COMPENDIUM OF OPINIONS

Volume XXIX

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

Compendium of Opinions

(Volume XXIX)

of the

Expert Advisory Committee

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
(*Set up by an Act of Parliament*)
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(This twenty ninth volume contains opinions finalised between February 2009 and January 2010. The opinions finalised upto September 1981 are contained in Volume I. The opinions finalised thereafter upto January 2009, are contained in Volumes II to XXVIII)

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Foreword

Over the years, the profession of Chartered Accountancy has grown leaps and bounds while responding to the ever-changing needs and expectations of the society. One of the major expectations of the society from the accountancy profession has ever been the assurance that the financial statements of various enterprises, in which the society is a stakeholder, portray a true and fair view of the financial position and state of affairs of those enterprises.

Normally, application of generally accepted accounting principles results in financial statements that convey what is generally understood as a true and fair view of such information. While ensuring application of GAAPs in the preparation and presentation of financial statements, the accounting professionals are often posed with the challenge of understanding and implementing them, especially, where the business situations to which these GAAPs are to be applied, are complex. Here comes the laudable role of the Expert Advisory Committee that extends a helping hand to the professionals in meeting this challenge by providing solutions to the intricate and complex issues faced by them.

I am happy to note that in its continued endeavour to serve the profession, the Committee has brought out yet another volume of its publication, namely, Compendium of Opinions, which is twenty-ninth in its series. I warmly welcome the publication of this volume which, I firmly believe, would be a continuous guiding resource for the accounting professionals.

New Delhi
11th February, 2010

CA. Uttam Prakash Agarwal
President

Preface

It gives me immense pleasure to present to the profession another volume of the Compendium of Opinions. It was my privilege to Chair the Committee this year for the second time during my tenure in the Council. This twenty-ninth volume contains opinions finalised by the Expert Advisory Committee during February 2009 to January 2010. I would like to mention that the opinions of the Expert Advisory Committee are the opinions or views of the members of the Committee on the given facts and circumstances of the query, arrived at on the basis of the applicable accounting/auditing standards, guidance notes, and other pronouncements of the Institute as well as the relevant laws and regulatory environment applicable under the circumstances of the query, as on the date of finalisation of the opinion. Every opinion, therefore, must be read and applied after taking into account any amendments and/or other developments subsequent to the date of finalisation of the opinion by the Committee which is mentioned thereagainst.

The Expert Advisory Committee is always dealing with issues that are contemporary and highly relevant to the profession. The discussions in the meetings, therefore, are always technically rich and very interesting. The members of the Committee have been instrumental in making the meetings lively with quality discussions. I would especially like to thank my learned colleagues including nominated members of the Council on the Committee, co-opted members and special invitees of the Committee, for sparing some of their invaluable time for participation in the deliberations at the meetings of the Committee and for their invaluable contribution in the process of finalisation of opinions by the Committee. I would also like to acknowledge the sincere efforts, support and contribution of CA. Anuradha Jain, Secretary, Expert Advisory Committee and Ms. Parul Gupta, Assistant Secretary, throughout the year. The methodically prepared draft opinions for the consideration of the Committee, bringing out every aspect of the intricate issues after taking into account all the relevant pronouncements of the Institute as well as international literature, reflect the immense hard work put in by these officers of the EAC Secretariat. My appreciation is also due to them for compilation of the opinions finalised during the period in the form of this Volume. I sincerely believe that this compilation will continue to justify the much faith and confidence reposed in the Committee by the accounting profession.

New Delhi
11th February, 2010

CA. Sunil H. Talati
C*hairman*
Expert Advisory Committee

Contents

Query No. 1

Subject: Accounting treatment of advance paid for construction of water reservoir to be owned by the State Government.[1]

A. Facts of the Case

1. A 50:50 joint venture company (the 'company') was set up to takeover and run the captive power plants of one of the venturers located at Durgapur, Rourkela and Bhilai. The entire electricity generated by these three plants is sold to and consumed by that venturer. The company is presently expanding the capacity in Bhilai by setting up a 2x250 MW capacity power plant to meet the increased captive requirement of the venturer and sell surplus power to other customers. As the surplus power generated is likely to be sold to other beneficiaries, the tariff for such sale will be determined by the Central Electricity Regulatory Commission (CERC). While fixing the tariff, CERC allows 14% return on equity and also allows the cost of borrowing in addition to other operating and maintenance charges on a normative basis.

2. The company requested the Water Resources Department (WRD) of the State Government for allocation of the industrial water to meet the needs of this project and an 'in principle' approval was received for the same in August 2003 for allocation of industrial water from an existing canal. Subsequently, in September 2005, the State Government indicated that due to paucity of water in the canal, it would not be possible to supply water from the existing sources but suggested an alternative for assured water supply for Bhilai Expansion Project. As per the initial suggestion, one new reservoir was required to be constructed at a cost of Rs.150 crore which was required to be borne by the company in lieu of which the authority would have charged the company 1/4th of the normal rates for the water supplies in future.

3. Subsequently, the estimated cost of the reservoir has gone up from Rs. 150 crore to Rs. 205 crore on account of escalation in rates, and the State Government also revoked the policy of supplying water at a concessional rate as stated in paragraph 2 above.

4. The total capacity of the new reservoir is estimated to be 1.53 TMC and considering the requirement of 0.82 TMC water from the reservoir for

[1] Opinion finalised by the Committee on 5.3.2009

the project, the State Government asked the company to proportionately contribute Rs. 110 crore out of the estimated cost of Rs. 205 crore for the share of water. Further, it has been indicated that in case of any increase/ decrease in the completed cost of new reservoir, the proportionate share of the company shall also correspondingly increase/decrease.

5. Further, as per the State Government's present policy, the said sum of Rs. 110 crore contributed by the company shall not bear any interest and shall be fully adjustable against water charges payable on annual basis as per the applicable rates for water in future. It is expected that considering the prevailing rate for industrial water, Rs. 110 crore deposited by the company shall be adjusted fully against annual water charges in a 12-13 year period and thereafter, water charges shall be payable to the State Government as per the then applicable rates.

6. While the ownership of the reservoir would vest with the State Government, water has been committed to be made available to this project of the company for the next thirty years as per an agreement with the WRD of the State Government. Also, till the construction of reservoir, water would be made available to the company from alternative sources.

7. Considering all the circumstances and the fact that the project cannot function without industrial water and such water is to be made available only by the State Government, the company's Board in a meeting held in November 2007 had agreed to pay the sum demanded by the WRD. Only after acceptance of the company's letter for sharing of cost of construction of Mohad reservoir, State Water Utilisation Committee sanctioned allotment of water from proposed Mohad reservoir for Bhilai expansion project in December 2007 on the following relevant conditions:

- Payment of amount of Rs. 110 crore in one instalment on demand from WRD.
- Any increase/decrease in completed cost of construction of reservoir to be borne by the company.
- Adjustment of the payment made by company against the water charges payable by the company at the then applicable rate.
- Construction of the reservoir to be carried out by WRD and ownership will also vest with them.

- Till the construction of Mohad reservoir, alternative arrangement for supply of water from Mahanadi project to be made available to the company.

8. On receipt of demand letter for Rs. 110 crore towards shared cost of construction of Mohad reservoir from the State Government, the company made the required payment in full in February 2008. The payment has been made out of the funds raised from lenders/promoters for financing the expansion project. The salient points of the agreement are as follows:

- Sanction letter for water allotment to form part of this agreement.
- The company shall pay for the water charges as per the applicable rates.
- Permission to the company to draw the allotted water from the Government source for 30 years.
- Further deposit of Rs. 1.5291 crore as water charges amount for three months period.

(The querist has furnished copies of the sanction letter, demand letter and draft agreement for the perusal of the Committee.)

9. Considering the commercial interest of the company and present regulatory norms applicable to power generating companies, the company capitalised the advance of Rs. 110 crore as a part of the project cost and intends to amortise it over a fixed period. Further, till such time the water charges are adjusted against Rs. 110 crore, the benefit of non-payment of water charges would be passed on to the customers. In such a case, Rs. 110 crore being a part of the project cost stands funded from term loan and equity already tied up for the project.

10. An alternative view which has been expressed regarding the accounting treatment of the amount of Rs. 110 crore paid to the State Government for the construction of the reservoir is to show it as a non-interest bearing advance recoverable in cash or kind (i.e., 'loans and advances', as a part of working capital) and adjust the water charges payable every year out of the advance. However, in such a case, availability of funds towards working capital advance of Rs. 110 crore for such purpose without any asset security and repayable over 12-13 year period may not be possible.

B. Query

11. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment for the payment made to the State Government for construction of reservoir as capital expenditure is in order or not.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to appropriateness of treatment, in the company's financial statements, of the non-interest bearing advance made to the State Government for construction of reservoir. Accordingly, the Committee has not touched upon any other issue that may be contained in the Facts of the Case, such as, impact of accounting treatment on tariff-fixation, etc.

13. 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 it is the 'resource controlled by the enterprise' which can be recognised as an asset in the balance sheet. Therefore, the issue raised by the querist requires examination from the point of view of the nature of the resource that the company controls as a result of payment of Rs. 110 crore. For this purpose, the Committee has examined whether the payment of Rs. 110 crore results into recognition of a tangible asset, an intangible asset, a lease, or an advance to be adjusted in future against supply of water.

14. The Committee is of the view that if payment of Rs. 110 crore can be considered to result into a tangible asset, i.e., reservoir, then, the company should be able to control the reservoir. The Committee is of the view that an

entity that controls an asset can generally deal with that asset as it pleases. For example, the entity having control of an asset can exchange it for other assets, employ it to produce goods or services, charge a price for others to use it, use it to settle liabilities, hold it, or distribute it to owners. Further, the Committee is of the view that an indicator of control of an item of (tangible) fixed asset would be that the entity is ordinarily responsible for the repair, maintenance, upgrade and replacement of that item. In other words, the entity should have the ability to decide how the fixed asset is operated and maintained and when it is replaced.

15. The Committee notes from the Facts of Case that the reservoir is the property of the State Government/WRD. The company is entitled to its allotted quantum of water supply only at the normal rates prevailing from time to time. It has no say on the distribution of water supply to others. While the company's entitlement to water supply is more than insignificant (0.82TMC out of 1.53TMC), other parties together also take more than insignificant quantity of water (0.71 TMC out of 1.53TMC). Further, there is no indication that the company is responsible for repairs, maintenance, upgrade and reconstruction of the reservoir. Thus, none of the factors mentioned in paragraph 14 above indicating control of the reservoir by the company is evident. In other words, it appears that the company does not have continuing managerial involvement for the reservoir so as to exploit the reservoir in any way it wants. Thus, reservoir is not the resource controlled by the company, and therefore, the amount of Rs. 110 crore cannot be capitalised as 'reservoir'.

16. The Committee now examines whether the payment of Rs. 110 crore results into an intangible asset for the company. The Committee notes that by giving an interest-free advance of Rs. 110 crore, the company has obtained a right to receive water supply for 30 years at normal rates prevailing from time to time, the payment for which is to be made by way of adjustment against the said advance. The whole of the amount of Rs. 110 crore paid by the company to the State Government would be utilised/adjusted towards the charges payable for supply of water in future at normal rates applicable at that time. Thus, the payment made can not be attributed to obtaining the right to get supply of water for 30 years. Hence, the Committee is of the view that capitalisation of Rs. 110 crore as an intangible asset is not possible.

17. The Committee also notes that as per the draft agreement with the WRD, except in the event of water shortage, the company has to pay water

charges for at least 90% of total quantum of water allowed to be drawn by it, even if actual quantity of water drawn is less than 90% of total quantum of water allowed to be drawn. This requires examination whether this arrangement contains a lease and if so whether it is a finance lease or operating lease. The Committee is of the view that meeting any of the following conditions indicates that the arrangement contains a lease:

(a) The company has the ability or right to operate the reservoir or direct others, such as, WRD to operate the reservoir in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the reservoir, i.e., water.

(b) The company has the ability or right to control physical access to the reservoir while obtaining or controlling more than an insignificant amount of the output or other utility of the reservoir, i.e., water.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the company will take more than an insignificant amount of the output or other utility, i.e., water from the reservoir during the term of the arrangement, and the price that the company will pay for the output, i.e., water is neither contractually fixed per unit of output (i.e., water) nor equal to the current market price per unit of output (i.e., water) as at the time of delivery of the output (i.e., water).

The Committee is of the view that none of the above conditions is met in the case under consideration. Hence, the Committee is of the view that the said arrangement does not contain a lease and, consequently, the question of treatment of the reservoir as an asset held under a finance lease (or even as an operating lease) does not arise at all.

18. The Committee further notes that, in effect, the company has paid an advance of Rs. 110 crore for future purchase of water at the rates prevailing from time to time. It is irrelevant that the advance is used by the State Government for part-financing the construction of the reservoir. Charges for the supply of water at the normal and prevailing rates are adjusted against the advance. This, in substance, means that the State Government/WRD has borrowed interest-free advance for supply of water and that the advance is used for the construction of the reservoir. All these factors indicate that

the amount paid by the company to the State Government towards construction of reservoir is nothing but advance. Further, the Committee notes that as per Schedule VI[2] to the Companies Act, 1956, 'Loans and Advances' include 'Advances recoverable in cash or kind or for value to be received'. Hence, the Committee is of the view that the aforesaid amount should be disclosed as an 'advance' for future purchase of water. Depending on the use, water purchased is put to, the cost thereof would be capitalised or expensed, i.e., if the water purchased is used for construction purposes, the cost thereof would be capitalised to that extent. However, the cost of water purchased after the construction of the project is over, would be expensed.

D. Opinion

19. On the basis of the above, the Committee is of the opinion that the accounting treatment for the payment (of Rs. 110 crore) made to the State Government for construction of reservoir as capital expenditure is not in order. Refer paragraph 18 above for appropriate accounting treatment.

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

Query No. 2

Subject: Treatment of expenditure on training as deferred revenue expenditure – whether appropriate.[1]

A. Facts of the Case

1. A company was incorporated in the year 1976 as a wholly owned Government of India enterprise under the administrative control of the Ministry of Power to plan, promote, investigate, survey, design, construct, generate, operate and maintain hydro and thermal power stations and to explore and utilise the power potential of North East in particular. The company is

[1] Opinion finalised by the Committee on 5.3.2009.

presently running three hydro projects and two thermal projects in north-eastern States and is catering to the demand of north-eastern States only. The company's shares are not listed with any stock exchange. The authorised and paid up share capital of the company as on 31.03.2008 are Rs. 3500 crore and Rs. 3178.93 crore, respectively. The turnover of the company for the year ending 31.03.2008 is Rs. 860.31 crore.

2. The company, as per its accounting policy, charges the expenses on training, recruitment, etc. to revenue in the year of incurrence. Expenses on training for plant operations, prior to the commissioning of a project are treated as deferred revenue expenditure to be written off within 5 years after commissioning of the project.

B. Query

3. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting policy adopted by the company is in compliance with the existing Accounting Standards and the generally accepted accounting principles. If not, the querist has sought advice with respect to the modifications required.

C. Points considered by the Committee

4. The Committee notes the definition of the term 'asset' as contained in paragraph 49 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, as below:

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

The Committee is of the view that training expenditure, whether technical, i.e., for plant operations, or otherwise, does not give rise to a resource under the control of the company.

5. In this context, the Committee also notes paragraph 16 of Accounting Standard (AS) 26, 'Intangible Assets', which is reproduced below:

> "16. An enterprise may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The enterprise may also expect that the staff will continue

to make their skills available to the enterprise. However, usually an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to consider that these items meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition."

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. For example, expenditure on research is always recognised as an expense when it is incurred (…). Examples of other expenditure that is recognised as an expense when it is incurred include:
>
> …
>
> (b) expenditure on training activities;
>
> …"

6. The Committee is of the view that the above reproduced paragraphs of AS 26 are applicable for all types of training and not restricted to general training, i.e., it does not make any distinction between the technical training for plant operations or any other type of training. The Committee notes from the Facts of the Case that the training in the instant case has been given to train/prepare the staff in advance for operating the plant in future after commissioning of the project. The Committee is of the view that though training may be necessary prior to commissioning of a project, the training expenditure is not incurred for construction of any asset(s) and/or bringing the asset to its working condition for its intended use. Accordingly, in the view of the Committee, the expenditure incurred on training for plant operations should be expensed when incurred in accordance with paragraph 56 of AS 26 as reproduced above.

D. Opinion

7. On the basis of the above, the Committee is of the opinion that the

accounting policy of the company treating the expenses on training for plant operations prior to the commissioning of a project as deferred revenue expenditure to be written off within 5 years after commissioning of the project, is not in compliance with the existing Accounting Standards and the generally accepted accounting principles. Such expenditure should be expensed when incurred. The accounting policy should be modified accordingly.

Query No. 3

Subject: Treatment of subsequent expenditure on fixed asset as deferred revenue expenditure – whether appropriate.[1]

A. Facts of the Case

1. A company was incorporated in the year 1976 as a wholly owned Government of India enterprise under the administrative control of the Ministry of Power to plan, promote, investigate, survey, design, construct, generate, operate and maintain hydro and thermal power stations and to explore and utilise the power potential of North East in particular. The company is presently running three hydro projects and two thermal projects in north-eastern States and is catering to the demand of north-eastern States only. The company's shares are not listed with any stock exchange. The authorised and paid up share capital of the company as on 31.03.2008 are Rs. 3500 crore and Rs. 3178.93 crore, respectively. The turnover of the company for the year ending 31.03.2008 is Rs. 860.31 crore.

2. The querist has referred to the notes to accounts of the company for the year 1987-88 which is reproduced below:

> "A mishap occurred in Umrong Tunnel during filling in September, 1986 followed by submerging of generating units of Kopili Power Station due to the unprecedented flood in the river in October, 1986. The total cost of rectification and remedial works, restoration of generating Unit

[1] Opinion finalised by the Committee on 5.3.2009

of Kopili Power House, Power house protection works and strengthening of portion of both Umrong and Khandong Tunnel due to leakage in tunnel after completion was estimated at Rs. 21.1 crore. This estimate has been cleared by Central Electricity Authority (CEA), but approval of Government of India is awaited. As per general practice, the Umrong Tunnel was not insured during construction and commissioning stage. The claim has however been made for damage to the power house equipments which were under insurance coverage. A sum of Rs. 20.00 lakh received from the insurance company towards this claim as an on-account payment pending completion of final assessment towards the cost of repairs/replacements of the power house equipment has been credited to the plant and machinery under installation under capital work-in-progress. The final position of claim will be known on final assessment of cost of repairs/replacements of the power house equipments.

The expenditure on remedial and strengthening of Khandong system which was under operation is being treated as deferred revenue expenditure to be written off in five accounting years including the accounting year in which the power house has been recommissioned."

B. Query

3. The querist has sought the opinion of the Expert Advisory Committee as to whether the treatment of expenditure incurred on remedial and strengthening measures of units which were under operation as deferred revenue expenditure to be written off in 5 accounting years, is in compliance with the existing Accounting Standards and generally accepted accounting principles. If not, the querist has sought advice with respect to the modification required.

C. Points considered by the Committee

4. The Committee notes from the Facts of the Case that rectification and remedial works were performed on certain units which were under construction and at commissioning stage and also on units which were under operation. The Committee further notes that the querist has raised the query only with respect to the expenditure incurred on units which were under operation and, therefore, the Committee restricts its opinion to this issue only. The Committee has not examined any other issue(s) that may be contained in the Facts of the Case.

5. The Committee is of the view that since the units were already under operation when the mishap occurred, any rectification and remedial work performed on the same would constitute subsequent expenditure related to the fixed asset. In this respect, the Committee notes the following paragraphs of Accounting Standard (AS) 10, 'Accounting for Fixed Assets':

> "12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.
>
> 12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately."
>
> ***"23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."***

6. The Committee is of the view that expenditure on fixed assets subsequent to their installation may be categorised into (i) repairs, and (ii) improvements or betterments. Repairs, in the Committee's view, implies the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated useful life or capacity. Expenditure on repairs, including replacement cost necessary to maintain the previously assessed standard of performance, is expensed in the same period. On the other hand, in the view of the Committee, expenditures on improvements or betterments are expenditures that add new fixed asset unit, or that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs. Such expenditures are capitalised. The Committee is of the view that 'previously assessed standard of performance' is not the actual performance

of the asset at the time of repair, improvement, etc., but the standard performance of the same asset expected at this stage of life, as assessed when the asset was installed.

7. From the above and in the absence of any information to the contrary, the Committee is of the view that subsequent expenditure incurred by the company on the units under operation is of the nature of repairs and, accordingly, the same should be expensed when incurred.

D. Opinion

8. On the basis of the above, the Committee is of the opinion that treatment of expenditure on remedial and strengthening measures of units which were under operation as deferred revenue expenditure to be written off in 5 accounting years is not in compliance with the existing Accounting Standards and generally accepted accounting principles. Such expenditure, in the case of the company, should be expensed when incurred. The accounting policy should be modified accordingly.

Query No. 4

Subject: Accounting treatment of exchange effects (gains/losses) from foreign currency transactions relatable to project construction period.[1]

A. Facts of the Case

1. A company is a listed public limited company, promoted by a State Government. It is engaged in the business of manufacture of newsprint, and printing & writing paper.

[1] Opinion finalised by the Committee on 5.3.2009. Subsequent to the issuance of this opinion, Notifications No. G.S.R. 225 (E) dated 31st March, 2009, G.S.R. 913 (E) and G.S.R. 914 (E) dated 29th December, 2011 issued by the Ministry of Corporate Affairs (MCA) came into effect, which may affect the opinion expressed herein.

2. During the financial year (F.Y.) 2005-06, the company embarked upon an expansion project under Mill Development Plan (MDP) at a capital outlay of Rs. 565 crore for augmenting its pulping capacity from 520 tpd to 720 tpd and the paper production capacity from 2.30 lakhs tpa to 2.45 lakhs tpa. This project was funded through borrowed funds (foreign currency/Rupee loans) and internal accruals. All the funds were used for the purpose of acquisition/construction of assets relating to the MDP.

3. During the project construction period (F.Y. 2005-06 to F.Y. 2007-08), the following exchange gains that emanated from the foreign currency borrowings and import of capital goods relating to the MDP were recognised in the books:

(a) An exchange gain of Rs. 14.22 crore on actual repayment of foreign currency loans during the project construction period and restatement of foreign currency loan liabilities on balance sheet date.

Since this exchange gain was directly attributable to and incidental to the expansion project, the same was accounted for under 'Capital Work-in-Progress (MDP) A/C' during the project construction period and the exchange gain was apportioned to the cost of various qualifying assets, upon commissioning of the project, by adopting the general principles under Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and the Guidance Note on Treatment of Expenditure during Construction period[2], issued by the Institute of Chartered Accountants of India (ICAI).

(b) Forward contracts were booked for hedging the currency risk associated with the commitments under Letter of Credit pertaining to the project imports. An exchange gain of Rs. 4.52 crore was realised on cancellation and rebooking/cancellation and settlement of project import dues covered under the forward exchange contracts. Since the exchange gain was directly attributable to MDP assets under construction, the same was also capitalised based on the principles of accounting for fixed assets under AS 10 and the Guidance Note issued by the ICAI.

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

4. While finalising accounts for the financial year 2007-08, the statutory auditors of the company made a qualification in their report to the shareholders that the financial statements comply with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956, except Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' in respect of non-recognition of the exchange fluctuation (gain) during the project construction period on foreign currency transactions to the profit and loss account, which has resulted in understatement of current year's profit and fixed assets/capital work-in-progress to the extent of exchange gains referred to in paragraph 3(a) and (b) above. During the course of discussion, they further relied on the opinion on 'Capitalisation/decapitalisation of exchange loss/gain' of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India, published as Query No. 32 of Volume XXVII of the 'Compendium of Opinions', apart from other published accounts of other public sector undertakings (PSUs).

