread over a large area. For construction and operation of a hydro-electric project, good network of roads and bridges is a pre-requisite so as to facilitate the movement of men and machinery. Network of roads and bridges so created by the company is not only used for movement of men and machinery related to the project but is also used by the general local public residing in the vicinity of project area.

2. The land on which such roads/bridges are created are generally of the following three types:

   (i) Freehold land;

   (ii) Other Government land on which company has a right to use through lease agreement or other similar arrangement; and

   (iii) Other land which is neither owned by the company nor the company has a right to use.

3. The querist has stated that roads/bridges created on land referred to in paragraph 2 (i) & (ii) above are treated as normal assets of the company following the provisions of the Accounting Standards and are depreciated as per depreciation policy of the company. So far as accounting for assets created on other land, which is neither owned by the company nor the company has a right to use, is concerned, the following accounting policies are being followed consistently:

“Policy No. 2.2: Fixed assets created on land not belonging to the corporation are included under fixed assets.

[1] Opinion finalised by the Committee on 10.1.2011

Policy No. 2.3: Capital expenditure on assets where neither the land nor the asset is owned by the company is reflected as a distinct item in capital work-in-progress till the period of completion and thereafter in the fixed assets.

Policy No. 5.8: Capital expenditure referred to in Policy 2.3 is amortised over a period of 5 years from the year in which the first unit of project concerned comes into commercial operation and thereafter from the year in which the relevant asset becomes available for use."

4. According to the querist, the above accounting policy is based on an earlier opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (refer Query No. 1.3 of Volume XII of the Compendium of Opinions). Relevant paragraphs of the said opinion have been reproduced by the querist as below:

"(a) Fixed assets which, *though having been built on land not belonging to the company, but are owned by the company*, should form part of the relevant head of fixed assets belonging to the company and treated accordingly.

(b) Regarding *fixed assets created on land not belonging to the company, which are also not owned by the company,* the Committee reiterates its previous opinion (as referred to above), i.e., the expenditure incurred on the construction of such assets should be classified as 'Capital Expenditure' in the balance sheet indicating appropriately, the nature of the expenditure including the fact that the assets are not owned by the company. Also, after the commencement of commercial operations, the same should be written off to the profit and loss account over the approximate period of its utility or over a relatively brief period not exceeding five years, whichever is less. Thus, the expenditure may be written off in the year of commencement of commercial production if its utility does not last beyond that year, as indicated by the querist in para 4(b) of the query."

(Emphasis supplied by the querist.)

5. The querist has stated that in one of the projects under construction, bridges/culverts etc. have been constructed over the land diverted to the company by forest department (falling under paragraph 2 (ii) above, as right to use the forest land is transferred to the company). Expenditure incurred for construction of these bridges/culverts etc. has been capitalised as distinct item of fixed asset under the head 'Roads & Bridges'. Depreciation is being charged on such bridges from the date bridges are available for use. Expenditure is also incurred by the company for maintenance of these bridges.

6. During the audit of accounts for the financial year 2009-10, Office of the Comptroller and Auditor General (C&AG) of India has given an observation that expenditure incurred on construction of roads/bridges should have been treated as 'Capital Expenditure on assets on land not owned by Company', since such roads & bridges are constructed on land not belonging to the company and expenditure so incurred by the company is in the nature of common public facilities on which company does not have exclusive ownership. Accordingly, the auditor is of the view that such expenditure should be accounted for as per accounting policy No.2.3 and 5.8 of the company. The observation of the Office of the C&AG of India is reproduced below:

> "Fixed Assets include Rs.____ lacs (inclusive of Bailey Bridge over______Nallah located on the road from_____ to _____ and Rs.____ lacs on two double lane permanent bridges over ______ Nallah and ____ Nallah) on Roads & Bridges constructed on the land not belonging to the Company.
>
> As per Accounting Policy No. 2.3 and 5.8, capital expenditure on assets where neither the land nor the asset is owned by the company is reflected as distinct item in Capital work-in-progress till the period of completion and thereafter in the fixed asset and amortised over a period of 5 years from the year in which the first unit of Project concerned comes into commercial operation.
>
> The above expenditure incurred for the purpose of project are in the nature of common public facilities on which the company does not have exclusive ownership and as such the same should have been shown under "Capital Expenditure" in the Balance Sheet instead of Fixed Assets resulting in over-statement of Gross Block, Net Block and Accumulated Depreciation by Rs._____ lacs, Rs.___ lacs and

Rs.___ lacs with corresponding under-statement of Capital Expenditure by Rs.____ lacs."

7. The management of the company contended that the land, on which these roads/bridges are constructed, belongs to company by virtue of 'right to use'. Therefore, assets created thereon shall be the assets of the company and mere use of these assets by public also does not change the nature of these assets. The contention of the management, however, did not find merit with the auditor on the ground that the roads/bridges under question are being used by common public also and as such, these should have been accounted for as per accounting policy no. 2.3 and 5.8 of the company. The management gave assurance to the auditor that the issue shall be referred to the Expert Advisory Committee. The excerpt of final assurance letter of management reads as under:

"————————— Land in these cases was either diverted by Forest Department or handed over by the ________ Board (from whom the said Project was taken over) to the company. Since the land belongs to company / company has the right to use this land, the asset created on these pieces of land are being treated as assets of the company and use by public also of these assets does not change the nature of assets. These assets are also being maintained by company. As agreed during today's discussions, we shall however be referring this issue to the Expert Advisory Committee of the Institute of Chartered Accountants of India and shall take further necessary action accordingly."