Company's Views

5. The company is of the view that the exchange effects (losses and gains) relatable to project construction period should be capitalised under AS 10 and should not be recognised under AS 11 as income in the period in which they arose, based on the premise that the fixed assets accounting under AS 10 prevails over AS 11 and Accounting Standard (AS) 16, 'Borrowing Costs', in respect of accounting for fixed assets especially during construction period. According to the querist, the company's views are based on the interpretation of relevant Accounting Standards as discussed in the paragraphs below.

Accounting for Exchange effects under AS 16

6. AS 16 deals exclusively with *interest and other financial charges* that can be regarded as 'borrowing costs' and the extent to which the same can be capitalised or recognised as an expense. As per paragraph 4(e) of AS 16, only a part of the exchange losses arising from foreign currency borrowings can be treated as 'borrowings cost'. In the view of the company, exchange effects other than those contemplated in AS 16 are required to be recognised in books under other relevant Accounting Standards.

7. As per the querist, the following exchange effects which are not covered under AS 16 have to be dealt with under AS 10 or AS 11, as the case may be:

(i) Exchange loss in excess of the amount regarded as interest adjustment.

(ii) Entire exchange gain arising from foreign currency borrowings relatable to construction and post construction period of the project.

(iii) All exchange effects arising from foreign currency transactions other than borrowings.

According to the querist, the effect of AS 16 is that exchange differences covered under (i) above (to the extent not regarded as borrowing cost) and items (ii) and (iii) are required to be recognised in books of account as 'Other Expenses / Income' under AS 10 or AS 11 and not as 'borrowing cost'.

Accounting for exchange effects under AS 11 read with AS 16

8. The querist has stated that AS 11 is a general Accounting Standard which deals with the exchange effects arising from the foreign currency transactions. As per paragraph 6 of AS 11, exchange differences arising from foreign currency borrowings to the extent regarded as adjustment to interest cost under paragraph 4(e) of AS 16, are to be dealt with under AS 16 and not under AS 11.

9. The querist further states that paragraphs 1 and 2 of AS 11 define its scope. But for a reference to paragraph 4(e) of AS 16 in paragraph 6, nowhere in AS 11 (including the paragraphs defining its scope) it is stated that this Accounting Standard overrides the accounting principles laid down in other Accounting Standards while dealing with the exchange differences on foreign currency transactions. *AS 11 (paragraph 6) is only an exclusion clause.* This paragraph does not determine the scope of AS 11*. It merely conveys that the exchange difference to the extent regarded as interest is to be excluded from the purview of AS 11. Therefore, from paragraph 6, an inference can not be drawn that all other exchange effects are to be dealt with under AS 11. If the intention of paragraph 6 of AS 11 is to cover all exchange effects (except to the extent regarded as interest cost) then it should have been explicitly stated that all other Accounting Standards are not applicable for the purpose of accounting for exchange effects.* (Emphasis supplied by the querist.)

10. Therefore, in the view of the querist, without taking cognisance of other relevant Accounting Standards, an inference that all exchange differences (except to the extent treated as an adjustment to interest cost) should be recognised under AS 11 as income or expenses in the period in which they arise, can not be drawn merely on the basis of paragraph 6 of AS 11.

Accounting for Fixed Assets – AS 10

11. According to the querist, AS 10 is an exclusive Accounting Standard on the Accounting for Fixed Assets which permits *capitalisation of not only the direct cost of acquisition* of assets (purchase price, duties, taxes, etc.,) *but also other directly attributable costs incurred in bringing the asset to its working condition for its intended use* (emphasis supplied by the querist). Paragraph 9.1 of AS 10 also recognises the effects of changes in foreign exchange rates as a component of cost of the asset.

12. Therefore, according to the querist, exchange effects of all foreign currency transactions, including foreign currency borrowings directly attributable and incurred in bringing the asset to its working condition, upto the commissioning of asset/project are eligible for capitalisation under AS 10, like other indirect expenditure/income incidental and related to project construction period. The transactions arise for bringing the asset to its working condition. Hence, exchange effects of all foreign currency transactions up to the date of commissioning of the asset/project is covered under AS 10. Further, nowhere in AS 10 it is stated that AS 11 overrides AS 10 as far as accounting for exchange effects related to acquisition/construction of assets is concerned.

13. The querist has also stated that when there is a mandatory requirement to deal with a particular issue under a specific AS, that particular AS will prevail over the general one. Nowhere in AS 11, it is categorically stated that all exchange effects (except to the extent regarded as interest cost) are governed by this Standard notwithstanding the accounting requirements under other Accounting Standards.

14. The Ministry of Corporate Affairs (MCA) notified AS 1 to 29 on the same date and therefore, a specific Accounting Standard – Accounting for Fixed assets can not be said to be subordinate to AS 11 in the absence of a specific provision in AS 11. It may also be noted that AS 11 is said to be

overruling Schedule VI[3] in view of the specific mention by way of a note in AS 11 while such exclusion is not made out for AS 10.

15. Therefore, according to the querist, in sum, on a collective reading of all the above Accounting Standards, it can reasonably be concluded that the exchange effects of foreign currency transactions relatable to project construction period are covered for capitalisation under AS 10 and only those exchange effects on foreign currency transactions, not covered under AS 10 and AS 16, are alone to be considered for accounting under AS 11.

B. Query

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

(i) Whether the exchange effects, i.e., the difference between initial recognition exchange rate and exchange rate on the date of settlement or date of reporting arising from all foreign currency transactions, like loans, import payables, advances for project imports, etc., and associated forward contracts, relatable to the assets during the project construction period, can be treated as part of the cost of the assets under AS 10 as other indirect expenses / income incurred in bringing the asset to its working condition, in the absence of any specific requirement under AS 11.

(ii) Whether it is appropriate to apply AS 11 for accounting for exchange effects arising from foreign currency transactions relatable to assets under construction when there is a specific AS 10 to deal with such items.

(iii) In a green field project with a gestation period of 2 – 4 years, whether the exchange effects pertaining to the foreign currency transactions relatable to project construction period can be treated as pre-operative expenses and accounted for as capital work-in-progress and eventually be capitalised at the time of completion of the project. If the same is eligible for capitalisation

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

under AS 10, whether the same treatment can be logically extended to exchange effects related to expansion project.

(iv) Whether the exchange effects (gains/losses) arising from forward contracts booked for long delivery import of capital goods related to new project/expansion project, attributable to acquisition of specific assets with an objective to freeze the capital cost of the assets can be treated as a direct or an indirect cost related to acquisition/construction of assets for capitalisation under AS 10.

(v) If the notional exchange gain (due to revaluation at market rate on reporting date – Mark to Market) arising during project construction period, is to be taken to the profit and loss account, whether it would be legal and proper if dividend is declared out of such gains.

C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to treatment of exchange differences (gains/losses) in respect of foreign currency borrowings arising during the project construction period. Accordingly, the Committee has not considered any other issue that may be contained in the Facts of the Case, such as, the nature of transactions in respect of which exchange differences are required to be accounted for, etc. The Committee also notes from the Facts of the Case that the construction of the project commenced in the financial year 2005-06. In the absence of information to the contrary, the Committee presumes that the foreign exchange transactions were entered into after 1.4.2004 by the company, i.e., the date of applicability of AS 11 (revised 2003). Accordingly, in the case under consideration, AS 11 (revised 2003) would be relevant in respect of such foreign currency transactions. The Committee further notes from the Facts of the Case that the querist has not raised the question of applicability of Schedule VI to the Companies Act, 1956 in respect of capitalisation of foreign exchange differences. Accordingly, while giving its opinion, the Committee has not dealt with that issue.

18. The Committee notes that paragraph 4(e) of AS 16, as notified by the Central Government under the Companies (Accounting Standards) Rules, 2006 provides that borrowing costs include “exchange differences arising from foreign currency borrowings to the extent that they are regarded as an

adjustment to interest costs". The Committee notes that with the notification of the Accounting Standards, Accounting Standards Interpretation (ASI) 10, Interpretation of paragraph 4(e) of AS 16, has been incorporated in the notified AS 16 by way of 'Explanation' which states as below:

> "Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings costs to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, The Effects of Changes in Foreign Exchange Rates. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings."

19. From the above, the Committee notes that as per paragraph 4(e) of notified AS 16, exchange loss on foreign currency loan is capitalised to the extent it amounts to adjustment towards interest costs provided other conditions of capitalisation under AS 16 are met. However, with respect to the foreign exchange gain arising on the foreign currency borrowings, the Committee is of the view that the same should be reduced from the cost of the fixed asset to the extent the exchange loss has been capitalised as per the provisions of paragraph 4(e) of AS 16. Since borrowing costs can be capitalised only with respect to a qualifying asset as per AS 16, the Committee is further of the view that decapitalisation can be done only during the period over which the fixed asset towards which the foreign currency loan has been taken continues to be a qualifying asset.

20. With respect to the foreign exchange differences on loan liabilities or other transactions, the Committee notes the 'Basis for Conclusions' of Accounting Standards Interpretation (ASI) 10, 'Interpretation of paragraph 4(e) of AS 16' issued by the ICAI, whose consensus paragraph has been included as an 'explanation' to paragraph 4(e) of AS 16 notified under the Companies (Accounting Standards) Rules, 2006. Paragraphs 4 and 5 of ASI 10 are reproduced below:

> "4. Enterprises often borrow in foreign currency at a lower interest rate as an alternative to borrowing locally in rupees, at a higher rate. However, the likely currency depreciation and resulting exchange loss often offset, fully or partly, the difference in the interest rates. In such cases, the exchange difference on the foreign currency borrowings to the extent of the difference between interest on local currency borrowing and interest on foreign currency borrowing, is regarded as an adjustment to the interest costs. This exchange difference is, in substance, a borrowing cost. In case of an enterprise, which instead of borrowing locally at a higher interest rate, borrows in foreign currency on the basis that the interest cost on foreign currency borrowings as adjusted by the exchange fluctuations, is expected to be less than the interest cost of an equivalent rupee borrowing, it is not appropriate to consider only the explicit interest cost on the foreign currency borrowing as the borrowing costs. In such a case, to the extent the exchange differences are regarded as an adjustment to the interest costs, as explained above, the same should also be considered as borrowing costs and accounted for accordingly with a view to reflect economic reality. Accordingly, such an exchange difference is covered under AS 16.
>
> 5. The explicit interest cost, including exchange difference thereon, if any, is covered under paragraph 4 (a) of AS 16, which provides that borrowing costs may include interest and commitment charges on bank borrowing and other short term and long term borrowings. Accordingly, the intention of paragraph 4(e) of AS 16 is to cover exchange differences on the amount of the principal of the foreign currency borrowings. Further, since paragraph 4(e) uses the words 'to the extent that they are regarded as an adjustment to interest costs', the entire exchange difference on principal amount is not covered by paragraph 4 (e). Since, the difference between interest on local currency borrowings and interest on foreign currency borrowings, is regarded as an adjustment to the interest costs, only the exchange difference to the extent of such difference is covered by paragraph 4 (e) of AS 16. The entire exchange difference on the principal amount is regarded as an adjustment to the interest cost only in a situation where the difference between interest on local currency borrowings and interest on foreign currency borrowings is equal to or more than the exchange difference."

Accordingly, from the above, the Committee is of the view that the foreign exchange loss over and above that covered under paragraph 4(e) of AS 16 is a cost that is not regarded as a borrowing cost. Such cost would not have been incurred had the entity borrowed the funds domestically. Thus, this cost cannot be attributed to the cost of construction of the project and should be expensed when incurred. Similarly, any exchange gain over and above the exchange gain adjusted to the cost of the fixed cost, as discussed in paragraph 19 above, should be accounted for as income for the year in which the same arises.

21. With respect to the applicability of AS 10 vis-à-vis AS 11 and AS 16, the Committee notes that while dealing with a particular item of expenditure, certain Accounting Standards require expensing thereof when incurred unless otherwise required under another Accounting Standard. For example, Accounting Standard (AS) 15, 'Employees Benefits', requires in paragraph 10(b) that short-term employee benefits should be recognised "as an expense, unless another Accounting Standard requires or permits the inclusion of the benefits in the cost of an asset (see, for example, AS 10, Accounting for Fixed Assets)". AS 16 requires the borrowing costs to be capitalised in case of a qualifying asset in accordance with the requirements of the Standard including the foreign exchange differences covered under paragraph 4(e) of AS 16. Other borrowing costs are required to be recognised as an expense in the period in which they are incurred. AS 11, however, requires all foreign exchange differences to be recognised as income or as expenses in the period in which they arise with the exception of those exchange differences that are required to be capitalised under paragraph 4(e) of AS 16. AS 11, thus, does not require capitalisation of any other exchange fluctuation by making reference to any other Accounting Standard such as, AS 10.

22. With respect to the argument forwarded by the querist in paragraph 11 of the Facts of the Case in regard to paragraph 9.1 of AS 10, the Committee notes that the Announcement 'Clarification on Status of Accounting Standards and Guidance Notes' issued by the Council of the Institute of Chartered Accountants of India (published in the Journal of the Institute, 'The Chartered Accountant', April 2002, page 1242), inter alia, states as below:

> "In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard."

The Committee further notes that AS 10 became mandatory in respect of accounting period commencing on or after 1.4.1991, whereas, AS 11 (revised 2003) became mandatory with effect from 1.4.2004. Keeping in view the above Announcement, the Committee is of the view that the provisions of AS 11 (revised 2003) would prevail over the provisions of AS 10 wherever relevant. The Committee is of the view that though both the Standards were notified by the Ministry of Corporate Affairs on the same day, the Standards were applicable even prior to that date under the proviso to section 211(3C) of the Companies Act, 1956.

23. With respect to the accounting for forward exchange contracts, the Committee notes that AS 11 (revised 2003) provides in paragraph 36 as below:

> ***"36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period."***

Accordingly, the exchange effects (gains/losses) arising from forward contracts in the case of the company should be treated as per the provisions of the above paragraph.

D. Opinion

24. On the basis of the existing Accounting Standards, including AS 11, and other pronouncements, as discussed above, the Committee is of the following opinion on the issues raised by the querist in paragraph 16 above:

(i) No, the exchange effects arising from the foreign currency transactions relatable to assets during the project construction period cannot be treated as part of the cost of the asset under

AS 10 as other indirect expenses/income incurred/earned in bringing the asset to its working condition, except for those foreign exchange differences which are covered under paragraph 4(e) of AS 16.

(ii) Yes, it is appropriate to apply AS 11 for accounting for exchange effects arising from foreign currency transactions relatable to assets under construction.

(iii) The provisions of AS 11 are required to be applied with respect to the exchange effects pertaining to the foreign currency transactions relatable to project construction period irrespective of whether the project is a green field project or an expansion project. Accordingly, all exchange differences have to be charged/credited to the profit and loss account except for those exchange differences which are covered under paragraph 4(e) of AS 16.

(iv) No, the exchange effects (gains/losses) arising from forward contracts cannot be treated as a direct or indirect costs related to acquisition/construction of asset for capitalisation under AS 10.

(v) This issue cannot be answered by the Committee as it requires interpretation of the requirements of the Companies Act, 1956 and as per Rule 2 of the Advisory Service Rules, in accordance with which the Committee answers the queries, the Committee is prohibited from answering queries that involve legal interpretation of various enactments.

Query No. 5

Subject: Accounting treatment of licence fee and technical know-how fee.[1]

A. Facts of the Case

1. A public sector company is engaged in refining and marketing of petroleum products. The company has entered into agreements with a foreign Licensor for the transfer of know-how for installation of Petrochemical Plant at one of its refineries. The query raised pertains to accounting for payments under the agreements as given below.

2. The Licensor has developed and/or acquired technical information, know-how and patent rights relating to a Process for the production of a specified product. The company has entered into two agreements with the foreign licensor namely, Licence_Agreement and Engineering Agreement.

Licence Agreement – the Licensor has agreed to grant the Licensee (the 'company') a non-exclusive, perpetual, non-transferable licence under patent rights containing right:

(a) to use each of Processes in the corresponding Unit;

(b) to use in carrying out the Processes in the corresponding Unit for any apparatus, catalysts, solid sorbents or desorbents therefor; and

(c) to export, sell or use in any country, the products of each of the Processes produced in the corresponding Unit.

Payment terms of the licence fee are usually as follows:

(i) First instalment becomes due and payable on the signing of the agreement, i.e., before the implementation of the project.

(ii) Next instalments become due and payable during the course of implementation of the project on reaching certain milestones.

(iii) Last instalment becomes due and payable after the commencement of commercial production from the project and

[1] Opinion finalised by the Committee on 5.3.2009

completion of other conditions, such as, performance guarantee test run, etc.

Engineering Agreement – The Licensor has to provide engineering and technical services in connection with the design of the plant.

3. The querist has explained the accounting treatment in respect of the expenditure incurred on technical know-how fees relating to manufacturing process (Licence Agreement) as below:

The erstwhile paragraph 16.5 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which, in respect of the company, was withdrawn w.e.f. 1st April, 2003, is reproduced below:

> "Know-how related to plans, designs and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such cases depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred."

The querist has drawn attention of the Expert Advisory Committee to its earlier opinion on 'Treatment of know-how cost' published as Query No. 1.34 in Compendium of Opinions-Vol. XVII. Paragraph 4 of the said opinion, inter alia, reads as below:

> "Thus, the Committee is of the opinion that if the said costs pertain basically to manufacturing process know-how, to that extent these should not be capitalised."

In line with the above, the expenditure incurred on technical know-how fees relating to manufacturing process, not being capital in nature, has been charged off by the company to profit and loss account consistently in the respective years of its incurrence. [Emphasis supplied by the querist.]

4. Further, the querist has drawn attention of the Expert Advisory Committee to paragraph 56 of Accounting Standard (AS) 26, 'Intangible Assets', which, inter alia, reads 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. ..."

As per the querist, it can be inferred from the above paragraph read with the principle laid down in the erstwhile paragraph 16.5 of AS 10 (quoted above) that payments for technical know-how relating to manufacturing process is not capital in nature but it is only an expenditure on an intangible item, which is to be expensed in the year of incurrence. In view of the above, the company has consistently followed the said principle even after introduction of AS 26 w.e.f. 1st April, 2003, following the underlying principle that the basic nature of technical know-how fees relating to manufacturing process not being capital in nature is not altered even after the introduction of AS 26. Accordingly, the expenditure incurred towards technical know-how relating to production process has been charged to revenue.

5. *However, as per the opinion of the statutory auditors of the company, after the introduction of AS 26, all the conditions for treating such expenses as 'intangible assets' are met.* [Emphasis supplied by the querist.] Their opinion is that since such payments to consultants/suppliers of technical know-how/licence are upfront lumpsum payments made by the company before and/or during the course of the implementation of the project and prior to the commencement of the production, they are not linked to production quantities. Further, economic benefits start flowing from use of intellectual property in the production process in the form of revenue from sale of products after the project is implemented and commercial production is commenced. Therefore, as per their view, the technical process know-how fee, as discussed above, creates an 'intangible asset' and, accordingly, should be treated as an 'intangible asset' as prescribed in AS 26.

6. The statutory auditors have drawn attention to the opinion of the Expert Advisory Committee given, as per the querist, on an identical issue contained as Query No. 4 in the Compendium of Opinions – Vol. XXIII (Opinion finalised by the Committee on 25.03.2003). The querist has given the extracts from the said opinion as below:

> "19. On the basis of the above, the Committee is of the opinion that the management of the company 'X' should ascertain the extent of the know-how fees payable in respect of plans, layout and designs of buildings and/or design of the plant and machinery which should be capitalised under the relevant heads. Know-how fees which are not so related and pertain to the period prior to commencement of commercial production should be treated as deferred revenue expenditure and expensed over a period of 3 to 5 years after commencement of commercial production."

> "18. The Committee incidentally notes that the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 26 on 'Intangible Assets'. From the date the Standard becomes mandatory (...) the paragraphs of AS 10, and paragraph 9.7(a) of the Guidance Note, reproduced in paragraphs 13 and 14 above, would stand withdrawn. Accordingly, the know-how costs incurred under the two agreements should be treated in accordance with AS 26. ..."

7. The querist has explained the accounting treatment in respect of the expenditure incurred on technical know-how fees relating to process design/plants/facilities (Engineering Agreement) as below:

> As far as expenditure incurred on technical know-how relating to process design/plants/facilities is concerned, the same is capitalised as 'intangible asset' and amortised on a straight line basis over a period of ten years or life of the said plant/facility, whichever is earlier. Before the introduction of AS 26, the expenditure incurred on technical know-how relating to process design/plants/facilities was being capitalised as a part of the corresponding fixed asset.

8. The querist has given the accounting policy of the company as below:

> "Costs incurred on technical know-how/licence fee relating to production process are charged to revenue in the year of incurrence."
>
> "Costs incurred on technical know-how/licence fee relating to process design/plants/facilities are accounted as 'Work-in Progress - Intangible Assets' during the construction period of the said plant/facility. At the time of capitalisation of the said plant/facility, such costs are capitalised as intangible asset and amortised on a straight line basis over a period of ten years or life of the said plant/facility, whichever is earlier, beginning from the quarter in which the said plant/facility is capitalised."

B. Query

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

(a) Whether the accounting treatment of charging to revenue in the year of payment of licence fee paid to acquire technical know-how (by way of upfront lumpsum payments before/during the course of implementation of the project and prior to commencement of production) is in order even after introduction of AS 26.

(b) Whether the accounting treatment of capitalising technical know-how fees relating to process design/plants/facilities as intangible assets and amortising the same on a straight line basis over a period of ten years or life of the said plant/facility, whichever is earlier is in order instead of capitalising the same as a part of the corresponding fixed asset as was being done till the introduction of AS 26.

(c) In case the answer to either query (a) or (b) is in the negative,

 (i) what is the suggested accounting treatment for technical know-how fees relating to production processes and technical know-how fees relating to process design/plants/facilities?

 (ii) what is the suggested accounting treatment for the past cases where after the introduction of AS 26, technical know-how fees relating to production processes has been charged to revenue and technical know-how fees relating to process design/plants/facilities has been capitalised as intangible assets and is being amortised on a straight line basis over a period of ten years or life of the said plant/facility, whichever is earlier?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to treatment of technical know-how fee related to production processes and technical know-how fee related to process design/plants/facilities after the introduction of AS 26. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, treatment of these items before AS 26 became mandatory. Further, AS 26 overrides the 'Guidance Note on Treatment of Expenditure during Construction Period' issued by the Institute of Chartered Accountants of India to the extent the provisions of the Guidance Note are

inconsistent with AS 26. The said Guidance Note has been withdrawn by the Council of the Institute of Chartered Accountants of India[2].

11. The Committee notes that an item of expenditure, such as, technical know-how fee may be incurred for different purposes as in the present case. In such cases, depending on the nature and purpose for which it is incurred, the relevant Accounting Standard will apply. In particular, if the expenditure is incurred in connection with the creation/acquisition of a fixed asset, it will be accounted for in accordance with AS 10. If it is incurred in connection with the creation/acquisition of an intangible asset within the scope of AS 26 or another Accounting Standard, it will be accounted for in accordance with the relevant Accounting Standard. In some situations, the expenditure may have to be charged to revenue, if required by the relevant Accounting Standard. Thus, the Committee is of the view that accounting treatment of expenditure on know-how fee depends on the nature and purpose for which it is incurred.

12. The Committee notes that paragraph 56 of AS 26 quoted by the querist in paragraph 4 above applies only if an item of expenditure, though incurred to provide future economic benefits, does not result in acquisition or creation of a tangible or other asset that can be recognised. Thus, if either a tangible asset or an intangible asset that can be recognised is created or acquired, the expenditure cannot be recognised as an expense. Similarly, if no such asset is created but a different accounting treatment is prescribed for that expenditure in another Accounting Standard, the expenditure cannot be recognised as an expense.

13. From the Facts of the Case, the Committee notes that know-how fee is related to three purposes, viz., (i) rights under the Lincence Agreement ('Right to use process'), (ii) know-how relating to process ('process know-how') and (iii) know-how related to plant and facilities ('plant know-how'). It is presumed that item (b) of the Licence Agreement mentioned in paragraph 2 above refers to 'right to use apparatus, catalysts, solid sorbents or desorbents' and not the cost of the same.

14. As regards plant know-how, the Committee notes that it is related to plant/facilities. The Committee notes the following paragraphs from AS 10:

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[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.

> "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; ..."
>
> ***"20. The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.***
>
> ***21. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset."***

15. From the above, the Committee is of the view that to the extent the know-how fee is related to plant know-how, it should be capitalised as part of cost of relevant fixed assets. Initially, it may be booked to capital work in progress and identified with the relevant asset under construction if the expenditure is directly related to, or benefits, a particular asset under construction. For this purpose, a nexus between the expenditure and the benefit/relationship with the asset can be established technologically. If the expenditure is related to, or benefits, more than one asset under construction, it should be booked to 'Capital Work in Progress – Pending allocation' and capitalised as part of cost of the relevant assets appropriately at the time of completing the exercise of capitalisation. Further, the Committee is of the view that the mere fact that paragraph 16.5 of AS 10 has been withdrawn on AS 26 becoming mandatory does not alter the position, if an expenditure is otherwise covered by the abovementioned paragraphs of AS 10. This is also supported by the reasons given in paragraphs 11 and 12 above. The Committee, therefore, does not agree with the changed accounting policy of the company of treating the expenditure on plant know-how as an intangible asset on AS 26 becoming mandatory.

16. As regards the right to use process and process know-how, they are intangible items. They can be recognised as intangible assets only if they satisfy the definition and recognition criteria prescribed in AS 26. In this connection, the Committee notes the following paragraphs from AS 26:

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

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

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

(a) controlled by an enterprise as a result of past events; and

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

"11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. ..."

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

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

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights..."

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

17. From the above, Committee is of the view that right to use process and process know-how meet the definition criteria of an 'intangible asset'. These items are non-monetary assets, without physical substance. The process know-how is used to produce the product and sell it, for which the right to use the process is a must. Thus, both the intangible items are essential for producing and selling the product which results in a future economic benefit, viz., revenue. Thus, flow of future economic benefits to the company can be expected. Though the right to process is non-exclusive and non-transferable, it is perpetual and it arises out of the contract which can be enforced legally. Hence, the identifiability and control criteria are also met.

18. As regards the recognition criteria, the Committee notes the following paragraphs from AS 26:

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

> ***(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and***
>
> ***(b) the cost of the asset can be measured reliably.***

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

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

"24. If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets."

19. From the Facts of the Case, the Committee notes that the know-how fee for right to use process and process know-how is paid in the form of cash and, hence, normally reliable measurement criterion will be met.

However, as is discussed in paragraph 23 below, the know-how fee may require some apportionment, for example, between plant know-how and process know-how. In such cases, apportionment should be made on a reasonable basis. Further, as noted in paragraph 17 above, flow of future economic benefits can be expected from the two intangible assets. The probability of flow of future economic benefits should be assessed by the company as per paragraph 21 read with paragraph 22 of AS 26, quoted in paragraph 18 above. If that assessment supports the expectation of inflow of probable future economic benefits, the expenditure incurred for right to use process and process know-how should be recognised as intangible assets. As regards measurement on initial recognition, the Committee notes that paragraph 23 of AS 26 reads as below:

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

Thus, to the extent recognition criteria are met, the abovementioned intangible assets should be measured initially at cost and amortised in accordance with AS 26.

20. The Committee notes that paragraph 64 of AS 26 lists various factors to be considered in determining the useful life of an intangible asset. Further, the Committee notes the following paragraphs from AS 26:

> ***"63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use."***

> ***"72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.***

> 73. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used

for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method."

21. Thus, the intangible assets representing the right to use process and process know-how should be amortised as stated above. The Committee is of the view that process know-how and right to use process have equal useful life. Presuming that their useful life is 10 years, it is appropriate to amortise them over a period of 10 years or the life of the plant/facilities in connection with which they are being used, whichever is earlier. Straight-line basis of amortisation may be followed, if that method is appropriate. However, as per paragraph 63 of AS 26 quoted in paragraph 20 above, amortisation should commence from the date when the intangible asset is available for use.

22. To the extent the expenditure for know-how fee is not eligible for recognition as part of cost of fixed assets as explained in paragraph 15 above or as an intangible asset as explained in paragraph 19 above, it should be recognised as an expense, unless any part of the consideration is related to other items, such as, cost of catalysts. The treatment for such items is not an issue raised by the querist and, hence, the Committee does not address that issue.

23. The Committee is of the view that the fee under the agreements should be carefully analysed to see whether there are any other items inbuilt in the said fee or whether fee payable under Licence Agreement is related to any service within the scope of the Engineering Agreement or vice versa, and, if so, the fee should be apportioned to various items on a reasonable basis. For example, Engineering Agreement may include supply of know-how relating to process as well as plant/facilities requiring the apportionment of the know-how fee between the two. Similarly, it may include cost of training not separately chargeable, cost of catalyst not separately chargeable, etc. The Committee notes that paragraph 56 of AS 26, inter alia, cites the example of expenditure on training activities as an item to be expensed.

24. The Committee, therefore, is of the view that on AS 26 becoming mandatory, the company's accounting policy of charging to revenue, in the

year of payment, of licence fee is not correct, if criteria for recognition as an intangible asset are met. Even if recognition criteria are not met, amount to be recognised as expense need not be equal to instalment amounts paid/ payable, as per the payment schedule. Further, while the Committee agrees with the accounting policy of capitalising the process know-how (process design) as an intangible asset, it does not agree with the policy of capitalising the plant know-how as an intangible asset. While the Facts of the Case do not contain payment terms for Engineering Agreement, in case the payment is to be made in instalments, the amount to be capitalised need not necessarily be equal to instalment amounts paid/payable. Further, the Committee agrees with the accounting policy on amortisation of only process know-how (and not plant know-how), if it is in accordance with the principles stated in paragraph 21 above.

25. To the extent the accounting treatment is not in accordance with the above paragraphs, it would be treated as an error which should be rectified as prior period items in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

D. Opinion

26. On the basis of the above, without going into the correctness of the accounting treatment prior to AS 26 coming into effect as stated in paragraph 10 above, the Committee is of the following opinion on the issues raised by the querist in paragraph 9 above:

(a) The correct accounting treatment of licence fee paid to acquire technical know how, i.e., technical know-how fees would depend on the nature and purpose for which it is acquired as discussed in various paragraphs above.

(b) The accounting treatment of capitalising technical know-how fees relating to process design as an intangible asset after AS 26 became mandatory is in order. The amortisation of the same on a straight line basis over a period of ten years (presuming its useful life is 10 years) or life of the related plant/facility, whichever is earlier, after AS 26 becoming mandatory, is in order, if it is in accordance with the principles stated in paragraph 21 above. The accounting treatment of know-how fee relating to plant/facilities is not in order. For appropriate accounting treatment, refer to paragraph 15 above.

(c)(i) The correct accounting treatment for technical know-how fees relating to production processes (i.e., right to use process) is to recognise the same as an intangible asset (as in the case of know-how relating to process design), if recognition criteria prescribed in AS 26 are met. The correct accounting treatment for technical know-how fees relating to plant/facilities is to capitalise the same as part of cost of the relevant fixed asset. To the extent the know-how fee is not eligible for recognition as an intangible asset or capitalisation as part of cost of a (tangible) fixed asset, it should be recognised as an expense, unless it is for items which cannot be immediately expensed, such as, catalysts. In any case, expenditure amount need not necessarily be equal to the instalment amounts paid/payable as per payment schedule. Further, the know-how fee under the relevant agreements should be analysed as suggested in paragraph 23 above. The amortisation of the intangible assets should be in accordance with the principles stated in paragraph 21 above.

(ii) The errors arising out of incorrect accounting treatment in the past years after AS 26 became mandatory should be rectified as prior period items in accordance with AS 5. The accounting policy should also be amended to reflect the correct accounting treatment.

Query No. 6

Subject: Computation of lease term and accounting for scheduled rent increases in case of an operating lease.[1]

A. Facts of the Case

1. A company is in transport industry and provides radio taxi services across India. The company (hereinafter referred to as 'the lessee') has taken on 1st September, 2007, a premises on lease. The term of the lease is 5 years and it is renewable at the end of the lease term. The querist has provided the following clauses of the agreement (hereinafter referred to as the 'first lease agreement'):

> "That the lease shall be for a period of 5 years, commencing from 1st September, 2007. On expiry of the lease period of 5 years, the lease can be renewed. After 12 months, 5% enhancement will be done every year."
>
> "That notwithstanding that is stated above, this agreement is terminable by 3 months notice in writing by either side."

According to the querist, there is no non-cancellable period in the agreement as there is no lock-in-period.

2. On 1st August, 2007, the company has taken another premises on lease. The querist has provided the following clauses of the agreement (hereinafter referred to as the 'second lease agreement'):

> "In consideration of the lease rental hereinafter reserved and all the covenants and conditions hereinafter contained to be observed and performed on the part of the lessee, the lessor does hereby agree to grant, demise by way of lease the demised premises to the lessee for a period of five years from 1st August, 2007 to 31st July, 2012 with the *sole and absolute option* of lessee to extend the lease for a period of four years on the same terms and conditions, except rent, by execution of fresh lease agreement for such extended period of four years. After expiry of subsequent four years, i.e., on 31st July, 2016, if extension is required a fresh lease deed shall be executed in writing and registered on mutually agreed rent, terms and conditions". (Emphasis supplied by the querist.)

[1] Opinion finalised by the Committee on 5.3.2009

"That the lease deed shall commence and come into operation with effect from 1st August, 2007."

"The rent shall be as follows:

A. For the first three years of period commencing from 1st August, 2007 to 31st July, 2010, the rent shall be Rs. 5,15,000 per month (Rupees five lakh fifteen thousand only).

B. For the second three years commencing from 1st August, 2010 to 31st July, 2013, the rent shall be Rs. 6,18,000 per month (Rupees six lakh eighteen thousand only).

C. For the third three years, final period commencing from 1st August, 2013 to 31st July, 2016, the rent shall be Rs. 7,41,600 per month (Rupees seven lakh fourty one thousand six hundred only).

However, a fresh deed will be executed and registered after the expiry of 5 years period."

"The lessee shall be entitled to terminate the lease by giving three months advance notice to the lessor and upon expiry of such notice period, the lessee shall hand over physical vacant possession of the demised premises to the lessor. However, in case the lessee wants to vacate the demised premises before the expiry of four years from the date of signing of this lease deed, the lessee can do so by giving four months advance notice to the lessor. During the notice period rent will be paid by the lessee."

As per the querist, there is no non-cancellable period in the agreement as there is no lock-in-period. The querist has further clarified that the lessor, under the agreement, does not have a right to ask the company to vacate the premises.

3. The querist has stated that there may be various kinds of lease agreements entered into by the company:

(i) Lease agreement with no 'non-cancellable period'.

(ii) Lease agreement with *non*-cancellable period *together with* any further periods for which the lessee has the option to continue the lease (emphasis supplied by the querist).

(iii) Lease agreement with cancellable period together with any further periods for which the lessee has the option to continue the lease.

4. The auditors of the company have advised the company to consider all the periods, whether cancellable or non-cancellable lease term and equalise the rent over the lease term as per paragraph 23 of Accounting Standard (AS) 19, 'Leases'.

5. In support of the company's view, the querist has quoted the definition of 'lease term' as given in AS 19:

> ***"The <u>lease term</u> is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise."***

The company believes that to qualify under the above definition, there has to be a 'non-cancellable lease term together with any further periods for which the lessee has the option to continue the lease'. Therefore, in the view of the querist, the definition of 'lease term' should not apply to lease agreements of the type mentioned in paragraph 3(i) and (iii) above but will apply to lease agreements of the type mentioned in paragraph 3(ii) only.

B. Query

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

(i) What should be the lease term in the case of second lease agreement?

(ii) Whether there is a need to equalise rent over the lease term as per AS 19, if the option to terminate the agreement lies with

(a) any of the parties (in case of the first lease agreement).

(b) only with lessee (in case of the second lease agreement).

(iii) Whether there is a need to equalise rent over the lease term as there is no lock-in-period (in case of lease agreements of the type mentioned in paragraph 3(i) and (iii) above) as per the definition of 'lease term' given in AS 19.

C. Points considered by the Committee

7. The Committee notes that the basic issues raised in the query relate to determination of lease term and whether there is a need to equalise rent over the lease term. The Committee has, therefore, answered only these issues and has not gone into the specific cases under the two lease agreements cited by the querist in the absence of the relevant information with respect to both the agreements. The Committee presumes from the Facts of the Case that the lease under both the cases is an operating lease.

8. The Committee notes the following definitions from AS 19:

> ***"The <u>lease term</u> is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise."***
>
> "***A <u>non-cancellable lease</u> is a lease that is cancellable only:***
>
> ***(a) upon the occurrence of some remote contingency; or***
>
> ***(b) with the permission of the lessor; or***
>
> ***(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or***
>
> ***(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain."***

9. As far as the determination of lease term is concerned, the Committee is of the view that the lease term is the non-cancellable period for which the lease has been contracted plus further period(s) for which the lessee has the option to continue the lease provided such option at the inception of the lease it is reasonably certain that the lessee will exercise. If any of the terms contained in the lease agreement with respect to cancellation thereof, are covered by the definition of 'non-cancellable lease', the agreement will

be treated as non-cancellable. If there are no terms in the lease agreement with respect to cancellation thereof, in the view of the Committee, it would also be treated as non-cancellable lease. Existence of a clause permitting termination of a lease agreement upon notice does not by itself amount to a cancellable lease. Moreover, existence of a clause of notice period in the lease agreement implies that as a minimum, the lease is non-cancellable for the duration of the notice period. With respect to the reasonable certainty of continuation of the lease term, the Committee is of the view that when a lease agreement is entered into for a certain initial period, that initial period can be construed as the period for which the lease of the asset is reasonably certain to continue at the inception of the lease. For any extension of the initial lease term to be treated as the 'lease term' in accordance with the definition reproduced in paragraph 8 above, the Committee is of the view that the reasonable certainty of renewal of the lease agreement at the inception of the lease should be considered. The same should be determined on the basis of the facts and circumstances of the case considering various factors, e.g., the expectation that the rentals during the period of renewal are expected to be considerably lower than the fair market value of the rentals at the date the option by the lessee becomes exercisable, the lessee has made substantial expenditure on leasehold improvements which have useful life much in excess of the initial lease period, importance of the lease to the business, or the fact that the lessee has entered into business commitments, the fulfillment of which would require renewing the lease of the premises beyond the initial lease term, uniqueness of purpose or location of the property, the availability of a comparable replacement property, ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates, any past practice in this regard in comparable circumstances, etc.

10. With respect to equalisation of the rent over the lease term, the Committee notes the following paragraph of AS 19:

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

11. From the above paragraph, the Committee is of the view that the lease rentals payable over the lease term should be recognised on a straight-line

basis unless there is another systematic basis which is representative of the time pattern of the benefit derived by the lessee from that asset. The Committee is of the view that the Standard does not recognise increases in the lease rentals on a scheduled basis as a factor representing the time pattern of the user's benefit. Accordingly, the lease payments, including the scheduled rent increases in the lease rentals, should ordinarily be recognised on a straight-line basis over the lease term as determined in accordance with paragraph 9 above.

D. Opinion

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

(i) In view of non-availability of the relevant facts for determining whether the lease would be extended beyond the initial lease term, the specific issue with respect to lease term in the case of the second lease agreement is not being answered. As a matter of general principle, the lease term is the non-cancellable period for which the lease has been contracted plus further period(s) for which the lessee has the option to continue the lease provided such option at the inception of the lease it is reasonably certain that the lessee will exercise. For determination of the lease term, please refer to the discussion in paragraph 9 above.

(ii) Irrespective of whether the option to terminate the lease agreement lies with the lessee or with both, the lessor and the lessee, the lease rentals should be equalised over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit, as discussed in paragraph 11 above.

(iii) Since there is no concept of 'lock-in-period' in AS 19, the question of considering the same while determining the need to equalise rent over the lease term does not arise. As discussed in paragraph 11 above, the lease rent is required to be equalised over the lease term determined in accordance with paragraph 9 above.

Query No.7

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

A. Facts of the Case

1. A Government of India enterprise incorporated under the Companies Act, 1956, is engaged in the business of transmission of power from the generating units to different State Electricity Boards (SEBs) through its transmission network. With the growing investment in power sector, it also undertakes construction of new transmission systems linked with the generating units as well as system strengthening schemes of the existing networks.

2. The company has borrowed foreign currency loans to partly finance its capital expenditure on construction of new projects. The principal and interest on the loans are repaid in the agreed foreign currencies as per the terms of the various loan agreements. As per the querist, the resulting foreign exchange rate variation (FERV) is being accounted for as per the requirements of Accounting Standard (AS) 11 (pre-revised as well as revised), i.e., 'Accounting for the Effects of Changes in Foreign Exchange Rates' (1994) and 'The Effects of Changes in Foreign Exchange Rates' (revised 2003), as applicable, and Accounting Standards Interpretation (ASI) 10[2], 'Interpretation of paragraph 4(e) of AS 16' issued by the Institute of Chartered Accountants of India.

3. The querist has stated that due to fluctuations in exchange rates of various currencies, the accounting for accrued FERV, as stated above, results into vast fluctuations in the quarterly as well as the annual results of the company. As per the Central Electricity Regulatory Commission (CERC) norms, FERV is recoverable in tariff from State Electricity Boards on actual payment basis. The querist has informed that to avoid the mismatch, the matter was referred to the Expert Advisory Committee (EAC) which had

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[1] Opinion finalised by the Committee on 8.5.2009

[2] The ASI 10 has been withdrawn by the Council of the Institute of Chartered Accountants of India and the Consensus portion thereof has been added as 'Explanation' to the paragraph 4(e) of Accounting Standard (AS) 16, 'Borrowing Costs'.

given its opinion on the same (copy enclosed as Annexure. The Opinion is also published as Query No. 10 of Compendium of Opinions Volume XXVII).

4. The querist has mentioned that the accounting treatment suggested by EAC in the above mentioned opinion would resolve mismatch between the recovery in tariff and the accounting treatment as per the provisions of AS 11 and ASI 10. However, according to the querist, the opinion of EAC regarding (i) the date of implementation of the suggested accounting treatment with retrospective effect; and (ii) charging the financial impact of the suggested accounting treatment pertaining to earlier years to the profit and loss account as 'prior period item' may be reconsidered in view of the facts and reasons brought out in subsequent paragraphs. The opinion given in these two matters has been reproduced by the querist as below:

"15. …

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

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

5. As per the querist, the opinion regarding implementation of the suggested accounting treatment with retrospective effect from the date accounting Standard (AS) 16, 'Borrowing Costs' became applicable may be reconsidered in view of the following facts:

(a) Reimbursement of FERV stated in paragraph 3(ii) of the earlier opinion is reckoned as per the present CERC norms in this regard. As such, the reimbursement of FERV is considered with respect to exchange rates prevailing as on 01/04/2004 or the date of commercial operation of the respective transmission projects whichever is later.

(b) Reimbursement of FERV is allowed in respect of amount of loan outstanding as on 01/04/2004 or the date of commercial operation of the respective transmission project whichever is later.

(c) FERV accrued up to 31/03/2004 was included in the capital cost for the purpose of tariff. On such capital cost (including FERV upto 31/03/2004) normal tariff is allowed as per CERC norms.

Considering the above, the querist is of the view that it will be more appropriate to implement the accounting treatment opined by the Expert Advisory Committee w.e.f. 01/04/2004 or the date of commercial operation, whichever is later. Further, as per the querist, if the accounting treatment is implemented from any other date, the amount being depicted as 'deferred foreign currency fluctuation asset/liability account' in accordance with the earlier opinion shall not match with the actual amount recoverable/payable as per the provisions of CERC norms.

6. The querist has further mentioned that in paragraph 15(iii) of the earlier opinion (reproduced in paragraph 4 above), EAC has suggested that adjustments arising from retrospective implementation should be accounted for as "prior period items". Alternatively, as per the earlier opinion, the amount may be included in the 'natural heads' provided the nature thereof and the relevant amounts are disclosed in the Notes to Accounts. In view of the querist, this opinion may be reconsidered in view of the fact that implementation of the suggested accounting treatment with retrospective effect is not on account of any error or omissions in the earlier years. Further, the querist is of the view that alternatively, the amount to be credited/debited to the profit and loss account on account of retrospective implementation upto 31/03/2007 may be accounted for as an adjustment to "General Reserve" as has been allowed in the case of transition period applicability of Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005) and Accounting Standard (AS) 22, 'Accounting for Taxes on Income'. The querist has stated that this is in view of the fact that amount being reversed now has already been adjusted in general reserve through the profit and loss account. Further, as per the querist, this accounting treatment

is considered appropriate and prudent, particularly, as the shares of the company are listed.

B. Query

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

(i) Whether the accounting treatment suggested in the earlier opinion of the Committee referred in paragraph 3 above, should be implemented from 01/04/2004 or the date of commercial operation of the respective transmission project, whichever is later, in respect of the amount of loan outstanding as on that date, instead of from the date of applicability of AS 16 (as suggested in the earlier opinion).

(ii) Whether adjustment on account of retrospective implementation for the period from 01/04/2004 to 31/03/2007 may be made through general reserve instead of as prior period items through profit and loss account.

C. Points considered by the Committee

8. The Committee notes the opinion issued earlier which is given in the Annexure. The Committee has considered only the issues raised by the querist in paragraph 7 above and has not examined any other issue(s) that may be contained in the Facts of the Case or the earlier opinion of the Committee referred by the querist. The views of the Committee contained herein are only with respect to the reimbursement of FERV to the company. The Committee has not examined the recovery of FERV through inclusion in capital cost for tariff purposes or in any other manner as the matter has not been raised by the querist. The Committee has also not revisited its earlier opinion except with respect to the two issues raised by the querist in paragraph 7 above.

9. The Committee notes from the Facts of the Case that it appears that the scheme of reimbursement of foreign exchange rate variation (FERV) to the company by the State Electricity Boards is effective only from April 1, 2004. The Committee also notes that it appears that the reimbursement is only *with respect to* the exchange differences arising on foreign currency loans from April 1, 2004, i.e., considering the foreign exchange rates

prevailing on April 1, 2004 or the date of commencement of commercial operation, whichever is later. Consequently, the exchange differences on outstanding loans prior to April 1, 2004 are not reimbursable to the company.

10. From the above, in the light of the new facts now supplied by the querist, the Committee is of the view that in case of the loans pertaining to projects already in operation on April 1, 2004, since the reimbursement of FERV on actual basis as stated in paragraph 3(ii) of the earlier opinion (see Annexure) is made in the present scheme with effect from April 1, 2004, the accounting treatment suggested in paragraphs 10, 11 and 13 of the earlier opinion of the Committee relating to accounting for FERV which is recognised in the financial statements on the balance sheet date for accounting purposes in one year but is recovered in a later year, should be implemented from April 1, 2004, that is the date from which the foreign exchange differences are effectively reimbursable to the company. In case of new projects, the accounting treatment suggested in the earlier opinion should be followed from the date of expensing/capitalisation of the foreign exchange differences, as the case may be, if at that point of time itself it is known that such foreign exchange differences will be reimbursed to the company at a later date. In case the reimbursement is to be received in respect of FERV arising after the date of commencement of commercial production, the treatment suggested in the earlier opinion should be followed from that date.

11. With respect to the adjustments arising from retrospective implementation (in the present case, implementation from April 1, 2004 or the date since when reimbursement is to be received or the date of commercial operation, as the case may be, as per discussion in paragraph 10 above), the Committee notes that the same will have to be accounted for as a prior period item as per the provisions of Accounting Standard (AS) 5, 'Net Profit or loss for the Period, Prior Period Items and Changes in Accounting Policies'. Accordingly, no adjustment on this account can be made directly to the general reserve. The Committee is of the view that adjustment directly to the general reserve under the transitional provisions of some new accounting standards are specifically allowed under those Standards only.