8. The issue was dropped on the aforesaid assurance of the management.

B. Query

9. Keeping in view the above, the querist has sought the opinion of EAC on the following issues:

(a) Whether the accounting treatment followed by the company and referred to in paragraphs 2 and 5 above is correct in terms of Indian Generally Accepted Accounting Principles (GAAPs).

(b) If not, what should have been the accounting treatment for such assets.

(c) Whether mere use of the assets, created on land referred to in paragraph 2 (i) and (ii) above, also by public changes the nature of assets.

C. Points considered by the Committee

10. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to accounting for expenditure incurred on construction of roads, bridges, etc. which are created by the company on two types of lands, viz., (i) freehold land owned by the company and (ii) land which is not owned by the company but the company has a right to use it. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, amortisation, if any, to be provided on roads, bridges, etc. At the outset, the Committee also wishes to point out that the opinion expressed by the Committee, hereinafter, is in respect of accounting for the expenditure incurred on above-mentioned assets and not in respect of freehold land or right to use of land which would be recognised separately in the books of the company.

11. 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 asset that is important for recognising an asset rather than ownership as being argued in the Facts of the Case. 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 expenditure on the said assets/facilities (roads, bridges, etc.). For this purpose, the Committee has examined whether the expenditure results into recognition of a tangible asset or an intangible asset.

12. The Committee is of the view that the above-mentioned expenditure can be considered to result into a tangible asset, only when, the company has a 'control' over 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, 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 of an item of fixed asset would be that the entity can restrict the access of others to the benefits derived from that asset. This view is also supported by the principles enunciated in paragraph 14 of Accounting Standard (AS) 26, 'Intangible Assets', as reproduced in paragraph 14 below.

13. The Committee notes from the Facts of the Case that the facility of roads, bridges, etc. *is being used* by the general public. However, it is not clear from the Facts of the Case that whether the company has a *right to restrict their use* by the general public. Also, it is not clear whether the other above-mentioned factors indicating control of the company on these assets exist.

14. The Committee now examines whether the above-said expenditure results into an intangible asset for the company. In this context, the Committee notes the following paragraphs from AS 26:

> ***"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.***
>
> ***An <u>asset</u> is a resource:***
>
> ***(a) controlled by an enterprise as a result of past events; and***
>
> ***(b) from which future economic benefits are expected to flow to the enterprise."***
>
> "14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. ..."

From the above, the Committee is of the view that the expenditure incurred by the company on these assets would meet the definitions of the terms 'asset' and 'intangible asset' only when these assets are controlled by the company. Accordingly, the expenditure incurred by the company on these assets can be recognised as an asset only when the company has a 'control' over these assets keeping in view the various factors as mentioned in the above paragraphs. The Committee is further of the view that in the absence of such 'control', the expenditure incurred on the said assets should be expensed and charged to the profit and loss account of the period in which these are incurred, even though the economic benefits are expected to flow to the enterprise from such facilities. 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. ..."

15. The Committee may also state that the treatment given in the earlier opinion of the Committee (Query No. 1.3 of Volume XII of the Compendium of Opinions), as referred by the querist was based on the provisions of the Guidance Note on Treatment of Expenditure during Construction Period, which has been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision taken at its 280th meeting held on August 7-9, 2008. Further, the recommendations contained in the Guidance Note in respect of this type of expenditure were superseded from the date AS 26 became applicable to the company, which required expensing of such expenditures where no asset is created as discussed above. Therefore, if, after AS 26 became applicable to the company, the expenditure incurred on these assets where no 'control' exists, was not expensed by the company as per the requirements of AS 26, as discussed above, the same is an error committed in the prior years which should be rectified in the financial statements and disclosed as a 'prior period item' of the period in which such rectification is carried out in accordance with the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

D. Opinion

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

(a) The accounting treatment followed by the company of recognising the expenditure incurred on roads, bridges, etc. which are created on freehold land/land on which the company has a right to use as fixed asset/'capital expenditure on assets on land not owned by the company' would be correct only when the company has a 'control' over these resources as discussed in paragraphs 12, 13 and 14 above.

(b) The accounting treatment of the expenditure incurred on these assets not owned by the company would depend upon whether these assets are controlled by the company. Refer to paragraphs 12, 13, 14 and 15 above.

(c) Mere *use* of the assets by public, created on the land in question does not change the nature of the assets, the basic idea is to consider control as discussed in paragraphs 13 and 14 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.org

9. The Committee reserves its right to decline to answer any query on an appropriate consideration of facts. If the Committee feels that it would not be in a position to, or should not reply to a query, the amount will be refunded to the querist.

10. The right of reproduction of the query and the opinion of the Committee thereon will rest with the Committee. The Committee reserves the right to publish the query together with its opinion thereon in such form as it may deem proper. The identity of the querist and/or the client will, however, not be disclosed, as far as possible.

11. It should be understood clearly that although the Committee has been appointed by the Council, an opinion given or a view expressed by the Committee would represent nothing more than the opinion or view of the members of the Committee and not the official opinion of the Council.

12. It must be appreciated that sufficient time is necessary for the Committee to formulate its opinion.

13. The queries conforming to above Rules should be addressed to the Secretary, Expert Advisory Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi- 110 002.