D. Opinion

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

(i) In case the reimbursement of foreign exchange rate variation is effective from April 1, 2004, the treatment suggested in paragraphs 10, 11 and 13 of the earlier opinion of the Committee (contained in Annexure) should be applied from that date. However, in case of new projects, the said accounting treatment will have to be followed from the date of expensing/capitalisation of the foreign exchange differences if it is known at that point of time that the same would be reimbursed under the tariff plan at a later date. In case the reimbursement is to be received in respect of FERV arising after the date of commencement of commercial production, the treatment suggested in the earlier opinion should be followed from that date. Please refer to paragraph 10 above.

(ii) The adjustment of amounts on retrospective implementation for the period from April 1, 2004 to March 31, 2007 cannot be made directly through general reserve. The said adjustment will have to be made as a 'prior period item' through the profit and loss account of the year in which the treatment is so adopted.

ANNEXURE

Opinion[3]

Subject: ***Accounting for foreign exchange rate variation (FERV) in respect of foreign currency loans restated at the balance sheet date and recoverable from State Electricity Boards later on actual payment basis.***[4]

A. Facts of the Case

1. A Government of India enterprise incorporated under the Companies Act, 1956, is engaged in the business of transmission of power from the generating units to different State Electricity Boards (SEBs) through its

[3] Opinion has been published as Query No. 10 of Compendium of Opinions – Volume XXVII.

[4] Opinion finalised by the Committee on 14.5.2007.

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

2. The company has borrowed foreign currency loans to partly finance its capital expenditure on construction of new projects. The principal and interest on the loans are repaid in the agreed foreign currencies as per the terms of the various loans. According to the querist, as per the requirements of Accounting Standard (AS) 11 (pre-revised as well as revised), the outstanding loans are restated at the year-end on the prevailing exchange rates as on that date (i.e., 31st March of each year). The resulting foreign exchange rate variation (FERV) is being accounted for as under:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) the amount debited or credited in the profit and loss account due to FERV in the form of interest, depreciation and FERV (as explained in paragraph 2 above) should be depicted as 'deferred foreign currency fluctuation asset/liability' under the current assets or liabilities in the balance sheet by corresponding debit/

credit to the profit and loss account as 'deferred income/ expenditure from foreign currency fluctuation', to the extent the same is recoverable as per the tariff norms of the Regulatory Commission.

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

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

B. Query

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

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

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

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

C. Points considered by the Committee

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

variation as stated in paragraph 2 above.

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

9. The consequence of the above peculiarities of tariff fixation in the electricity companies is that there would be a divergence between the accounting income, i.e., the income computed by applying the generally accepted accounting principles and the income computed by applying the tariff fixation requirements. With a view to reflect a true and fair view of the profit (loss) for the period, the revenues and expenses need to be matched. The Committee is of the view that the matching can be achieved in respect of the situations mentioned in above paragraphs by recognising a deferred liability in the cases where excess revenue arises in the initial years because higher costs are considered for tariff purposes as compared to those recognised in the financial statements, which gets reversed in the later years when the expenses for tariff purposes become lower as compared to those recognised in the financial statements. Similarly, the matching can be achieved in respect of the situations, where an expense is recognised earlier in the financial statements as compared to that for tariff purposes, by recognising a deferred asset subject to the consideration of prudence, i.e., the realisability of the asset is reasonably certain or where the company has a history of business losses, the realisability of the asset is virtually certain, also keeping in view the contractual reimbursement rights as per the tariff norms of the regulatory authority. In respect of the situations where the differences between the expenses/revenue do not get reversed in the subsequent years, no effect is required to be given.

10. Regarding the issue raised by the querist in the present case related to accounting for foreign exchange rate variation in respect of the foreign currency loan, which is recognised in the financial statements on the balance

sheet date for accounting purposes in one year but is recovered in a later year for tariff purposes, two situations would arise:

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

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

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

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

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

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

9 above.

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

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

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

13. The Committee, however, notes that on 7/12/2006, the Ministry of Company Affairs, Government of India, has notified the Accounting Standards 1 to 7 and 9 to 29 as recommended by the Institute of Chartered Accountants of India, which are specified in the Annexure to the Companies (Accounting Standards) Rules, 2006. Accounting Standard (AS) 11, as contained in the Annexure to these Rules, while prescribing the accounting treatment in respect of recognition of exchange differences, states in paragraph 13, " ***Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise..."*** and also contains a footnote which states that the "accounting treatment of exchange differences contained in this Standard is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956". Accordingly, in the view of the Committee, with effect from accounting periods commencing on or after 7/12/2006, the foreign exchange differences arising in respect of fixed assets purchased from abroad would also have to be recognised in the profit and loss account, which were hitherto, debited to the cost of fixed asset in view of the requirements of Schedule VI to the Companies Act, 1956. Accordingly, the treatment prescribed in paragraph 11 above which relates to recognising FERV in the profit and loss account would be relevant.

14. As far as the issues raised in paragraph 6(ii) and (iii) are concerned, the Committee notes that paragraph 4(e) of AS 16 became applicable from the date when AS 16 came into force and ASI 10 deals only with the interpretation of the same. Accordingly, paragraph 4(e) of AS 16 should be interpreted in the way stipulated in ASI 10 from the date the Standard came into force. Therefore, in the view of the Committee, insofar as the capitalisation of FERV in respect of foreign currency loan as per the requirements of AS 16 read with ASI 10 is concerned, the accounting treatment prescribed above in respect thereof should be applied from the date AS 16 became applicable to the company with retrospective effect. The adjustments arising from the retrospective implementation should be treated as 'prior period items' and should be accounted for keeping in view the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India. The disclosure of the amounts arising therefrom may be included in the natural heads provided the nature thereof and the relevant amounts are disclosed in the notes to accounts, so that their impact on the profit or loss can be perceived. These can also be reflected as a separate item in the statement of profit and loss. In this regard, the Committee notes paragraph 15 of AS 5, which states as follows:

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

D. Opinion

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

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

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

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

Query No. 8

Subject: Revenue recognition from sale of WEGs, and providing installation, commissioning and other related services.[1]

A. Facts of the Case

1. A company is engaged in the business of manufacture, erection and commissioning of Wind Electric Generators (WEGs). The company is also engaged in the business of providing sales services for the WEGs besides earning revenue from generation of electricity from its own WEGs.

2. Based on negotiations by the company, the customers agreeing to place orders with the company, issue the following three separate Purchase/ Work Orders (a copy each of the formats for these orders have been furnished by the querist for the perusal of the Committee):

(i) Purchase Order for supply of WEGs.

(ii) Work Order for civil, electrical and infrastructure work.

(iii) Order for erection and commissioning of WEGs.

[1] Opinion finalised by the Committee on 8.5.2009

3. The company has been recognising revenue based on the completion of an activity covered in the above mentioned three Purchase/Work Orders separately. As per the querist, the reasons for taking this view are the following:

(i) Each activity is an independent activity governed by a separate Purchase/Work Order.

(ii) Each Purchase/Work Order has a different payment schedule.

(iii) The taxes, as applicable for each Purchase/Work Order, are different and are deposited by the company on completion of the specific activity of the said Purchase/Work Order.

(iv) Accounting Standard (AS) 9, 'Revenue Recognition', requires that the amount of revenue arising on a transaction is usually determined by an agreement between the parties involved in the transaction. The company enters into separate Purchase/ Work Orders and hence, complies with the requirement.

(v) AS 9 requires that the key criterion to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property to the buyer for a consideration.

4. As per the querist, the accounting policy now suggested by the company for adoption in respect of revenue recognition is as under:

"Revenue Recognition

- Revenue comprises sale of WEGs and its spare parts, project income being installation and commissioning of WEGs, income from maintenance services, power generation from own WEGs and interest income. Revenue is recognised to the extent it is probable that the economic benefits will flow to the company and that the revenue can be reliably measured and is expected to be received. Revenue is disclosed net of taxes.

- Sale of WEGs and spare parts are recognised when the significant risks and rewards in respect of ownership of goods have been transferred to the buyer as per the terms of the respective sale orders. Income from project involving installation, commissioning and other incidental works is recognised on completion of the respective work, as per the terms of the work orders.

- Revenue from annual maintenance contracts is recognised on a proportionate basis over the period of the contract on a straight line basis. Income from support services is recognised upon completion of the services.

- Power generation income is recognised on the basis of electricity units generated, net of wheeling and transmission loss.

- Interest income is recognised on a time proportion basis."

5. The querist has informed that the time required for supply of WEGs, completion of civil, electrical and infrastructure works and erection and commissioning normally varies between 4 to 6 months from the date of receipt of purchase order by the company. The period may vary depending on the total capacity of the project and the location of the project. The querist has stated that there are certain situations when part of the activities are completed as at the end of the financial year, e.g., as on March 31, only delivery of WEGs takes place while all other activities, i.e., installation, erection and commissioning gets shifted to the next financial year. Insofar as the company is concerned, major cost of the project is already incurred by the company and supply of WEGs is completed as per supply order and accordingly, as per the querist, it should be possible to fully book the revenue of the same as on 31st March. The querist has stated that it has been indicated to the company that if revenue for supply of WEGs is to be booked, a letter be obtained from the customer certifying receipt of WEGs and confirming that risks and rewards in respect of ownership of goods have been transferred to the customer.

6. The querist has further stated that the following background needs to be kept in view with respect to the requirement of obtaining the above-mentioned letter:

(a) The policy followed by the company is that after manufacturing the WEGs, these are transferred by the company on a stock transfer basis to a particular site in a particular State and as and when order is received by the company from any customer, the WEGs are allocated to that customer and invoice is raised from that particular site and State in the name of the customer. The WEGs after allocation continue to be in the possession of the company for installation, erection and commissioning. The site is handed over to the customer after commissioning of the WEGs.

(b) Since the WEGs are taken over by the customer after commissioning alongwith relevant papers at site, there is reluctance on the part of the customer to give any kind of letter confirming passing of significant risks and rewards in respect of ownership of goods prior to that stage. It is, however, a fact that WEGs are installed at remote sites, where no representative of the customer is present and as such question of obtaining any letter is, therefore, difficult. On the company's part, it is important to recognise revenue as manufactured goods leave the premises and are invoiced in the name of the customer as on 31st March.

B. Query

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

(a) Whether the accounting policy for revenue recognition presently suggested to the company is in line with AS 9 or any change is required to be made.

(b) Whether the company can adopt the policy on revenue recognition independently for all the three orders, without insisting on obtaining a letter from the customers regarding transfer of significant risks and rewards, on account of peculiar nature of the situation.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to whether the accounting policy suggested to the company in respect of recognition of revenue from sale of WEGs and performance of related activities, such as, installation, erection and commissioning in respect thereof is in order. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may be contained in the Facts of the Case, such as, revenue from sale of spare parts, generation of electricity, annual maintenance contract, support services, interest income, etc. Further, the Committee has not examined the accounting for cost of land, path way

rights etc. as mentioned in the format for work order for civil, electrical and infrastructural work as the adequate details in respect of the same have not been provided.

9. The Committee notes from the Facts of the Case that the querist has stated that based on negotiations by the company, the customers agreeing to place orders with the company issue three separate purchase/work orders for supply of WEGs and related activities, implying that there are common negotiations for all the three orders. Further, on a perusal of the formats for the said three orders, the Committee notes that the activities performed under the three orders are inter-connected and for all the three orders, commissioning of the WEG is an essential part. From the above, the Committee is of the view that the three separate contracts entered into by the company with its customers are in fact one composite contract which has been broken into three separate agreements.

10. The Committee further notes from the Facts of the Case that the WEGs are manufactured by the company and kept in stock for allocation to the customers upon receiving an order. Further, as stated by the querist, as far as the company is concerned, the major cost of the project is incurred upto the supply of the WEGs. Accordingly, in the view of the Committee, the contract in the present case basically relates to sale of WEGs.

11. 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."

"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."***

12. The Committee notes from the above that in the instant case, the performance in respect of sale of WEGs is not complete until the commissioning of the WEGs as commissioning is an essential part of all the agreements. The company retains its effective control over the WEGs till the handing over thereof to the customer after commissioning. The Committee is of the view that mere allocation of WEGs to a particular customer/site, or raising of invoice in the name of customer, or delivery of WEGs at the customer's site, do not result in transfer of significant risks and rewards relating to ownership of goods. In this connection, the Committee wishes to point out that the reluctance on the part of the customer to give any kind of letter confirming passing of significant risks and rewards in respect of ownership of goods before commissioning and handing over of the WEGs to the customer, also gives an indication that significant risks and rewards of ownership of goods do not pass to the customer before commissioning of WEGs. Thus, revenue in the present case should be recognised only on the commissioning of the WEGs. Accordingly, in the view of the Committee, the accounting policy of the company in respect of recognition of revenue from sale of WEGs and performance of various activities, such as, erection, installation, commissioning and other incidental works, on completion of the

respective activities as per the terms of the respective purchase/work order is not correct and the same should be rectified on the lines discussed above.

13. As regards obtaining a letter of confirmation from the customer with respect to passing of the significant risks and rewards of ownership, the Committee is of the view that although AS 9 does not contemplate obtaining such a confirmation, the auditor, while gathering audit evidences can consider obtaining such confirmations.

D. Opinion

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

(a) Subject to paragraph 8 above, the accounting policy for revenue recognition presently suggested to the company is not in line with AS 9 and the same should be rectified on the lines discussed in paragraph 12 above.

(b) No, the company cannot adopt the policy on revenue recognition independently for the three orders as these form part of a single composite contract as discussed in paragraph 9 above. As regards obtaining a letter from the customers regarding passing of significant risks and rewards of ownership, refer paragraph 13 above.

Query No. 9

Subject: Accounting treatment of exchange differences in respect of loan transactions entered into prior to 1.4.2004.[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.

2. The company borrows in foreign currency to meet its fund requirement for construction of projects. Such foreign currency loans are taken for acquiring assets from outside India and also for acquiring assets from within India. The querist has stated that all the agreements for foreign currency loans had been entered into prior to 01.04.2004. During the construction stage of a hydro project, no profit and loss account is prepared. Indirect expenditure during construction, such as, employee cost, depreciation and interest cost (net of any receipts) are taken to an account known as 'Incidental Expenditure During Construction (IEDC)', which is prepared in lieu of profit and loss account. The whole of the direct capital expenditure and the indirect expenditure during construction becomes the total capitalised cost of the project on commissioning of the project. Profit and loss account of a project is prepared from the date of commencement of commercial operation (COD). During the construction phase, the project is termed as 'construction project' and after COD, it is termed as 'power station'.

3. The querist has stated that the company has been giving accounting treatment to foreign exchange rate variation (FERV) on restatement of loan utilised for acquiring assets as per the provisions of Accounting Standard (AS) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates' (1994), read with Accounting Standard (AS) 16, 'Borrowing Costs', and Accounting Standards Interpretation (ASI) 10[2] on Interpretation of paragraph 4(e) of AS 16, issued by the Institute of Chartered Accountants of India, which is explained below through pictorial diagrams:

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[1] Opinion finalised by the Committee on 8.5.2009

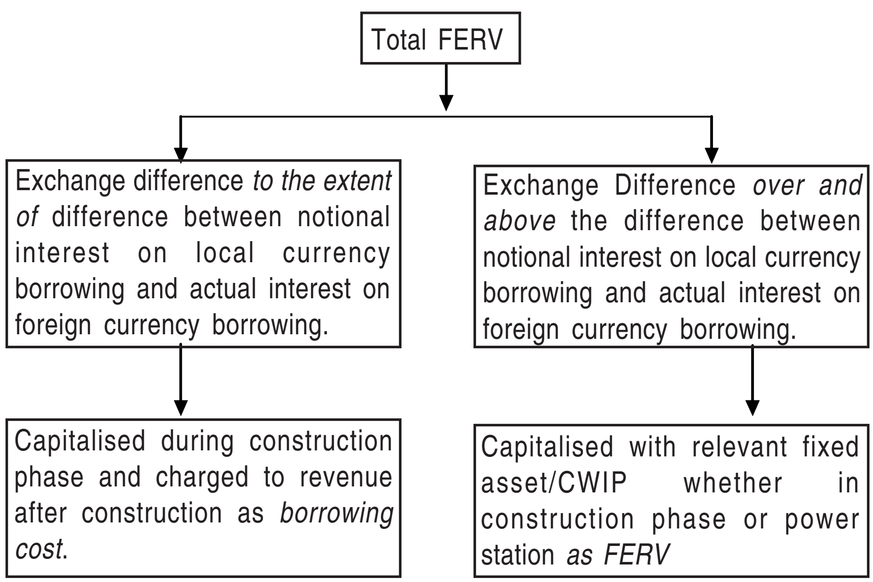
[2] The ASI 10 has been withdrawn by the Council of the Institute of Chartered Accountants of India and the Consensus portion thereof has been added as 'Explanation' to the paragraph 4(e) of Accounting Standard (AS) 16, 'Borrowing Costs'.

(A) Till the financial year 2006-07 (prior to notification of Accounting Standards under section 211(3C) of the Companies Act, 1956)

Case I: FERV in respect of loans contracted prior to 01.04.2004 for acquiring assets from outside India:

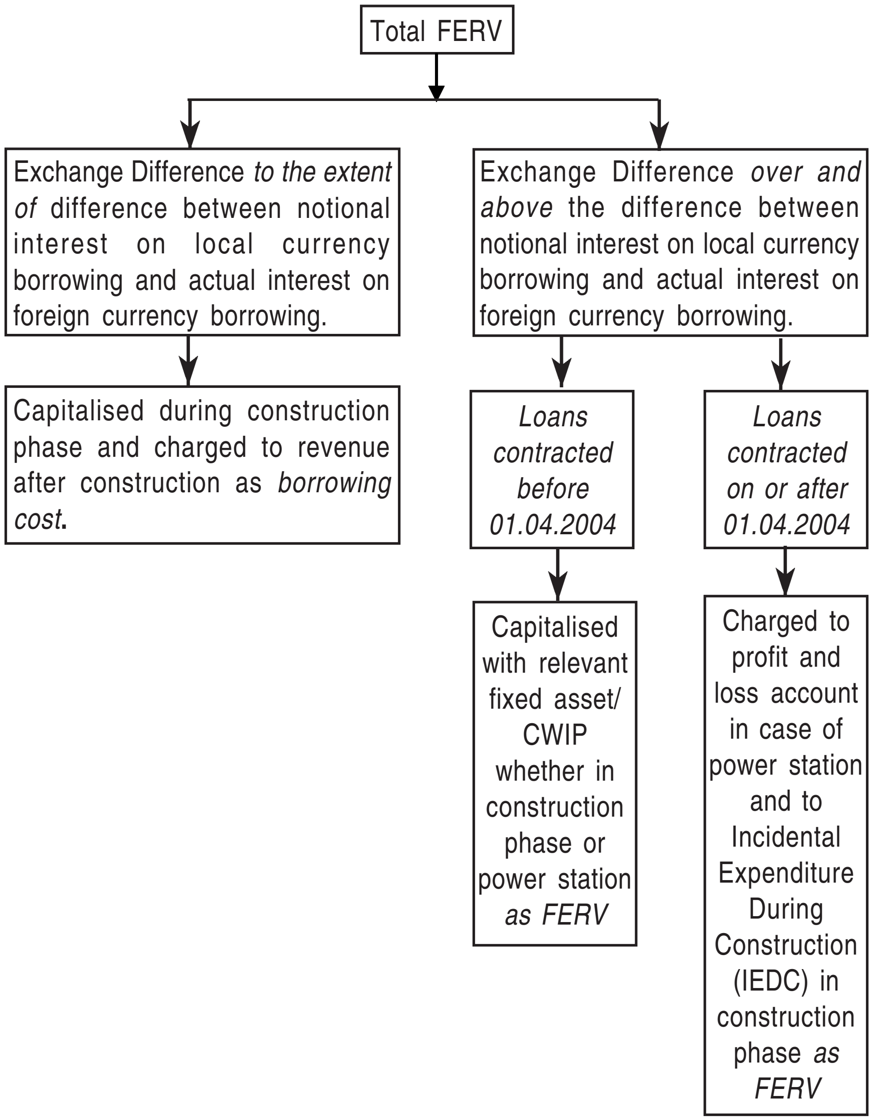
The whole of FERV (gain or loss) was capitalised keeping in view the provisions contained in Schedule VI[3] to the Companies Act, 1956, irrespective of whether the project was a construction project or power station. In case of a construction project, FERV was debited/credited to Capital Work-in-Progress ('CWIP') and in case of power station the same was debited/credited to the respective fixed assets.

Case II: FERV (gain or loss) in respect of loans contracted prior to 01.04.2004 for_acquiring assets from within India:



(B) From the financial year 2007-08 (after notification of Accounting Standards under section 211(3C) of the Companies Act, 1956, irrespective of the fact whether assets are acquired from outside India or from within India)

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



(Emphasis supplied by the querist.)

4. The company is under regulatory regime and tariff (sale price) for electricity is fixed by Central Electricity Regulatory Commission (CERC). The querist has stated that as per one of the latest regulation, exchange rate variation loss incurred by power station is recoverable from the beneficiary, i.e., the company's customers. As such, according to the querist,

irrespective of any accounting treatment of FERV, i.e., whether to charge/ credit FERV in the profit and loss account or to capitalise/decapitalise in carrying value of assets, FERV shall not be having any impact on the profit and loss account in view of an earlier opinion expressed by the Expert Advisory Committee of the Institute of Chartered Accountants of India published as Query No. 37 in the Compendium of Opinions – Vol.XXV.

5. During the financial year 2007-08, the company has incurred FERV loss (net of FERV gain at one of the locations). FERV loss and gain was compared with the difference between the interest on local currency borrowings and the interest on foreign currency borrowings in order to know the amount of FERV which can be regarded as adjustment to interest cost in terms of paragraph 4(e) of AS 16, as per which, borrowing costs may include 'exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs'. FERV loss to the extent of difference between the interest on local currency borrowings and the interest on foreign currency borrowings has been accounted for as borrowing cost and charged to profit and loss account in case of power station. Following the same principle, FERV gain amounting to Rs. 7.41 crore arising out of the foreign currency loan contracted prior to 01.04.2004 in respect of one of the power stations was credited to the profit and loss account as borrowing cost (negative). This treatment was done because, as per the querist, such FERV loss/gain satisfies the criteria of paragraph 4(e) of AS 16 read with paragraph 3 of ASI 10 which is reproduced below:

> "… If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or *more than the exchange difference* on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4(e) of AS 16."

In other words, according to the querist, *FERV gain shall always be less than the difference between the interest on local currency borrowings and the interest on foreign currency borrowings* and**,** as such, the whole of FERV gain qualifies to be covered under paragraph 4(e) of AS 16 (emphasis supplied by the querist).

6. However, during the audit of accounts for the financial year 2007-08, the government auditors gave an observation on the accounting treatment given by the company in respect of FERV gain. The contention of the auditors

was that FERV gain should have been adjusted in the carrying amount of the respective fixed assets of the power station instead of crediting to the profit and loss account.

7. The management is of the view that ASI 10 on interpretation of paragraph 4(e) of AS 16 does not distinguish between FERV loss and FERV gain. As per the management, the basic underlying principle as given in ASI 10 is to treat the entire FERV as borrowing cost, if it is *less than or equal to the difference between the interest on local currency borrowings and the interest on foreign currency borrowings.* As such, by virtue of this principle, when FERV becomes borrowing cost, the provisions of AS 16 should apply. In this regard, the querist has reproduced the following extract from the company's reply to the auditors:

> "... In any case, the difference between interest on local currency borrowings and the interest on foreign currency borrowings in the above case is more than the FERV gain of Rs. 7.41 crore and accordingly the same has been recognised as an adjustment to the borrowing cost. If we were to adjust this gain in the carrying amount of respective assets, ASI 10 on AS 16 would not have been complied with."

The auditors' observation was not pressed further on the assurance that the management shall solicit the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the issue (emphasis supplied by the querist).

B. Query

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

(i) Whether the accounting treatment followed by the company as explained in paragraph 5 above is correct.

(ii) Other alternative treatment, if any, in lieu of the aforesaid treatment.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to the treatment of FERV loss/gain on foreign currency loan transactions entered into prior to 1.4.2004. Therefore, the Committee has examined only

this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, non-preparation of profit and loss account for the construction project which needs to be examined separately, capitalisation of whole of the indirect expenditure incurred during construction of the project, etc. The Committee has also not examined the aspect of appropriateness of netting off of the FERV loss and FERV gain mentioned by the querist in paragraph 5 above, as the relevant information in this respect has not been provided. The querist has stated in the facts of the case that all the agreements for foreign currency loans had been entered into/contracted prior to 01.04.2004. The Committee presumes that the loan 'transactions' were entered into prior to 1.4.2004 and, therefore, Accounting Standard (AS) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates' (1994) is applicable. It appears to the Committee that interest on notional local currency borrowing exceeds interest on foreign currency borrowing in all the cases.

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

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

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

> "Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates (revised 2003), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable."

From the above, the Committee is of the view that in the year 2007-08, for the transactions entered into prior to 01.04.2004, AS 11(1994) continues to apply.

11. The Committee notes that AS 11 (1994) requires that the exchange differences arising on foreign currency borrowings for the purpose of acquiring fixed assets should be adjusted in the carrying amount of the respective fixed assets. The requirements in this regard are contained in paragraph 10 of the said Standard which is reproduced below:

> ***"10. Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which are carried in terms of historical cost, should be adjusted in the carrying amount of the respective fixed assets. The carrying amount of such fixed assets should, to the extent not already so adjusted or otherwise accounted for, also be adjusted to account for any increase or decrease in the liability of the enterprise, as expressed in the reporting currency by applying the closing rate, for making payment towards the whole or a part of the cost of the assets or for repayment of the whole or a part of the monies borrowed by the enterprise from any person, directly or indirectly, in foreign currency specifically for the purpose of acquiring those assets."***

12. The Committee notes that Accounting Standard (AS) 16, 'Borrowing Costs', issued by the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1.4.2000. This Standard was later notified under the Companies (Accounting Standards) Rules, 2006. Paragraph 4(e) of this Standard states that borrowing costs include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. The Institute of Chartered Accountants of India issued ASI 10 on Interpretation of paragraph 4(e) of AS 16, whose consensus portion formed the basis for the 'Explanation' to paragraph 4(e) of AS 16 which was notified under the Rules. The Committee notes the 'Explanation' to paragraph 4(e) which is reproduced below:

> **"Explanation:**
>
> Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to

the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings costs to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, The Effects of Changes in Foreign Exchange Rates. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings."

13. From the above, the Committee is of the following view in respect of foreign exchange loss on account of foreign currency borrowings for the purpose of fixed assets:

A. When the construction period is over, i.e., in case of power station

(i) Till the financial year 1999-2000 (i.e., upto 31st March, 2000)

The entire foreign exchange loss should be added to the cost of the relevant fixed assets.

(ii) From the financial year 2000-01 (i.e., from 1.4.2000)

(a) The foreign exchange loss on principal amount of foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings is a borrowing cost under paragraph 4(e) of AS 16. The same should be expensed, i.e., charged to the profit and loss account because the relevant fixed asset is not a qualifying asset under AS 16, irrespective of the requirements of Schedule VI (in relation to capitalisation of foreign exchange differences) which do not apply to borrowing cost.

(b) The foreign exchange loss other than that covered under (a) above should be added to the cost of the relevant fixed asset in view of the requirements of AS 11 (1994).

B. When the construction period is not over, i.e., in case of construction project

The entire foreign exchange loss should be added to the cost of the relevant fixed assets either as a part of the borrowing costs (keeping in view the applicability of paragraph 4(e) of AS 16) or as foreign exchange differences covered under AS 11 (1994).

14. The Committee is of the following view in respect of foreign exchange gain on foreign currency borrowings for the purpose of fixed assets:

A. When the construction period is over, i.e., in case of power station

The entire foreign exchange gain on the borrowings should be reduced from the cost of the fixed assets keeping in view the requirements of AS 11 (1994).

B. When the construction period is not over, i.e., in case of construction project

(i) Till the financial year 1999-2000 (i.e., upto 31st March, 2000)

The entire foreign exchange gain should be reduced from the cost of the relevant fixed assets keeping in view the requirements of AS 11 (1994).

(ii) From the financial year 2000-01 (i.e., from 1.4.2000)

The entire foreign exchange gain should be reduced from the cost of the relevant fixed assets either in the form of reduced borrowing costs (to the extent the foreign exchange loss was added to the cost of the fixed assets under paragraph 4(e) of AS 16) or as foreign exchange differences under AS 11 (1994).

15. With respect to the treatment followed by the company as stated in paragraph 5 above, from the year 2007-08, the Committee is of the view that the treatment followed by the company is not entirely correct. The treatment should be in accordance with the treatment explained in paragraphs 13 and 14 above. The Committee does not agree with the reasoning given by the querist in paragraph 5 above for the treatment followed by the company.

D. Opinion

16. On the basis of the above, under the presumptions/circumstances of the company as stated in paragraph 9 above, the Committee is of the following opinion on the issues raised by the querist in paragraph 8 above:

(i) The accounting treatment followed by the company as explained in paragraph 5 above is not entirely correct. The correct treatment would be the treatment explained in paragraphs 13 and 14 above.

(ii) In view of the correct treatment explained in paragraphs 13 and 14 above, the question of alternative treatment does not arise.

Query No.10

Subject: Accounting treatment of Environment and Health Cess on mineral rights.[1]

A. Facts of the Case

1. A State Government enterprise (hereafter referred to as the 'company') is engaged in mining and marketing of four major minerals, namely, Rock Phosphate, Gypsum, Lignite and Limestone. It is also in the business of generating and selling of wind energy. The querist has stated that the Government of Rajasthan vide its Notification no. F 12(15) FD/Tax/2008-09 dated 25.2.2008 has imposed Environment and Health Cess on mineral rights (hereinafter referred to as 'M.R. Cess') on the despatch of certain minerals from the mines at the rates prescribed and mentioned in the Notification.

2. As per the querist, since the cess is in the nature of indirect tax and the point of levy is the despatch of minerals from mine, the liability of the company to pay the cess arises as soon as the mineral is despatched from mines. Thus, the amount of cess paid/payable on the minerals despatched

[1] Opinion finalised by the Committee on 8.5.2009

from the mines is treated as an expenditure of the company and is, therefore, debited to the profit and loss account under the head 'M.R. Cess on Minerals'. (At the same time, the value of cess on material remaining unsold at the railway sidings is included in the cost of closing stock.)

3. The querist has stated that being an indirect tax, the same is collected through customers at the time of sale at the rate specified by the State Government as under:

(i) Rock Phosphate @ Rs. 35 per MT

(ii) Gypsum @ Rs. 5 per MT

(iii) Cement Grade Limestone @ Rs. 5 per MT

The cess is shown separately in the invoices. In addition to this, the sales tax is also charged thereon and the same is paid to the sales tax department.

4. At the time of preparation of the financial statements for the financial year 2007-08, the company has shown the amount of cess collected as its operational revenue and included in sales. The querist has stated that the accounting treatment given by the company has also been confirmed by the Accountant General ('AG') auditors while conducting their audit under section 619(4) of the Companies Act, 1956.

5. The statutory auditors, during the course of conducting their audit under section 224 of the Companies Act, 1956, held a different opinion on the accounting treatment given by the company, and issued their report with the following qualification:

> "The M.R. Cess has been imposed by the Government of Rajasthan w.e.f. 25.2.08 on despatches of certain minerals and has been credited Rs. 35,24,452/- in the sales of the company and the amount of Rs. 58,08,272/- against the M.R. Cess due for payment to the Government of Rajasthan has been shown in Mining Expenditure whereas the M.R. Cess is neither a part of the sales nor the amount due to the Government of Rajasthan is an expenditure of the company. Thus the sales of Rs. 35,24,452/- has been overstated and expenditure of M.R. Cess has been overstated to the extent of Rs. 58,08,272/- in the profit and loss account."

6. The querist has also provided the AG Auditors' observations on the report of the statutory auditors which states as below:

> "A reference is invited to qualification no: F(xii) wherein it was stated that cess on mineral rights (M.R. cess) imposed by the Government of Rajasthan on despatch of Rock Phosphate, Gypsum and cement grade limestone was neither a part of the sales nor the expenditure of the company and hence there was overstatement of expenditure by Rs.58.08 lakh and sales by Rs.35.24 lakh as the company accounted for both expenditure and sales in the profit and loss account.
>
> The clarification of the statutory auditors was not in order as the company, in pursuance of the notification (February, 2008), was liable to pay the environment and health cess on the mineral rights (M.R. cess) at the prescribed rates on the despatch of Rock Phosphate, Gypsum and Limestone (cement grade) on the material despatched from mines as was done in respect of payment of royalty and is recovering the same from the customers by including in the sales invoice on the quantity sold. Thus, the company was liable for payment of M.R. cess on the quantity despatched from mines whether they were sold or not and at the same time it was realising the amount from the customers by including in the sales invoice only on the quantity sold. Hence, the payment is expenditure and the amount included in the sales invoices is an income to the company. Thus, the accounting treatment given by the company in its books of account was in order."

B. Query

7. Since the view of statutory auditors contradicted the accounting treatment given by the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the accounting treatment given by the company for cess collected and payable is correct or not. If not, what alternative treatment is possible.

(ii) Whether charging of sales tax on the cess is in accordance with the provisions of Rajasthan VAT Act and CST Act.

C. Points considered by the Committee

8. The Committee notes that the first issue raised by the querist in paragraph 7 above, relates to the accounting treatment of Environment and Health Cess on mineral rights collected and payable. As regards the second issue on charging of sales tax on the cess in accordance with the provisions of Rajasthan VAT Act and CST Act, the Committee refrains from examining the issue and expressing any opinion thereon since it involves interpretation of an enactment and as per Rule 2 of the Advisory Service Rules of the Committee, it does not answer queries which involve pure interpretation of legal enactments. Therefore, the Committee has examined only the first issue and has not examined any other issue that may be contained in the Facts of the Case. Further, the Committee has not examined the point of time of levy of cess in view of the said Rule 2 of the Advisory Service Rules and presumes that M.R. Cess is levied at the time of despatch of minerals as stated by the querist in the Facts of the Case.

9. The Committee is of the view that since the M.R. Cess is to be paid by the company on despatch of minerals irrespective of the purpose for despatch, i.e., whether the minerals despatched are sold or not, whether the minerals are despatched for captive use, etc., the cess is an operational expenditure which should be charged to the profit and loss account.

10. In the context of inclusion of cess in the cost of inventory, the Committee examines the applicability of Accounting Standard (AS) 2, 'Valuation of Inventories', to the company. The Committee notes that paragraph 1(d) of AS 2 excludes from its scope the following:

> ***"(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries."***

From the copy of the Annual Report for the year 2007-08 furnished separately by the querist, the Committee notes that the company follows the following accounting policy in respect of valuation of inventories:

> "The valuation of inventories is carried out on the principle of net realisable value or cost of production whichever is less except Stock of Green Marble which is valued at a token value of Re. 1/- per MT."

From the above, it appears that the company does not value the inventories of minerals at its net realisable value, rather values the same on the principle of cost or net realisable value, whichever is lower. Thus, the inventories of minerals in the case of the company do not fall within paragraph 1(d) of AS 2 reproduced above, and therefore, do not get excluded from the scope of AS 2. Accordingly, provisions of AS 2 will apply to the company.

11. The Committee further notes the following paragraph of AS 2:

> ***"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition."***

In accordance with the provisions of AS 2 as quoted above, the cost of inventories of minerals should be inclusive of the cess thereon.

12. With respect to the inclusion of the amount of cess collected as part of operational revenue, the Committee is of the view that since cess is a part of the operational cost, inclusion of the same in the operational revenue is in order.

D. Opinion

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

(i) Subject to the considerations stated in paragraph 8 above, the accounting treatment given by the company for cess collected and payable is correct. If the amount of cess is material having regard to the facts and circumstances, both cess ex penditure and cess amount included in sales, should be disclosed. The question of alternative treatment does not arise.

(ii) As stated in paragraph 8 above, in view of Rule 2 of the Advisory Service Rules, the Committee refrains from expressing any opinion on this issue.

Query No.11

Subject: Exchange rate for accounting of foreign currency transactions through EEFC account.[1]

A. Facts of the Case

1. A public sector company is engaged in the manufacture of power equipments. The company has manufacturing units, power sector regions, service centers and regional offices besides project sites spread all over India and abroad. For executing the orders received, the company receives payments partly in foreign currency and partly in Indian rupees from its customers, both domestic and overseas. The foreign currency receipts, nearly all, from customers are received centrally at Delhi and the outward payments in foreign currency above a threshold (individual payment) are made centrally from corporate office. The small value foreign currency payments are made from the bank account of unit/ region/ regional office. With a view to avoid the adverse exchange rate fluctuations as well as the difference between the buying and selling exchange rate of banks due to time lag between receipts and payments in foreign currency, the company has been maintaining Exchange Earners Foreign Currency (EEFC) accounts in USD and EURO with various banks in line with FEMA regulations. Foreign currency receipts on account of both physical and deemed exports released by customers are credited to the said EEFC accounts. The amount so credited is utilised by the company towards its imports payments to foreign suppliers/contractors without purchasing the foreign currency from the market.

2. The company's accounting policy with regard to 'accounting for foreign currency transactions' is as under:

> "Transactions in foreign currencies are recorded at the exchange rates prevailing on the date of the transaction. Foreign currency monetary assets and liabilities are translated at year end exchange rates. Exchange difference arising on settlement of transactions and translation of monetary items are recognised as income or expense in the year in which they arise."

3. With respect to accounting practice for EEFC accounts and provisions of Accounting Standard (AS) 11 (revised 2003), 'The Effects of Changes in

[1] Opinion finalised by the Committee on 8.5.2009

Foreign Exchange Rates', the querist has stated that the inwards in foreign currency are credited to EEFC account on the date of receipt and the foreign currency payments are made from EEFC account on daily basis (considering the funds available in the EEFC account). Though the said foreign currency receipts and payments are transacted in foreign currency only but they are to be recorded in bank book in INR. For the purpose of accounting for foreign currency transactions in Rupees, suitable exchange rate needs to be applied. In this respect, the querist has reproduced the following extracts from AS 11:

> ***"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.***
>
> 10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.
>
> ***11. At each balance sheet date:***
>
> > ***(a) foreign currency monetary items should be reported using the closing rate..."***

4. The accounting procedure followed by the company for foreign currency transactions routed through EEFC accounts is as under:

(i) Amounts received in USD and EURO are credited to the respective EEFC account without converting the same into Rupees. For accounting, the amount in foreign currency is converted into Indian Rupees at the exchange rates prevailing on the date of credit.

(ii) In case of outward payments from the said EEFC accounts, the same is also converted into Indian Rupees at the exchange rates prevailing on the date of payment.

(iii) Upto a period, State Bank of India (SBI) Card Rates prevailing on the date of actual receipt into and payments from EEFC accounts were being used for reporting the foreign currency amounts into Rupees for the purpose of accounting. Difference between the exchange rates prevailing on the date of payments and the exchange rates prevailing on the date of receipts adjusted on First-in, First out (FIFO) basis was booked to the profit and loss account under the head 'exchange variation'.

(iv) As SBI Card Rates are different for receipts (assets) and payments (liabilities) which varies from Inter Bank Rate (IBR) on both sides by around 25-30 paisa, the same was resulting into booking of exchange variation gain without any real movement in the exchange rates in the market. Even in case of receipt and payment of same foreign currency amount on a single day, the booking at SBI Card Rates would result into exchange variation gain simply due to significant difference between buying and selling rates (as against the normal 1 paisa spread between Bid and Ask rates).

(v) During the year 2007-08, the volume of forex remittances increased significantly and LCs/bills payable not only at SBI but also with various other banks were paid through the EEFC accounts. Thus, instead of buying foreign currency from each bank for payment of LCs/bills due with them, foreign currency is made available to them through EEFC account maintained with banks. As each bank has its own card rates for foreign currency payments, it was thought appropriate to use one common exchange rate for accounting in Rupees.

(vi) Reserve Bank of India (RBI) issues reference rate on daily basis during the afternoon after taking the prevailing market rates from various banks. As such, the recording of receipts and payments in EEFC account at the RBI reference rate would lead to recording of the foreign currency transactions at a rate prevailing on the date of transaction representing the market closely. Moreover, there is only 1 paisa bid/ask spread between the RBI rates applicable for receipts and payments.

(vii) As such, for the purpose of accounting for foreign currency transactions in EEFC accounts, instead of SBI Card rates it was decided to adopt the exchange rate circulated by RBI which is common for all commercial banks.

5. The querist has stated that the exchange rates adopted for accounting of other foreign currency income, expenditure, assets and liabilities are as below:

(i) EEFC accounts are exclusively maintained by the corporate office, where transactions are made by banks in foreign currency only and bank statement given by the bank is also in foreign currency. Only for the purpose of accounting, exchange rates are applied to convert the foreign currency amount into Rupees. On the other hand, foreign currency transactions at units/regions/divisions are made from their Rupee account at the actual settled exchange rates with banks.

(ii) For other foreign currency transactions at units/regions/divisions where exchange rates are only required for accounting, the corporate office circulates exchange rates on monthly, quarterly and annual basis for accounting of foreign currency transactions at the units/regions/divisions. These exchange rates are required for conversion of foreign currency transactions relating to current assets, cash & bank balances, liabilities, income and expenditure, to ensure application of suitable rate depending upon the type of foreign currency transactions. Accordingly, SBI Card Rates are circulated to units separately for Telegraphic Transfer (TT)/ Bills Buying and TT/ Bills Selling.

(iii) Over the years, all accounting units in the company have been following SBI Card Rates for translation of foreign currency monetary assets and liabilities.

6. During the accounts closing for the financial year 2007-08, the government auditors have raised a query that individual banks' exchange rates should have been used while accounting for the transactions in Rupees instead of using RBI rates. During discussion with the government auditors at their Director level, it was pointed out by them that units are accounting for foreign currency transactions on the basis of SBI exchange rates while for EEFC accounts, RBI rates are being used.

B. Query

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

(i) Since the main objective of operating EEFC accounts is to hedge against fluctuations in the exchange rates of foreign currencies, there should not be any element of gain or loss on account of exchange variation due to operation of the said accounts. As such, whether the company can account for the payments from EEFC accounts at the exchange rates applicable to receipts without considering the exchange rates prevailing on the dates of payment from the accounts. By following this method, no exchange rate variation will be booked for inflow and outflow transactions from EEFC accounts except to the extent applicable on the closing balances which can be converted at the applicable SBI Card Rates. Moreover, in EEFC accounts all transactions take place in foreign currency and for the purpose of recording only, exchange rate is applied to work out the amount in Rupees.

(ii) If the answer to the above is not in the affirmative, and the exchange rates applicable on receipt and payments dates only have to be applied to inflows and outflows respectively, please clarify as to which exchange rates are to be adopted, viz., SBI Card Rates or RBI Reference Rates or any other exchange rates for transactions through EEFC accounts.

(iii) Considering the appropriateness of RBI Reference Rate for EEFC accounts' transactions and SBI Card Rates for accounting of other foreign currency transactions (due to availability of both buying and selling exchange rates separately), shall it be appropriate to continue applying RBI Reference Rate for EEFC accounts' transactions during the accounting period to resemble the market rate more appropriately and at the end of the accounting period, the SBI Card Rate would be applied for conversion of EEFC accounts' balances so as to bring uniformity at company level with the exchange rate applicable for accounting of other foreign currency transactions.

C. Points considered by the Committee

8. The Committee restricts itself to the particular issues raised by the querist in paragraph 7 above and has not examined any other accounting issues that may be contained in the Facts of the Case.

9. The Committee notes paragraphs 9, 10 and 11 of AS 11 reproduced in paragraph 3 above. From the said paragraphs, the Committee notes that all transactions, whether involving receipt of foreign currency or payment in foreign currency, should be recorded at the exchange rate on the date of transaction, or at a rate that approximates the actual rate at the date of the respective transactions, e.g., an average rate. Accordingly, the Committee is of the view that a common rate circulated by the corporate office for recording of transactions effected at different branches/regions, etc. through different bank accounts is not appropriate unless it approximates the actual rate. Since the exchange rate used for recording a foreign currency transaction should reflect the actual rate at the date of the transaction, the Committee is of the view that the transactions effected through EEFC accounts should also be recorded at the rate at the date of the transaction. The exchange rate at which monies were received in the EEFC account will have no bearing on the exchange rate applicable to payments made out of that account. The Committee is also of the view that all monetary liabilities and bank balances as on the date of the balance sheet should be reported using the closing rate.

10. With respect to the rate to be used for recording the foreign exchange transactions, the Committee is of the view that the actual exchange rate of the bank through which the transaction is effected would be the appropriate rate. For transactions through the EEFC accounts, the exchange rate of the bank with whom the respective EEFC accounts are maintained, should be used.

D. Opinion

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

(i) Keeping in view the requirements of AS 11 and appreciating the intention of paragraph 10 thereof that a rate that approximates the actual rate at the date of transaction should be used for recording foreign exchange transactions, the company cannot account for the payments from EEFC accounts at the exchange rates applicable to receipts without considering the exchange rates prevailing on the dates of payments from the accounts. For transactions through the EEFC accounts, the exchange rate of the bank with whom the respective EEFC accounts are maintained, should be used. The closing balances of the EEFC accounts should be converted at the closing rate of the bank with whom the respective EEFC accounts are maintained.

(ii) The actual exchange rate of the bank through which the transaction is effected should be used for recording foreign currency receipts and payments. For transactions through the EEFC accounts, the exchange rate of the bank with whom the respective EEFC accounts are maintained, should be used.

(iii) The issue raised has been replied in (i) and (ii) above.

Query No. 12

Subject: Accounting for expenditure incurred on evacuation of accumulated ash in the ash dyke.[1]

A. Facts of the Case

1. A Government of India enterprise was incorporated in the year 1975 as a company under the Companies Act, 1956, to engage in the business of electricity generation by setting up coal based super thermal power stations across the country. Subsequently, it has set up gas and liquid fuel based power generating stations also. The company has diversified into oil and gas exploration, coal mining, hydro-power generation, consultancy and also into power trading, power distribution, etc., through its subsidiaries and joint ventures.

[1] Opinion finalised by the Committee on 8.5.2009

2. In coal based power stations of the company set up in early eighties, the disposal of ash left after burning of coal was generally addressed by construction of ash dykes. An ash dyke is constructed by enclosing a large area of land by high walls on the periphery so that a deep cavity results in which ash in the form of slurry is disposed. Over a period of time, the ash gets accumulated and fills up the dyke, and then to fill up ash, additional capacity is created by either raising the ash dyke walls or construction of a new ash dyke on an additional land. When an ash dyke is further raised, it is done gradually in a number of phases and with each phase of raising, additional capacity for disposal of ash is created which takes care of the requirement of the station for a period ranging from 1 to 5 years. The querist has informed that the expenditure incurred in the construction of the ash dyke as well as its further raising is capitalised as per paragraphs 6.1, 12.1 and 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India and the total cost of the ash dyke is amortised over the revised useful life of the ash dyke.

3. As per the querist, the basic principle behind capitalisation of the expenditure incurred on raising of ash dyke and treating it as an asset is that the fruits of the expenditure so incurred, i.e., capacity created for disposal of ash, are enjoyed over a number of accounting periods and the capitalised expenditure is depreciated over the revised useful life of the ash dyke.

4. The querist has informed that some of the old stations of the company have exhausted all the land earmarked for ash disposal and after a number of raisings of the ash dyke, there is no scope for further raisings of the ash dyke as it is considered to be a potential hazard for the neighbouring habitat. Further, it is now proposed that further capacity for disposal of ash at the station be created by incurring expenditure on evacuating the ash accumulated in the existing ash dyke. The ash accumulated over a number of years is proposed to be dug up and evacuated by transporting it to distant places where it can be used for filling up low lying areas or in road embankments.

5. According to the querist, the expenditure incurred on raising of ash dyke is capitalised only because it creates additional capacity for ash disposal which can be used over a number of years. Similarly, the querist has argued that capacity for disposal of ash can be created by digging a deep pit, well or a cavity on virgin land and such expenditure would also qualify for capitalisation as the facility so created would be held with the intention of

being used for the purpose of providing services of safe ash disposal in the normal course of business of electricity generation. The querist has mentioned that similar capacity for ash disposal is now proposed to be created at a comparable cost by evacuating the accumulated ash from the existing ash dyke and disposing it in far away uninhabited low lying areas or in construction activities. The only difference in this case is that instead of digging earth, the ash accumulated in the ash dyke over a number of years is proposed to be dug and disposed of for creation of capacity for further ash disposal. Accordingly, the querist has informed that the expenditure so incurred in evacuation of ash from the existing ash dyke is proposed to be capitalised and depreciated over the remaining extended life of the ash dyke.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to whether the proposed accounting treatment of capitalisation of expenditure incurred on evacuation of ash from fully raised ash dyke resulting in further creation of capacity for future disposal of ash as suggested in paragraph 5 above would be in accordance with paragraphs 12.1 and 23 of AS 10.

C. Points considered by the Committee

7. The Committee restricts itself to the particular issue raised by the querist in paragraph 6 above and has not examined any other issue that may be contained in the Facts of the Case, such as, treatment of revenue from the disposal of ash evacuated from the ash dyke, accounting for the use to which the ash evacuated is put to, etc.

8. The Committee notes below paragraphs 12.1 and 23 of AS 10 referred by the querist in paragraph 2 above:

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

> "***23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.***"

9. The Committee is of the view that expenditure on fixed assets subsequent to their installation may be categorised into (i) repairs and maintenance, and (ii) improvements or betterments. Repairs and maintenance, in the Committee's view, implies the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated useful life or capacity. Expenditure on repairs and maintenance, including replacement cost necessary to maintain the previously assessed standard of performance, is expensed in the same period. On the other hand, in the view of the Committee, expenditures on improvements or betterments are expenditures that add new fixed asset unit, or that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs. Such expenditures are capitalised.

10. From the above, the Committee is of the view that in the case of the company, it needs to be examined whether the capacity of the ash dyke was initially decided after taking into account the capacity that would be created by the evacuation of ash from the ash dyke and whether useful life of the dyke was decided on that basis. In other words, it needs to be examined whether the ash dyke constructed and subsequently raised by the company was intended to be emptied for further use of disposal of ash in the ash dyke. In case it was so intended, evacuation of ash from the ash dyke does not result in creation of additional capacity or in the extension of the useful life of the ash dyke. In such a case, the cost of evacuation of ash from the ash dyke is of the nature of repairs and maintenance and, therefore, should be expensed when incurred. However, in case the ash dyke was not intended to be emptied, i.e., the dyke was meant to be for single-use only and useful life thereof was decided on that basis, the expenditure incurred on evacuation of ash from the ash dyke results into creation of additional capacity for disposal of ash in the ash dyke. In such a case, the Committee is of the view that the expenditure incurred on evacuation of ash from the ash dyke is of the nature of improvement of fixed assets and, therefore, should be capitalised.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that the proposed accounting treatment of capitalisation of expenditure incurred on evacuation of ash from fully raised ash dyke resulting in further creation of capacity for future disposal of ash as suggested in paragraph 5 above would be in accordance with paragraphs 12.1 and 23 of AS 10 provided the ash dyke when constructed and when further raised was not intended to be emptied for creation of further capacity for disposal of ash in the ash dyke and its useful life was determined on that basis. Please refer paragraph 10 above.

Query No. 13

Subject: Determination of the category of assets for the purpose of depreciation as per Schedule XIV to the Companies Act, 1956 on the basis of the report of technical experts.[1]

A. Facts of the Case

1. A company is a joint venture between Government of India and the Government of National Capital Territory of Delhi, and is engaged in the business of construction, operation and maintenance of Mass Rapid Transit System (MRTS) in the National Capital Region.

2. The operation of MRTS involves incurrence of huge capital expenditure. Consequently, depreciation constitutes a significant element of cost of operations. Automatic Fare Collection (AFC) System used for collection of fares and the Signalling and Telecommunication (S&T) Equipments used for signalling and operation of trains are important constituents of capital cost of the MRTS.

[1] Opinion finalised by the Committee on 8.5.2009

3. Operational timings of the MRTS are from 6.00 A.M. to 11.00 P.M. Depreciation on assets including AFC and S&T equipments used in MRTS has so far been charged on the basis of single shift rates. The company has followed this practice since inception.

4. The querist has stated that during the year 2007-08, the Government auditors have raised the issue that since the MRTS is working through out the year from 6.00 A.M. to 11.00 P.M., whether the company should charge depreciation on single shift basis (i.e., @ 4.75%) on the Automatic Fare Collection (AFC) System and the Signalling and Telecommunication (S&T) equipments. The alternative view can be that depreciation on these assets should be charged on double shift basis (i.e., @ 7.42%), as the system is working in double shifts and these assets are not specifically listed in Note 6 to Schedule XIV to the Companies Act, 1956 amongst items on which extra shift depreciation need not be charged.

5. The view of the company is that AFC System and S&T equipments mainly consist of cables and wires, wireless apparatus and electrical stationary plant. As per the querist, such equipments are covered under item Nos. 5 and 23 of clause 6 of the Notes to Schedule XIV to the Companies Act, 1956 for which no extra shift depreciation (NESD) is to be charged. The relevant extracts from clause 6 are given below:

Item No. 5	Electrical machinery – switchgear and instruments, transformers and **other stationary plant** and wiring and fitting of electric light and fan installations.
Item No. 23	**Wireless apparatus and gear, wireless appliances and accessories.**

(Emphasis supplied by the querist.)

6. To substantiate the view of the company that the AFC and S&T equipments used in MRTS fall within the two items referred to in Schedule XIV, a report of technical experts on technical nature and structure of these systems was sought by the company. This procedure, as per the querist, is well recognised under Standard on Auditing (SA) 620 (AAS 9), 'Using the Work of an Expert'[2], which, as per the querist, recognises that since the

[2] Standard on Auditing (SA) 620 has since been revised and renamed as Standard on Auditing (SA) 620 (Revised), 'Using the Work of an Auditor's Expert'.

auditor is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer, he is entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. The querist has drawn the attention of the Committee to paragraphs 1 and 2 of SA 620 in this respect.

7. The querist has provided the following extracts from the report of two internal experts, both of whom are stated to be Chief Engineers (S&T) and experts in telecommunication and signalling system respectively, having extensive experience in the matter. Both belong to the Indian Railways Service of Signal & Telecommunication Engineers (IRSSE) and are presently working in the company on deputation.

(a) Telecommunication System

- The telecommunication system acts as the communication backbone for signalling systems and other systems, such as, Supervisory Control and Data Acquisition (SCADA), AFC, etc. and provides telecommunication services to meet operational and administrative requirements of metro network.

- The wireless mobile radio communication system is the most significant component of the telecommunication system. Other constituents of the system are telephone exchange and Synchronous Digital Hierarchy (SDH), passenger information display and announcement system and Closed Circuit Television (CCTV) system.

(b) Automatic Fare Collection System

- The most significant constituents of Automatic Fare Collection System are the retractable type entry-exit gates provided at each station which control the entry to/exit from the station based on smart cards/tokens issued to passenger by manually-operated ticket office machines.

A copy of the report and a brief description of the professional qualifications and experience of the internal experts have been supplied by the querist for the perusal of the Committee.

8. According to the querist, from the above, it is clear that the essential nature of telecommunication system is that of wireless communication system. Hence, as per the querist, it falls under item 23 of note 6 to the Schedule XIV, i.e., wireless apparatus and gear, wireless appliances and accessories. Similarly, the automatic fare collection system consists of specialised entry/exit gates, which are in the nature of specialised stationary plant (item 5 of Note 6 to Schedule XIV).

9. The querist has stated that it would be significant to note that all major equipments, e.g., locomotives, rolling stock, etc., constituting the company's system are depreciated at single shift rates.

10. The querist has also mentioned that the useful life of similar equipments has been evaluated by other players in the industry on a similar basis as would be evident from the following table:

Type of Asset	**Companies Act rate/use-ful life (single shift basis only)**	**Indian Railways**	**Konkan Railways**	**London Underground**
Signalling & Telecom	4.75% - 20 years	25 years	4.75% 20 years	Upto 40 years
Automatic Fare Collection	4.75% - 20 years	20 years	Not applicable	(#)

(#) AFC equipment is supplied under a private finance initiative contract.

B. Query

11. During discussion with the Member Audit Board (MAB) Office, it was agreed that the issue will be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India for its expert opinion. Accordingly, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Where an engineering system is specific to the business of an undertaking, whether its nature should be a matter of expert engineer's technical opinion in order to determine the overall category of assets listed in Schedule XIV to the Companies Act, 1956, in which the respective assets fall (so as to decide about the appropriate rate of depreciation).

(b) Assuming that the expert's opinion is a correct analysis of the nature of AFC System and S&T equipments, whether it is reasonable to conclude that these are covered under items 5 and 23 of clause 6 of the notes to Schedule XIV to the Companies Act, 1956.

C. Points considered by the Committee

12. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 11 above, viz., whether the report of a technical expert can be used while determining the overall category of assets listed in Schedule XIV to the Companies Act, 1956 and whether on the basis of the experts' opinion obtained by the company it is reasonable to conclude that AFC System and S&T equipments are covered under items 5 and 23 of clause 26 of the Notes to Schedule XIV to the Companies Act, 1956. The Committee has not touched upon any other issue that may arise from the Facts of the Case, such as, whether the extra shift depreciation would be applicable to the company keeping in view its normal working hours, i.e., whether the working hours of the company could be called as extra shift, or the appropriateness of the depreciation policy of the company for other equipments, such as, locomotives, rolling stocks, etc.

13. The Committee notes that the basic purpose of charging depreciation is to allocate depreciable value of an asset over its useful life so as to exhibit a true and fair view of the financial statements. The Committee notes that the Guidance Note on Accounting for Depreciation in Companies, issued by the Institute of Chartered Accountants of India, provides in paragraph 9 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." From the above, the Committee is of the view that determination of commercial life would also depend on the category of

assets in which the concerned asset falls under Schedule XIV. In case of highly technical assets, in the view of the Committee, the help of an expert may be taken in determining the category of assets under Schedule XIV in which the concerned asset would fall.

14. The Committee notes that the Institute of Chartered Accountants of India has issued Standard on Auditing (SA) 620 (AAS 9), 'Using the Work of an Expert'. This Standard recognises that an auditor may have to rely on the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation. The Standard prescribes various procedures and precautions the auditor must undertake under such circumstances. The Committee specially draws attention to the following paragraphs of SA 620 (AAS 9):

> ***Skills and Competence of the Expert***
>
> "7. When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:
>
> - professional qualifications, licence or membership in an appropriate professional body, and
> - experience and reputation in the field in which the evidence is sought.
>
> However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence.
>
> **Objectivity of the Expert**
>
> 8. The auditor should also consider the objectivity of the expert. The risk that an expert's objectivity will be impaired increases when the expert is:
>
> - employed by the client, or
> - related in some other manner to the client.
>
> Accordingly, in these circumstances, the auditor should (after taking into account the factors in paragraphs 6 and 7) consider performing more extensive procedures than would otherwise have been planned, or he might consider engaging another expert.

Evaluating the Work of an Expert

9. When the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as:

- the objectives and scope of the expert's work,
- a general outline as to the specific items in the expert's report,
- confidentiality of the expert's work, including the possibility of its communication to third parties,
- the expert's relationship with the client, if any,
- confidentiality of the client's information used by the expert.

10. The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:-

- the source data used,
- the assumptions and methods used and, if appropriate, their consistency with the prior period, and
- the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

11. The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:

- making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

> 12. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures."

15. With respect to the issue raised by the querist in paragraph 11(b) above, the Committee is of the view that the report of the technical experts submitted in the present case regarding the nature of AFC System and S&T equipments is not technically complete as only the functions of the relevant assets have been discussed in the said report. No technological arguments have been given in the report to support (or otherwise) inclusion of the said items of assets under item nos. 5 and 23 of clause 6 of the Notes to Schedule XIV to the Companies Act, 1956. Accordingly, no conclusion can be drawn from the said report. In any case, the Committee is of view that the auditor will have to assess the reliability of the report of the experts keeping in view the discussion in paragraph 14 above.

D. Opinion

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

(a) The services of a technical expert may be used for determining the category of assets listed in Schedule XIV to the Companies Act, 1956, subject to the considerations/discussion in paragraph 14 above.

(b) In the present case, the experts' report is not technically complete as discussed in paragraph 15 above. Accordingly, no conclusion can be drawn from the said report regarding inclusion of AFC System and S&T equipments under items 5 and 23 of clause 6 of the notes to Schedule XIV to the Companies Act, 1956. In any case, the auditor will have to assess the reliability of the report of the experts keeping in view the discussion in paragraph 14 above.

Query No. 14

Subject: Accounting treatment of excise duty.[1]

A. Facts of the Case

1. A wholly owned Government of India enterprise (hereinafter referred to as the 'company') is engaged in manufacturing of automotive tyres. The company is under reference to the Board for Industrial and Financial Reconstruction (BIFR) since the year 1992. Due to non-availability of working capital, the company had to discontinue the production of its own-brand products. At present, the company is doing 100% jobbing work for other major manufacturing companies (hereinafter referred to as the 'other manufacturing companies') of similar product, i.e., tyres. The 'other manufacturing companies' are providing 100% major raw materials and chemicals for manufacturing of tyres in their brand name. The cost of other indirect materials, labour, power and fuel, etc., are borne by the company. The company is charging conversion charges at fixed rate per tyre produced, as is mutually agreed.

2. The querist has stated that the 'other manufacturing companies' are submitting their price list as per the Central Excise Rules and the company delivers the finished goods to these companies from the plant by issuing invoice under Rule 11 of the Central Excise Rules (permission has been accorded for separate invoice for separate 'other manufacturing companies') to remove the goods to their nearest godown by paying appropriate excise duty as adjusted by utilisation of CENVAT credited to their respective accounts (since raw materials are supplied by the 'other manufacturing companies').

3. Thus, the querist has stated, for all practical purposes, as per the Excise Rules, the company is the manufacturer and all liabilities on account of excise duty are to be shouldered by it as all manufacturing activities are done under the company's code number allotted by the Excise Authorities, although, as per the Memorandum of Understanding (MOU) entered into with each of the 'other manufacturing companies', liabilities on account of excise duty, present or future, for tyres manufactured at the company's plant are to be borne/reimbursed by them.

[1] Opinion finalised by the Committee on 24.8.2009

Accounting treatment

4. The querist has stated that before the introduction of e-payment of excise duty, the company was accounting for only the conversion charges receivable from the 'other manufacturing companies' by credit to its profit and loss account. The 'other manufacturing companies' used to pay excise duty directly to the designated bank through demand drafts under the company's code number. Since no money was received/paid by the company on account of excise duty for tyres manufactured on behalf of 'other manufacturing companies' at the company's factory, no accounting was done/reflected in the financial books/profit and loss account of the company.

5. The querist has further stated that with the introduction of e-payment, the methodology has been changed and presently, the excise duty payable (net of CENVAT credit as availed on their inputs) by the 'other manufacturing companies' is remitted to the company's bank account and the company is making the net payment of excise duty to the authorities. The amount so received from the 'other manufacturing companies' for payment of excise duty is being treated as "Collection (received from the 'other manufacturing companies' on account of excise) to be paid out".

B. Query

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

(i) Whether the accounting done by the company for conversion charges as mentioned above is sufficient for such jobbing work.

(ii) Whether the amount remitted by the 'other manufacturing companies' on account of excise duty on tyres manufactured by the company on their behalf and payment of the same to the Excise Authorities are also required to be accounted for by the company under appropriate account heads and reflected in the profit and loss account, instead of under the account head 'Collection to be paid out', considering that the payment of excise duty is routed through the bank account of the company (for e-payment) and the tyres are manufactured in the company's factory. If so, how it is to be accounted for/reflected in the accounts?

C. Points considered by the Committee

7. The Committee, while answering the query, has examined only the issues raised in paragraph 6 above and has not touched upon any other issue that may arise from the Facts of the Case, such as, the accounting treatment followed by the company earlier, i.e., before the introduction of e-payment of excise duty, etc. Further, the Committee has considered the issue only from an accounting point of view and has not examined any other issue that may involve interpretation of legal enactments, such as, the Central Excise Rules or, Cenvat Credit Rules, as Rule 2 of the Advisory Service Rules in accordance with which the Committee answers the queries, prohibits it from answering queries involving interpretation of legal enactments.

8. The Committee notes that Accounting Standard (AS) 9, 'Revenue Recognition', defines the term 'revenue' as follows:

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

9. The Committee notes from the Facts of the Case that the company is doing 100% jobbing work for other major manufacturing companies by charging only conversion charges at fixed rate per tyre produced and delivers the finished goods to these companies. From this, it appears to the Committee that the significant risks and rewards of ownership of goods are not transferred from 'other manufacturing companies' to the company and that the company in the instant case is manufacturing the goods only on behalf of other manufacturing companies. If that be the case, in the view of the Committee, the revenue of the company would be limited to the conversion charges receivable as per the terms of the contract.

10. As regards the accounting for excise duty, the Committee notes that the primary liability of paying the excise duty to the authorities is that of the company in question. Accordingly, the excise duty expense should be reflected in the financial statements of the company. For the purpose of

reflecting the excise duty expense, the Committee is of the view that the expense is of two types, viz., (i) excise duty on the goods manufactured by the company, which has been paid during the accounting period and (ii) the excise duty in respect of the goods which have been manufactured but still not removed from the factory premises of the company or from the bonded warehouse, if any and, therefore, excise duty has not been paid on the same. With regard to the latter, the Committee notes the following requirements of the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India:

> "18. Since the liability for excise duty arises when the manufacture of the goods is completed, it is necessary to create a provision for liability of unpaid excise duty on stocks lying in the factory or bonded warehouse. ..."

Accordingly, with respect to (ii) above, the company should make a provision for the excise duty payable.

11. Regarding the reimbursement receivable towards excise duty payable in respect of which a provision is made as per paragraph 10 above, the Committee is of the view that the accounting treatment should be in accordance with the following paragraphs of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets':

> ***"46. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.***
>
> ***47. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement."***
>
> ***"67. An enterprise should disclose the following for each class of provision:***
>
> ***...***
>
> ***(c) the amount of any expected reimbursement, stating the***

amount of any asset that has been recognised for that expected reimbursement."

12. With regard to the excise duty paid by the company during the year on the goods manufactured and transferred to the other manufacturing companies, the Committee is of the view that since the company is doing the jobbing work for other manufacturing companies, the requirements of the following Explanation to paragraph 10 of AS 9 notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, does not apply since the company is not selling the goods.

> **"Explanation:**
>
> ***The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit and loss:***

Turnover (Gross)	***XX***	
Less: Excise Duty	***XX***	
Turnover (Net)		***XX***

> ***The amount of excise duty to be deducted from the turnover should be the total excise duty for the year except the excise duty related to the difference between the closing stock and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty."***

Since the requirements of the above Explanation do not apply to the company, the excise duty paid may be presented net of the amount of reimbursement in the statement of profit and loss. The amount of the excise duty paid and the reimbursements thereagainst during the period should be disclosed in the notes to the accounts.

D. Opinion

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

(i) In the facts and circumstances of the case, recognition of the conversion charges as revenue appears to be correct. Please refer paragraph 9 above.

(ii) The accounting for excise duty and reimbursement of the same by the 'other manufacturing companies' should be done as discussed in paragraphs 10, 11 and 12 above.

Query No.15

Subject : Provision for sick leave benefit.[1]

A. Facts of the Case

1. A company in textile sector has about 40 manufacturing units under its control. As per the leave rules of the company, officers, technical staff and administrative staff are eligible for sick leave. The workmen are not eligible for sick leave. The Sick Leave Rules for officers and staff are as under:

(a) Half-pay leave: Each employee's leave account is credited by 20 days half-pay leave for each calendar year.

(b) Commuted leave: Half-pay leave can be commuted into full-pay leave upto 180 days, on production of medical certificate.

The said credit of leaves can be carried forward till the employee's service with the company. Sick leave is not encashable.

2. The manufacturing units are working 24 hours in 3 shifts. Hence, if a person is on leave, a substitute is provided in the production department by engaging for an extra time/ by giving compensatory leave. In the case of administrative office if a person is on leave, no substitute is provided.

3. In addition to sick leave, the employees are entitled to earned leave at the rate of 30 days per year which can be carried forward up to a maximum

[1] Opinion finalised by the Committee on 24.8.2009

of 300 days. Encashment of earned leave is limited to a maximum of 90 days in a calendar year out of encashable earned leave. At the time of retirement, all the earned leaves standing to the credit of the employee, up to a maximum of 300 days, are encashed.

4. The querist has stated that the company is having the policy of making provision for leave salary benefits including sick leave benefits on the basis of actuarial valuation of the leave which stood to the credit of employees at the year-end as it is a long term obligation for the company. As per the querist, the government auditors are, however, of a different view that it is not necessary to provide for sick leave since it is not encashable.

B. Query

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

(i) Whether or not, sick leave, which is not encashable, is required to be provided for on actuarial basis as per Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005).

(ii) If it is to be provided for, in case of engagement of a substitute,

(a) whether the employees have to be divided into categories for working units where substitutes are provided and administrative office where no substitute is provided.

(b) considering the difficulty in dividing the employees into different categories on the basis of engaging substitutes, whether there can be any other basis of providing for sick leave benefits.

C. Points considered by the Committee

6. The Committee, while answering the query, has considered only the issues raised in paragraph 5 above and has not touched upon any other issue that may arise from the Facts of the Case, such as, accounting treatment for earned leave benefits, etc.

7. The Committee notes the definition of the term 'short-term employee benefits' as given in paragraph 7 of Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005) as below:

"<u>Short-term employee benefits</u> are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service."

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

"8. Short-term employee benefits include items such as:

...

(b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;

..."

9. From the above, the Committee is of the view that short-term employee benefits include only those compensated absences which accrue to the employees and are expected to be availed (or encashed, as the case may be) within twelve months after the end of the period in which the employees render the related service. Thus, those compensated absences which can be and are also expected to be carried forward for any further period cannot be termed as 'short-term employee benefits'. In this context, the Committee also notes the definition of the term 'Other long-term employee benefits' as contained in AS 15 (revised 2005) which is reproduced below:

"<u>Other long-term employee benefits</u> are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service."

10. The Committee notes from the Facts of the Case that the company is treating the sick leave benefit as a long-term benefit. From this it appears that the sick leave entitlement of the employees of the company is not expected to wholly occur within twelve months after the end of the period in which employees render the related service. Therefore, the benefit arising to the employees on account of sick leave falls within the category of 'other long-term employee benefits'.

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

12. In the view of the Committee, the cost incurred for getting the services of a substitute during the period the employee availed sick leave, whether in the form of extra payment or in the form of compensatory leave is of no relevance for the measurement of provision for sick leave, since the provision for sick leave is measured in terms of the salary or wages payable to the employee for the period during which he does not render any services to the employer.

D. Opinion

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

(i) The sick leave benefit should be treated as 'other long-term employee benefits' in accordance with the provisions of AS 15 (revised 2005) and should be provided for on actuarial basis even if it is not encashable.

(ii)(a)&(b) Engagement of a substitute during the period an employee avails of sick leave, has no relevance for the measurement of provision for sick leave as explained in paragraph 12 above. The issues in paragraph 5(ii)(a) & (b) above, therefore, do not arise.

Query No. 16

Subject: Transfer price for the purpose of segment reporting.[1]

A. Facts of the Case

1. A company is a public sector enterprise under the administrative control of 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 market. The company has four production units (i) 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 3,41,000 tonnes 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 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

[1] Opinion finalised by the Committee on 24.8.2009

4. The company has entered into an agreement dated 30th August, 2004, valid upto 31st August, 2009 with company 'G' for sale and purchase of power.

(a) For sale of surplus power, the base price is:

(i) Upto 40 MU/month	– @ 110 paise/kwh
(ii) Beyond 40 MU/month upto 60 MU/month	– @ 112 paise/kwh
(iii) Beyond 60 MU/month upto 80 MU month	– @ 114 paise/kwh
(iv) Beyond 80 MU/month upto 100 MU month	– @ 118 paise/kwh
(v) Beyond 100 MU/month	– @ 122 paise/kwh

The agreement provides for escalation in case of increase in prices of 'F' grade coal obtained domestically and fuel oil, and has a provision for supply of emergency power and back-up power by company 'G'.

The above escalation does not take into account the higher impact on cost due to use of e-auction coal and imported coal.

(b) Rate for emergency power and back-up power

For supply of emergency power and back-up power, company 'G' charges at a rate three times the weighted average rate of power for the month injected by the company**,** as mentioned at (a) above.

5. The querist has stated that explanation on 'inter-segment transfers' given at the end of Appendix III (termed as Illustration-III in the notified Accounting Standard) to Accounting Standard (AS) 17, **'**Segment Reporting', reads as follows:

> "Segment revenue, segment expenses and segment result include transfers between business segments and between geographical segments. *Such transfers are accounted for at competitive market prices charged to unaffiliated customers for similar goods. Those transfers are eliminated in consolidation."* [Emphasis supplied by the querist.]

The querist has stated that at present company 'G' is the only unaffiliated customer for the company. Accordingly, the average of rates as mentioned at paragraph 4(a) charged to company 'G' is considered as transfer price for the purpose of inter-segment transfer of power, i.e., power exported to Smelter division, and to Aluminium Refinery by way of wheeling of power through company 'G'.

6. In the event of short supply of linkage coal from domestic sources, the company is forced by the circumstances to consume imported coal, which results in higher cost of generation of power. The sale price, as detailed in paragraph 4(a) above is not remunerative as compared to the cost of generation and as such, management decided to generate power only to meet the internal consumption of Smelter and Aluminium Refinery, thereby avoiding sale of power to company 'G' at loss. However, this cannot be avoided in totality and hence, most of the sales are made only @ 110 paise/ kwh.

7. As per the querist, even though, the cost of generation of power is higher, as per AS 17, as stated at paragraph 5 above, transfer price of power for the purpose of segment reporting is considered only at 110 paise/ kwh, which results in segment loss in case of Captive Power Plant (even though the unit is functioning efficiently and upto the satisfaction of the management) and higher revenue for Chemical and Aluminium segments.

8. Segment report for the quarter ended 31st December, 2008 was examined by the statutory auditors at the time of limited review and they were of the opinion that though the unit is performing well, as a result of compliance with the provisions of AS 17 for inter-segment transfers, as stated hereinbefore, the power segment reveals loss, which does not appear to be a proper disclosure.

9. As per the querist, in case the company is allowed to sell power to parties other than company 'G', revenue earned will be at least three to four times more. However, since the company is largely dependent upon company 'G' for emergency power and back-up power, it will not be practicable to delink from company 'G'. The present agreement with company 'G' is valid upto 31st August, 2009. Efforts have already been put in motion to get higher sales price per unit, which will recoup the higher cost of generation. In such a situation, power segment will again start showing profit in segment report.

10. From the aforesaid facts, according to the querist, it is revealed that the circumstances have arisen only because of non-remunerative sale price and will continue to be the same till the rate charged from company 'G' is revised.

11. Audit Committee of the company advised the management to seek opinion on the subject from the Expert Advisory Committee of the Institute of Chartered Accountants of India.

B. Query

12. The querist has sought the opinion of the Expert Advisory Committee as to whether in the circumstances explained above, the loss disclosed in the segment report can be explained by way of giving a note with reference to the provision of Accounting Standard or whether any other formula for transfer pricing can be adopted, which may necessitate revision of AS 17.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised by the querist relates to pricing of inter-segment transfers for segment reporting under Accounting Standard (AS) 17, 'Segment Reporting'. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case, e.g., whether reportable segments are properly identified by the company in accordance with AS 17, etc.

14. The Committee notes the following paragraphs of AS 17:

> ***"5.10 <u>Segment accounting policies</u> are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting."***
>
> "18. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments."
>
> ***"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."

15. From the above, the Committee notes that inter-segment transfer pricing is an accounting policy which relates specifically to segment reporting and that inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. In other words, the price that is actually used in the books of account to reflect the transaction between different segments and the price that is used to reflect segment results for the purpose of segment reporting under AS 17, should be same. The Committee notes that AS 17 neither requires nor recommends that inter-segment transfers should be priced in any particular manner, such as, competitive market prices charged to unaffiliated customers for similar goods as stated by the querist. The portion from AS 17 quoted by the querist in paragraph 5 above is an extract from Appendix III (termed as Illustration III in the notified Accounting Standard), 'Illustrative Segment Disclosures'. At the beginning of the said Appendix itself, it is clearly mentioned that the Appendix does not form part of the Accounting Standard and that its purpose is to illustrate the application of paragraphs 38-59 of the Accounting Standard. It is only by way of illustration that the basis of pricing inter-segment transfers is stated to be competitive market prices charged to unaffiliated customers for similar goods in the said Appendix. 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. Thus, the question of explanation of the loss with reference to any provision/requirement of AS 17, if the existing policy is continued to be followed, by way of a note to the segment report, does not arise. However, if the company chooses, the loss may be explained by way of a note to the segment report; the note should not state that AS 17 requires adoption of that particular pricing policy. Also, revision to AS 17 with respect to the issue raised by the querist, is not required.

16. The Committee is of the view that the above views of the Committee are also relevant in the context of segment reports furnished along with unaudited quarterly financial results which are subject to limited review.

D. Opinion

17. On the basis of the above, the Committee is of the opinion that the company is free to choose any appropriate pricing policy for inter-segment transfers. Thus, the question of explanation of the loss with reference to any provision/requirement of AS 17, if the existing policy of transfer pricing is continued to be followed, by way of a note to the segment report, does not arise. However, if the company chooses, the loss may be explained by way of a note to the segment report; the note should not state that AS 17 requires adoption of that particular pricing policy. Also, revision to AS 17 with respect to the issue raised by the querist, is not required.

Query No. 17

Subject: Accounting for insurance claim.[1]

A. Facts of the Case

1. A listed company is engaged in manufacturing of chemicals. It has five factories located in various States of India. All the factories have, more or less, equal production capacity. The main building at one of its factories which also has other buildings, contains the production facility. The production facility is divided into various sections, according to the type of chemical produced, like stiff chemicals section, liquid chemical section, etc.

2. All the assets of this factory, e.g., buildings, plant and machinery, furniture, fixtures and inventories are insured under a fire insurance policy on the basis of reinstatement value option. Accordingly, the estimated replacement values of the various classes of factory assets were mentioned in the policy and the insurance premium was paid by the company based on those replacement values. The querist has stated that the memorandum for reinstatement value, which is a part of the insurance policy, includes the following terms:

[1] Opinion finalised by the Committee on 24.8.2009

"...the basis upon which the amount payable under the policy is to be calculated, shall be the cost of replacing or reinstating on the same site property of the same kind or type but not superior to or more extensive than the insured property when new..."

"Until expenditure has been incurred by the insured in replacing or reinstating the property destroyed or damaged the company shall not be liable for any payment in excess of the amount which would have been payable under the Policy if this memorandum had not been incorporated therein."

"This memorandum shall be without force or effect if ... the insured is unable or unwilling to replace or reinstate the property destroyed or damaged on the same or another site."

3. In April 2006, some portion of the main building mentioned in paragraph 1 above, caught fire and the assets located in the said portion were damaged or destroyed by the fire. The details of damaged or destroyed fixed assets are as follows:

(Rs. lakh)

Class of asset	Replacement value of variousassets in the main building as mentioned in the policy	Written down value (WDV) as on 31.03.2006 of all the fixed assets in the factory as per books of account	WDV as on 31.03.2006 of assets in Main Building	WDV as on 31.03.2006 of assets destroyed/ damaged by fire
Building	1,500	800	110	5
Plant and Machinery	2,600	500	225	90
Furniture and others	25	5	2	*Not significant
Total	4,125	1,305	337	95

*The WDV of furniture affected is Rs.0.03 lakh only.

Apart from damage to fixed assets, inventory of Rs.700 lakh was also destroyed by the fire.

4. The company immediately lodged an insurance claim with the insurance company for Rs. 20 crore comprising loss of inventory and estimated replacement value of the destroyed assets. The company received Rs. 100 lakh from disposal of damaged assets. The company also started the work of installing new plant and machinery and repairing the building. Since the plant and machinery destroyed by fire were very old, the exact replacements were not available in the market. The company had to install higher versions of the plant and machinery available in the market. The new assets are of more sophisticated technology and have higher production capacity. The building repair work and installation work of the plant and machinery was completed during the financial year 2007-08. While the approval of the final amount of claim was pending, the company received on account payment of Rs.1,000 lakh during the financial year 2006-07 from the insurance company.

5. During the financial year 2006-07, the company recognised Rs.305 lakh in its profit and loss account (as 'other income') on account of surplus from insurance claim. The surplus from insurance claim was computed after deducting WDV of Rs.95 lakh of damaged or destroyed fixed assets and destroyed inventory of Rs.700 lakh from the disposal proceeds of Rs. 100 lakh and from the on account receipt of insurance claim of Rs.1,000 lakh. Since the company was unable to make a reliable estimate of the amount at which the claim of the company shall be settled, only the on account amount received, i.e., Rs.1,000 lakh was considered for computation of the surplus. During the financial year 2008-09, the final claim was approved for a total amount of Rs.1,931 lakh and the company received the balance claim amount of Rs.931 lakh which has been recognised as 'other income' in the profit and loss account.

6. As per the querist, the accounting treatment consistently followed by the company as discussed above in both the years is based on the following:

(i) The loss of assets, the related insurance claim and subsequent purchase of replacement assets are separate economic events and should be accounted for separately. On loss of assets, the relevant asset accounts should be credited with debit to the profit and loss account. Insurance claim should be recognised in the profit and loss account when it is appropriately certain to be received. The purchase of assets is the third event which should be recognised independently of the first two. As per Accounting Standard (AS) 10, 'Accounting for Fixed Assets', assets are recorded at cost. In the instant case, the cost of the replaced asset is what has actually been paid to acquire it.

(ii) The accounting treatment followed by the company is in consonance with the opinion given by the Expert Advisory Committee in a similar case published in the Compendium of Opinions – Vol. XI, page no. 89, paragraph 2 of which states as below:

"2. In the facts and circumstances of the present case, the Committee is of the opinion that it will be appropriate to credit the profit and loss account with the profit arising on settlement of insurance claim (i.e., the excess of insurance claim over the written down value of the helicopter) with the disclosure as per para 5 below."

(iii) Reference may also be made to the following extracts from the Exposure Draft of Accounting Standard (AS) 10 (revised), 'Tangible Fixed Assets', issued by the Institute of Chartered Accountants of India, which specifically discusses the principles of accounting for compensation received from third parties for tangible fixed assets that were impaired, lost or given up and derecognition of tangible fixed assets:

"65. Compensation from third parties for tangible fixed assets that were impaired, lost or given up should be included in the statement of profit and loss when the compensation becomes receivable.

66. Impairments or losses of tangible fixed assets, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

(a) impairments of tangible fixed assets are recognised in accordance with AS 28;

(b) derecognition of tangible fixed assets retired or disposed of is determined in accordance with this Statement;

(c) compensation from third parties for tangible fixed assets that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

(d) the cost of tangible fixed assets restored, purchased or constructed as replacements is determined in accordance with this Statement.

Derecognition

67. The carrying amount of a tangible fixed asset should be derecognised:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

68. The gain or loss arising from the derecognition of tangible fixed asset should be included in the statement of profit and loss when the asset is derecognised (unless AS 19, Leases, requires otherwise on a sale and leaseback). Gains should not be classified as revenue, as defined in AS 9, Revenue Recognition."

"71. The gain or loss arising from the derecognition of a tangible fixed asset should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset."

"73. The financial statements should also disclose:

...

(d) if it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for tangible fixed

> ***assets that were impaired, lost or given up that is included in the statement of profit and loss."***

As per the querist, as per the above, the claim, being compensation from a third party, should be included in the statement of profit and loss when it becomes receivable and should not be reduced from the cost of replaced assets. According to the querist, the accounting policy of the company is consistent with these principles also and same principles have been enunciated in International Accounting Standard (IAS) 16, 'Property, Plant and Equipment', issued by the International Accounting Standards Board (IASB).

7. As per the querist, an alternative approach to the accounting treatment followed by the company can be to reduce the surplus arising out of the insurance claim from the cost of replaced assets. The alternative treatment has the effect of reducing the total block of the fixed assets not only to the extent of the WDV of the relevant fixed asset but also to the extent of the surplus arising out of the claim over such WDV.

B. Query

8. 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 the answer to (i) above is in the affirmative, then, whether only the net gain should be disclosed in the profit and loss account with an explanatory note or whether the loss can be shown as a deduction from the insurance claim.

C. Points considered by the Committee

9. The Committee notes that the issue raised by the querist basically relates to the accounting treatment of insurance claim. Therefore, the Committee has examined only this issue and has not touched upon any other issue that may be contained in the Facts of the Case, such as, timing of recognition of insurance claim, etc. The Committee notes that while there was replacement of destroyed/damaged plant and machinery by new plant and machinery with higher production capacity, in the case of buildings, repair work was involved. It is not clear as to whether new inventory was

purchased/ produced to replace the destroyed inventory. Further, while the querist has stated in paragraph 4 above that the company received Rs. 100 lakh from disposal of 'damaged assets', it appears that the disposal proceeds were in respect of disposal of damaged plant and machinery and no portion of it is attributed to inventory or building. (Furniture and fixtures are stated by the querist to be not significant in paragraph 3 above and, hence, are not specifically considered by the Committee.)

10. The Committee notes that the disposal of damaged/destroyed fixed assets (i.e., plant and machinery) took place in the same year in which the damage was caused by fire, i.e., 2006-07. Consequently, the loss or gain arising from such disposal should be recognised pursuant to paragraph 26 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which reads as below:

> ***"26. Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement."***

The Committee is of the view that loss or gain arising from disposal of damaged/destroyed fixed assets should be computed by deducting their carrying amount from the net disposal proceeds. Further, the Committee is of the view that insurance proceeds are not disposal proceeds since they do not arise on disposal of the fixed assets. Rather, they arise on the happening of the event and meeting the conditions specified under the contract with insurers.

11. With respect to the accounting for insurance claim, the Committee notes the following paragraphs from the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, which reads as below:

> "69. ...
>
> (a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
>
> (b)..."

"91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. ..."

From the above, the Committee notes that compensation receivable from third parties by an enterprise for the loss of assets or restoration or replacement thereof meets the definition of the term 'income'. Thus, the entire compensation amount should be credited to the profit and loss account as income in the year in which it is eligible for recognition. This may be included under the head 'other income'. (See paragraph 16 below for further discussion.)

12. As regards accounting for the new fixed assets acquired/constructed as a replacement of the damaged/destroyed fixed assets, the Committee notes the following paragraphs of AS 10:

"9.1. ...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."

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

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

From the above, the Committee is of the view that proceeds from insurance claim cannot be deducted from the cost of fixed assets purchased or constructed as a replacement of damaged/destroyed fixed assets. Thus, the Committee does not agree with the alternative approach mentioned by the querist in paragraph 7 above. The capitalisation of expenditure on purchase or construction of fixed assets as replacements should be determined in accordance with AS 10.

13. The Committee notes paragraph 6 of Accounting Standard (AS) 2, 'Valuation of Inventories', which reads as below:

"6. The cost of inventories should comprise all costs of

> ***purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition."***

From the above, the Committee is of the view that insurance proceeds in respect of damaged inventory cannot be deducted from the cost of inventories restored, repurchased or reproduced, if any. Determination of costs that can be included in the cost of inventories should be in accordance with AS 2. For the reasons stated in paragraph 11 above, the Committee is of the view that insurance compensation amount in respect of damaged/destroyed inventory should be credited to profit and loss account which may be included under the head 'other income'. As stated in paragraph 9 above, it appears that there were no disposal proceeds in respect of the inventory destroyed. The loss should be appropriately accounted for.

14. As regards the building, the Committee notes that it was not destroyed, rather it was damaged and repair work was undertaken on the same which was completed in the year 2007-08. In this context, the Committee notes paragraph 23 of AS 10 which states as below:

> ***"23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."***

The Committee is of the view that subsequent expenditure on fixed assets amounting to repairs implies expenditure on restoration of the capital asset without increase in the previously estimated service life or capacity after damage, accident or prolonged use. In other words, repair is undertaken to bring back the asset (in this case, the building) to its normal working condition, in which case, there is no question of impairment loss on account of the damage/accident. Accordingly, in the view of the Committee, the cost of repair to the building should be expensed in the year in which the same is incurred (unless it results into betterment or improvement and is eligible for capitalisation as per paragraph 23 of AS 10 reproduced above). No loss on account of damage to the building by fire should be debited to the profit and loss account separately. The insurance claim received on this account should be recognised as income as discussed in paragraph 11 above when it becomes eligible for recognition.

15. In view of the above, the Committee does not agree with the company's treatment of recognition of excess of insurance claim and disposal proceeds

over net book value of the damaged/destroyed fixed assets and inventories in the profit and loss account for the year 2006-07 as ‘other income’. The company’s treatment mixes up several items resulting in recognition of a single amount as ‘other income’ in the profit and loss account, without any disclosure of the break-up of the elements constituting the net amount, which is not proper. Further, when there is no disposal of building, deducting the entire WDV of damaged/destroyed fixed assets of Rs.95 lakh, which includes WDV of damaged building, i.e., Rs.5 lakh, from the total of disposal proceeds and insurance compensation is not correct.

16. As regards presentation in the profit and loss account, the Committee is of the view that the expense and income related to various items discussed in the above paragraphs should be presented separately. Alternatively, it is permissible to present the expense corresponding to each of the items, viz., plant and machinery, and building separately as a deduction from the corresponding insurance compensation and then a sub-total representing the net gain (loss) can be presented and appropriately described. Such presentation may be made either on the face of the profit and loss account or in the notes. In respect of the loss of inventory, the same may be recognised by way of lower closing inventory. Therefore, no separate debit would appear in the profit and loss account for this purpose. However, loss of stock should be reflected in the notes to accounts. Alternatively, closing stock may be presented at the gross amount and loss of stock may be shown as deduction therefrom in the inner column. The corresponding insurance claim recognised as income in the profit and loss account should be appropriately described. Assuming that timing of recognition of insurance claim is proper, the recognition of balance insurance amount of Rs.931 lakh as ‘other income’ in the profit and loss account for the year 2008-09 is in order.

D. Opinion

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

(i) The accounting treatment followed by the company is partially correct. It is correct to the extent that the cost of newly acquired fixed assets is not reduced by insurance compensation. It is not correct to the extent that it is not in accordance with the accounting treatment, presentation and disclosure requirements mentioned in paragraphs 10, 11, 12, 13, 14 and 16 above. The accounting treatment of insurance claim in the year 2008-09 is correct, assuming that timing of recognition of the same is correct.

(ii) See paragraph 16 above.

Query No. 18

Subject: *Virtual certainty in respect of deferred tax assets*.[1]

A. Facts of the Case

1. A public sector company is engaged in construction of ships and ship repair activities. The company has an accumulated loss of Rs.847.42 crore as on 01.04.08 and a deferred tax asset of Rs.102.36 crore. As per the Income-tax Returns filed by the company and income tax assessments, the amount of unabsorbed depreciation and carried forward losses of the company is Rs. 255.51 crore. The company has also realised deferred tax asset to the extent of Rs.6.66 crore in the financial year 2007-08.

2. During the audit of accounts of the company for the financial year 2007-08, the government auditor had raised an observation in respect of accounting for deferred tax asset and issued a provisional comment as follows:

> "As per paragraph 17 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which deferred tax assets can be realised. Inspite of non-existence of virtual certainty supported by convincing evidence of availability of future taxable income and carrying an unabsorbed depreciation of Rs.13,019.94 lakh as on 31.03.08, the company recognised deferred tax asset. This has resulted in overstatement of

[1] Opinion finalised by the Committee on 24.8.2009

deferred tax assets and profit after taxation, and understatement of accumulated losses by Rs.11,446.90 lakh."

3. The company replied to the government auditor that there exists virtual certainty that sufficient future taxable income will be available for realising the above-mentioned deferred tax asset based on the following facts:

(a) The company has secured an order from Indian Navy for refit and modernisation of a submarine for a contract value of Rs.629 crore on nomination basis. As a part of this contract, the Indian Navy has catered Rs.50 crore for creating additional infrastructural facilities and it has been agreed in the contract on the modus operandi for amortisation of the said amount of Rs.50 crore over the future medium refits / normal refits. This fact confirms the existence of future profitable orders from Indian Navy in addition to the existing order.

(b) The company secured profitable orders for construction of six 53000 DWT Bulker for an order value of Rs.625.28 crore. The total ship-building order book position at present is around Rs.970 crore.

(c) The company also diversified its activities into repair of oil rigs and successfully acquired this expertise and completed the repairs of Jack-up Rig (JUR) of a company at a cost of more than Rs.100 crore. Recently, the company also secured another order for repair of another JUR of the same company at a contract price of Rs.361 crore. The company expects a series of such repair orders continuously.

(d) The financial restructuring proposal of the company is in the advanced stage of consideration by the Government of India. The said proposal has been submitted by the administrative ministry, the Ministry of Shipping, Road Transportation & Highways to the Cabinet Committee on Economic Affairs for their approval. The proposal envisages sanction of grants / waiver of loans and interests amounting to Rs.1,03,200 crore. On approval of the proposal, the said amount will be credited to the profit and loss account as income and the company will immediately realise the entire deferred tax asset accounted for in the previous years.

(e) The books of account are prepared under 'going concern concept'.

(f) Further to the above, the querist has submitted that an amount of Rs.141.15 crore representing the items covered under section 43B of the Income-tax Act, 1961 which shall be disallowed for computation of tax for the assessment year 2008-09, shall be allowed as expenditure in the year of payment without any time limit. Accordingly, as per the querist, virtual certainty exists for realisation of deferred tax assets in respect of these items amounting to Rs.47.98 crore.

(g) As regards provisions made in the accounts for liquidated damages, doubtful advances, guarantee repairs and other contingencies which shall be disallowed at the time of assessment, shall be allowed in the year of crystallisation of the expenditure without any time limit. Hence, the deferred tax asset so provided amounting to Rs.18.09 crore shall be realised with certainty.

(h) The querist has also submitted that there exists unabsorbed depreciation under the Income-tax Act, 1961 available for set-off in the future years to the tune of Rs.130.20 crore and the deferred tax asset on the said amount of unabsorbed depreciation would be Rs.44.25 crore, which will also be realised with certainty, since, according to the querist, as per the Income-tax Act, 1961, the unabsorbed depreciation can be set off without any time limit in accordance with section 32(2) of the Act. The querist has further submitted that the company is having brought forward losses to the tune of Rs.185.00 crore and deferred tax asset in respect of the same has not been considered since there is a time limit of 8 years for absorption of the same as per the Income-tax Act, 1961.

Based on the above facts, the company is of the view that there exists virtual certainty with convincing evidence that the company will have taxable income in the immediate future and will be able to realise the deferred tax assets.

4. The querist has mentioned that the deferred tax asset as at 31-3-2008 comprises the following:

			(Rs. Lakh)
(a)	*Deferred tax asset*		
	(i)	Unpaid interest and taxes, sums payable as employer, etc.	4,797.66
	(ii)	Provisions made against doubtful debts, doubtful advances and contingencies, etc.	1,809.14
	(iii)	Set off of unabsorbed depreciation available under the Income-tax Act, 1961	4,425.48
			11,032.28
(b)	*Deferred tax liability*		
	Timing difference between book depreciation and tax depreciation		796.69
	Net deferred tax asset		10,235.59

5. The querist has stated that having examined the management's contention mentioned at paragraph 3(a) to (d) above in the light of specific clarifications of Accounting Standards Interpretation (ASI) 9[2], 'Virtual certainty supported by convincing evidence', issued by the Institute of Chartered Accountants of India, read with specific provisions in paragraphs 17, 18 and 32 of AS 22, and also in the light of the past trend that ship-building activity of the company was a loss making activity, the auditor opined that there does not exist virtual certainty with convincing evidence in a concrete form as on the date of the balance sheet, i.e., on 31st March, 2008 about the company having taxable income in the immediate future and hence, the accounting for deferred tax assets is not in line with AS 22.

6. The company replied to the government auditor that considering that most of the ship-building orders are profitable and further, submarine refit order and all ship repair orders including major repair orders, such as, lay-

[2] The ASI has been withdrawn by the Council of the Institute of Chartered Accountants of India and the Consensus portion thereof has been added as 'Explanation 1' to the paragraph 17 of AS 22.

up repairs of rigs are profit making, the deferred tax assets are realisable based on the overall profitability of the company. Since there is a virtual certainty of earning future profits which would realise the deferred tax assets recognised in the accounts, the accounting for deferred tax assets is in line with AS 22.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting for deferred tax assets by the company is in compliance with AS 22, based on the inputs as stated above in respect of virtual certainty of future taxable income.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to recognition of deferred tax asset in situations of unabsorbed depreciation and brought forward losses. The Committee has, therefore, considered only this issue and has not touched upon any other issue arising from the Facts of the Case, such as, offsetting of deferred tax assets and deferred tax liabilities, propriety of accounting to be done by the company in respect of expected grants/waiver of loans and interests, etc. Further, the Committee's opinion is based on accounting principles and it has not gone into the calculations or computation of deferred tax assets.

9. The Committee notes paragraphs 17 and 18 of AS 22, which provide as below:

> ***"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.***
>
> 18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets

can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

10. The Committee further notes that AS 22 notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, contains, inter alia, an Explanation to paragraph 17 thereof regarding virtual certainty (which was hitherto contained in the consensus portion of ASI 9) which provides as below:

"Explanation:

1. Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement based on convincing evidence and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence."

11. On the basis of the above, the Committee is of the view that the orders secured by the company, as mentioned by the querist in paragraphs 3(a) to (c) above, may be considered while creating deferred tax asset provided these are binding on the other party and it can be demonstrated that they will result in future taxable income. However, mere projections made by the company indicating the earning of profits from future orders contemplated in paragraphs 3(a) and (c) above, or financial restructuring proposal under consideration of the Government of India or the fact that the books of account of the company are prepared on 'going concern' basis as mentioned by the querist in paragraphs 3(d) and (e) respectively, may not be considered as convincing evidence of virtual certainty as contemplated in the

'Explanation' to paragraph 17 of AS 22 reproduced above. Further, the mere fact that the items covered under section 43B of the Income-tax Act, 1961, the provision for liquidated damages, doubtful advances, guarantee repairs and other contingencies, and unabsorbed depreciation can be carried forward for unlimited number of years, can also not be a ground for recognising a deferred tax asset, as mentioned by the querist in paragraphs 3(f), (g) and (h) respectively, since paragraph 17 of AS 22 read with its 'Explanation', requires virtual certainty supported by convincing evidence at the date of the balance sheet. The Committee also wishes to point out that a deferred tax asset can be created to the extent that future taxable income will be available from future reversal of any deferred tax liability recognised at the balance sheet date. To that extent, it would not be necessary to consider the level of virtual certainty supported by convincing evidence.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that subject to paragraph 8 above, accounting for deferred tax asset by the company would be in compliance with AS 22 only to the extent it is in accordance with paragraph 11 above.

Query No. 19

Subject: Treatment of interest on mobilisation advance received from contractee.[1]

A. Facts of the Case

1. A company is engaged in the business of construction contracts. The contracts are mainly awarded by the Government bodies or autonomous companies controlled by the Central or State Government(s). In order to execute the contract(s), the terms thereof provide for granting of mobilisation advance to the awardee of the contract ('the company' in the present case).

[1] Opinion finalised by the Committee on 24.8.2009

The querist has provided the following clause as extracted from the document for proper understanding of the transaction:

> "(i) Plant, Machinery and Shuttering Material Advance
>
> An advance for plant, machinery and shuttering material required for the work and brought to site by the contractor may be given if requested by the contractor in writing within one month of bringing such plant and machinery to site. Such advance shall be given on such plant and machinery, which in the opinion of the Engineer-in-Charge will add to the expeditious execution of work and improve the quality of work. The amount of advance shall be restricted to 5% of the tender value. In case of new plant and equipment to be purchased for the work, the advance shall be restricted to 90% of the price of such new plant and equipment paid by the contractor for which the contractor shall produce evidence satisfactory to the Engineer-in-Charge. In the case of second hand and used plants and equipments, the amount of such advance shall be limited to 50% of the depreciated value of plant and equipment as may be decided by the Engineer-in-Charge. The contractor shall, if so required by the Engineer-in-Charge, submit the statement of value of such old plant and equipment duly approved by a Registered Valuer recognised by the Central Board of Direct Taxes under the Income-tax Act, 1961. No such advance shall be paid on any plant and equipment of perishable nature and on any plant and equipment of a value less than Rs. 50,000/-, seventy five per cent of such amount of advance shall be paid after the plant & equipment is brought to site and balance twenty five percent on successful commissioning of the same.
>
> Leasing of equipment shall be considered at par with purchase of equipment and shall be covered by tripartite agreement with the following:
>
> 1. Leasing company which gives certificate of agreeing to lease equipment to the contractor.
> 2. Engineer-in-Charge, and
> 3. The contractor.
>
> This advance shall further be subject to the condition that such plant and equipment (a) are considered by the Engineer-in-Charge to be necessary for the works; (b) are in and are maintained in working

order; (c) and are hypothecated to the Government as specified by the Engineer-in-Charge before the payment of advance is released. The contractor shall not be permitted to remove from the site, such hypothecated plant and equipment without the prior written permission of the Engineer-in-Charge. The contractor shall be responsible for maintaining such plant and equipment in good working order during the entire period of hypothecation failing which such advance shall be entirely recovered in lump sum. For this purpose, steel scaffolding and form work shall be treated as plant and equipment. The contractor shall insure the plant and machinery for which mobilisation advance is sought and given, for a sum sufficient to provide for their replacement at site. Any amounts not recovered from the insurer will be borne by the contractor.

(ii) Interest and Recovery

The mobilisation advance and plant and machinery advance in (ii) and (iii) above bear simple interest at the rate of 10 per cent per annum and shall be calculated from the date of payment to the date of recovery, both days inclusive, on the outstanding amount of advance. Recovery of such sums advanced shall be made by deduction from the contractor's bills commencing after first ten per cent of the gross value of the work is executed and paid on pro-rata percentage basis to the gross value of the work billed beyond 10% in such a way that the entire advance is recovered by the time eighty per cent of the gross value of the contract is executed and paid, together with interest due. The contractor shall at his risk and cost submit the samples of materials to be tested or analysed and shall not make use of or incorporate in the work any materials represented by the samples until the required tests or analysis have been made and materials finally accepted by the Engineer-in-Charge. The contractor shall not be eligible for any claim or compensation either arising out of any delay in the work or due to any corrective measures required to be taken on account of and as a result of testing of materials.

The contractor shall, at his risk and cost, make all arrangements and shall provide all facilities as the Engineer-in-Charge may require for collecting, and preparing the required number of samples for such tests at such time and to such place or places as may be directed by the Engineer-in-Charge and bear all charges and cost of test unless specifically provided for otherwise elsewhere in the contract or specifications. The Engineer-in-Charge or his authorised representative shall at all times have access to the works and to all workshops and places where work is being prepared or from where materials, manufactured articles or machinery are being obtained for the works and the contractor shall afford every facility and every assistance in obtaining the right to such access.

The Engineer-in-Charge shall have full powers to require the removal from the premises of all materials which in his opinion are not in accordance with the specifications and in case of default, the Engineer-in-Charge shall be at liberty to employ at the expense of the contractor, other persons to remove the same without being answerable or accountable for any loss or damage that may happen or arise to such materials. The Engineer-in-Charge shall also have full powers to require other proper materials to be substituted in place thereof and in case of default, the Engineer-in-Charge may cause the same to be supplied and all costs which may be incurred for such removal and substitution shall be borne by the Contractor."

2. The querist has drawn the attention of the Committee to paragraph 15 of Accounting Standard (AS) 7 (revised 2002), 'Construction Contracts', which is reproduced below:

"***15. Contract costs should comprise:***

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract, and

(c) such other costs as are specifically chargeable to the customer under the terms of contract."

3. The querist has stated that a cost that may be attributable to contract activity and can be allocated to specific contracts includes borrowing costs. As per the querist, in the present scenario, there appears to be a contradiction when AS 7 (revised 2002) is read with Accounting Standard (AS) 16, 'Borrowing Costs', which states that borrowing costs include interest and commitment charges on bank borrowings and other short-term and long-term borrowings.

4. As per the querist, since the advances received from the contractee

for the purpose of performance of contract are a part of short-term or long-term borrowings, the company is justified in treating interest paid on advances received from the contractee as a part of contract cost rather to treat it as a part of finance cost.

5. The querist has also drawn attention to paragraph 20 of AS 7 (revised 2002) which, inter alia, states that costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. Since, according to the querist, the interest expenses are exclusively incurred for the performance of the contract, it can be said that it is a part of contract cost.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to whether by treating the borrowing cost as cost of construction in accordance with AS 7 (revised 2002), the querist is properly adhering to the provisions of AS 7 (revised 2002) without violating the relevant provisions of AS 16 and the requirements of Schedule VI[2] to the Companies Act, 1956.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to treatment of interest expenditure on mobilisation advance for equipment to be used for the purposes of construction received from the customer for a specific contract as contract cost. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view, and is therefore, not meant for any other purpose, such as, determination of contract price in case of 'cost plus' contracts, in which case 'cost' for the purpose of determination of contract price should be determined as per the terms of the contract. Also, the Committee's opinion is restricted to the situation mentioned in the Facts of the Case and does not contemplate other possible situations. Incidentally, the Committee notes that it is not clear as to whether mobilisation advance and advance for plant, machinery and shuttering material are one and the same. The Committee presumes that the mobilisation advance is

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

for plant and machinery and shuttering material and that shuttering material is also a type of plant and machinery. It is also not clear as to what appears to be the 'contradiction' mentioned by the querist in paragraph 3 above. Further, while clauses (i) and (ii) of a document are reproduced by the querist in paragraph 1 above, in clause (ii), there is reference to clauses (ii) and (iii). The lack of clarity in the reference to the clauses of the document, however, does not affect the issue raised by the querist and the Committee's opinion thereon.

8. The Committee notes that the company incurs interest expenditure on mobilisation advance received from the customer which is recoverable by the customer along with the amount of the advance by deduction from the company's bills. Accordingly, the Committee is of the view that the mobilisation advance received by the company is of the nature of 'borrowing of funds'. This is because advance received from the customer is akin to a loan obtained which, in the ordinary commercial parlance, amounts to borrowing of funds. The nomenclature, viz., 'advance' and mode of repayment (i.e., adjustment against future billing in the manner stated in paragraph 1 above) do not alter the position. In this case, the borrowing has been made from the customer. Consequently, the Committee is of the view that interest expenditure on mobilisation advance is of the nature of 'borrowing cost' as AS 16 defines the term 'borrowing costs' as "***interest and other costs incurred by an enterprise in connection with borrowing of funds."*** However, the Committee is of the view that the objective of AS 16 is to deal with capitalisation or expensing of borrowing costs incurred in connection with assets. The Committee is of the view that in the present case the output of the contracts undertaken by the company are not its assets. In fact, the company is a contractor and the output of the contract does not belong to the company. Accordingly, the provisions of AS 16 do not apply in the present case. With respect to inclusion of the interest in the contract cost, the discussion is contained in the following paragraphs.

9. The Committee notes paragraph 15 of AS 7 (revised 2002) reproduced in paragraph 2 above. The Committee also notes paragraph 17 of the Standard, which is reproduced below:

> "17. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:
>
> > (a) insurance;

(b) costs of design and technical assistance that is not directly related to a specific contract; and

(c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs."

10. The Committee notes that in the present case, the purpose of mobilisation advance is to finance the purchase/taking on lease of plant and machinery required for the work and brought to the site. The Committee is of the view that if the plant and machinery are exclusively dedicated to the specific contract (with or without eventual disposal), the interest on mobilisation advance in respect of the same should be treated as a contract cost under paragraph 15(a) of AS 7 (revised 2002). If this is not the case and the company can use the plant and machinery for other contracts also, either before or after the completion of the specific contract, then, the interest cannot be treated as contract cost. This is because in that case the purpose of borrowing will be to finance acquisition of plant and machinery which is capable of being used in several contracts and there is no nexus between interest expenditure and the construction activities. Accordingly, in such a case, treating interest on mobilisation advance as contract cost under paragraph 15(b) of AS 7 (revised 2002) is not appropriate as it cannot be considered that such interest is attributable to the contract activity in general. Further, since the Facts of the Case do not indicate that interest is chargeable under the terms of contract to individual customers, it is not covered under paragraph 15(c) of AS 7 (revised 2002).

11. The Committee notes that Schedule VI to the Companies Act, 1956 does not address the issue raised by the querist as it contains no specific requirement with respect to elements of 'contract cost'. However, the Committee is of the view that the disclosure requirements of Schedule VI should be complied with.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that by treating the borrowing cost (representing interest on mobilisation advance) as cost of construction (i.e., contract cost) in accordance with AS 7 (revised 2002), the querist will be properly adhering to the provisions of AS 7 (revised 2002) without violating the relevant provisions of AS 16 only if the relevant plant and machinery is exclusively dedicated to the specific contract (with or without eventual disposal) as discussed in paragraph 10 above. Schedule VI to the Companies Act, 1956 does not address the issue raised by the querist as it contains no specific requirement with respect to elements of 'contract cost'. However, the disclosure requirements of Schedule VI should be complied with.

Query No. 20

Subject: Determination of current liabilities.[1]

A. Facts of the Case

1. A company is a flagship subsidiary company of another company M/s. XYZ Limited for its energy vertical activities. The company has diversified interest in energy segment both in India and overseas, like liquid fuel, thermal, hydro, stake in coal mines, etc. The company is also having various business plans/strategies to diversify further into segments like transmission, etc. To this end, the company made bids for various transmission bids announced by the Government of India through its various body corporates.

2. In order to qualify as a successful bidder for any transmission/power projects etc., all bidders have to fulfill various financial and technical criteria as per the requirements of the respective bid documents. Among others, some common financial criteria are to meet the minimum requirement of Internal Resource Generation (IRG) and net worth of the bidder either solely or in combination of consortium members as per the conditions of the bid documents.

[1] Opinion finalised by the Committee on 24.8.2009

3. In one of the recent tariff-based competitive bids announced by ABC Transmission Projects Company Ltd. (a wholly owned subsidiary of ABC Limited) to establish transmission lines, the company submitted its bid. As per its 'Request For Qualification' (RFQ) Document, a bidder needs to fulfill the financial requirements as defined under its clause 2.1.3 which is reproduced below:

> "2.1.3.1 The Bidder must fulfill following financial requirements:
>
> A. Internal Resource Generation:
>
> Internal Resource Generation should be equal to atleast Rs. 145.6 crore or equivalent USD (calculated as per provisions in Clause 3.1.3.1) computed as three times of the maximum of the internal resource generated in a financial year, based on unconsolidated audited annual accounts (refer to Note below) and any other documents related to business operations of any of the last three (3) financial years immediately preceding the last date of submission of Response to RFQ.
>
> B. Net worth:
>
> Net worth should be equal to at least Rs. 208 crore or equivalent USD (calculated as per provisions in Clause 3.1.3.1) computed as the Net worth based on unconsolidated annual accounts (refer to Note below) of any of the last three (3) financial years immediately preceding the last date of submission of Response to RFQ.
>
> Note: Audited consolidated annual accounts of the Bidder may be used for the purpose of financial criteria provided the Bidder has atleast 26% equity in each company whose accounts are merged in the audited consolidated accounts and provided further that the financial capability of such companies (of which accounts are being merged in the consolidated accounts) shall not be considered again for the purpose of evaluation of the Response to RFQ. Bidders shall furnish documentary evidence duly certified by Managing Director / Chief Executive Officer, being a full time director on the Board of the company /Manager of the company and the Statutory Auditor in support of their financial capability as defined in Clause 2.1.3 of this RFQ."

As per the querist, the parameters for both Internal Resource Generation and Net worth have been defined in clause 2.1.3.2 of above-referred RFQ document. The same has been reproduced below:

> "2.1.3.2 Above financial parameters shall be computed in the following manner by the Bidder:
>
> A. Internal Resource generation
>
> = Profit After Tax (PAT)
>
> | | |
> |---|---|
> | Add: | Depreciation and Amortisation |
> | *Add:* | *Decrease in Net Current Assets (excluding cash)* |
> | Add : | Any other non-cash expenditure (including deferred tax) |
> | Subtract : | Scheduled loan repayments and increase in net current assets (excluding cash) |
>
> (Emphasis supplied by the querist.)
>
> Provided, when an existing loan has been repaid through the proceeds of a new loan, then to the extent the proceeds of the new loan have been used to repay the existing loan, such repayment of existing loan shall not be considered for the purposes of computation of Internal Resource Generation.
>
> B. Net worth
>
> = Equity share capital
>
> | | |
> |---|---|
> | Add: | Reserves |
> | Subtract: | Revaluation Reserves |
> | Subtract: | Intangible Assets |
> | Subtract: | Miscellaneous expenditures to the extent not written off and carried forward losses." |

Accordingly, to arrive at IRG (Internal Resource Generation), net current assets need to be calculated. The 'Net Current Assets' is determined as under :

Total Current Assets – Total Current Liabilities.

4. The querist has stated that the term 'current liabilities', as per paragraph 3.35 of the Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India (ICAI), refers to those liabilities (including loans, deposits and overdraft) which fall due for payment in a relatively short period, normally not more than twelve months. From the above definition, according to the querist, it is clear that all liabilities (including short-term loans, working capital facilities, bills discounting, etc.) which fall due for payment within twelve months would form part of the current liabilities.

5. The querist has further stated that Schedule VI[2] to the Companies Act, 1956, does not follow this criterion strictly in respect of disclosure of all current liabilities under one head, i.e., 'Current Liabilities'. As per the requirements of Schedule VI to the Companies Act, 1956, in the view of the querist, all working capital facilities, bills discounting facilities and short-term loans need to be classified under secured loans/ unsecured loans even though the above are in the nature of current liabilities as per the above-mentioned Guidance Note issued by the ICAI.

6. The querist has stated that the company, based on the above-mentioned Guidance Note issued by the ICAI, has calculated total current liabilities by adding the working capital facility and bill discounting disclosed under the schedule 'Secured Loans'. On the basis of the current liabilities, determined in the aforesaid manner, the company determined the net current assets by deducting total current liabilities from total current assets. Such net current assets have been considered for calculation of IRG. Accordingly, the company has taken certificate of IRG from the statutory auditor.

7. As per the querist, ABC Ltd., however, is of the view that the net current assets should be the same figures as appearing in the financials/ balance sheet. Accordingly, short term loan, working capital facilities and bills discounting shown under the head, 'Secured Loans' (as per the disclosure requirements of Schedule VI to the Companies Act, 1956) in the balance sheet will not form part of current liabilities and, accordingly, will not be taken into account while calculating net current assets for the purpose of determination of IRG .

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

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee as to whether, in all cases, the calculation of net current assets has been done correctly by the company by including working capital facility, cash credit facility, short-term loans and bill discounting facilities (which are payable within a period of one year) as part of current liabilities irrespective of the fact that the above being in the nature of current liabilities are not being shown under the head 'Current Liabilities' and are being disclosed separately in the balance sheet as per the requirements of Schedule VI to the Companies Act, 1956.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that the basic issue raised in the query pertains to determination of current liabilities, i.e., what items should be considered as current liabilities for bidding purposes. However, the Committee has considered the query keeping in view only the general accounting principles involved and not specifically for the purpose of the calculation of net current assets for ascertainment of IRG. In the view of the Committee, it is possible for an entity to specify the calculation of current liabilities in a different way depending on the objective which is expected to be served, e.g., for bidding purposes. However, in the absence of any such specified manner of computation, ordinarily the computations for accounting purposes may be applicable. Accordingly, the Committee has not examined any other issue that may arise from the Facts of the Case, such as, appropriateness or otherwise of the disclosure of working capital facilities, cash credit facilities and bills discounting facilities, etc. under the head secured loans/unsecured loans, or the items that may/may not be included under the head 'current liabilities', etc., for disclosure in the balance sheet as per the requirements of Schedule VI to the Companies Act, 1956.

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

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

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

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

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

From the above, it is clear that as per the requirements of Schedule VI, the primary bifurcation of liabilities is on the basis of whether the liabilities are secured or unsecured rather than on the basis of current or non-current liabilities. Thus, as per Schedule VI, a liability which is of the nature of loans and advances will be disclosed under the head 'Secured Loans' or 'Unsecured Loans' even if it is a current liability. Accordingly, the Committee is of the view that all liabilities including loans, whether secured or unsecured, payable within a time period of twelve months should be considered for calculating 'current liabilities' irrespective of the fact that the same are not being shown under the head 'current liabilities' in the balance sheet as per the requirements of Schedule VI to the Companies Act, 1956.

D. Opinion

12. On the basis of paragraphs 10 and 11 above and subject to paragraph 9 above, the Committee is of the opinion that the working capital facilities, cash credit facilities, short term loans and bill discounting facilities, whether secured or unsecured, which are payable within a period of one year should be considered as current liabilities, irrespective of the fact that the same are not being shown under the head 'Current Liabilities' in the balance sheet as per the requirements of Schedule VI to the Companies Act, 1956.

Query No. 21

Subject: Whether a company registered under section 25 of the Companies Act, 1956, should prepare Income and Expenditure Account or Profit and Loss Account.[1]

A. Facts of the Case

1. A company is a non-profit organisation registered under section 25 of the Companies Act, 1956, with the Central Government holding its 100 percent shares. It is presently working under the Department of Scientific and Industrial Research, Ministry of Science & Technology, with the objective to develop, promote and transfer technologies emanating from various national research and development (R&D) institutions. It has been offering the services in improving the manufacturing base in India with innovative technologies and, as per the querist, is acting as an effective catalyst translating innovative research into marketable industrial products. The querist has stated that the company is being used by the Government of India in spreading technical knowledge and providing financial aids to new entrepreneurs. It is also conducting different educational and promotional programmes on behalf of the Government of India. In doing so, the company has been receiving government grants/aids.

2. The company has been licensing indigenous technologies. It has occasionally sold compact disks containing blue print of technologies. But, as per the querist, the sale has not been substantial and did not result in profits.

3. The company had also been entering into transactions of the nature of 'sale'. It was purchasing 'Unani' products from another company, which is using the licensed technology of the company. The product was further sold in market. The querist has stated that the main motto of such trade is to promote its technology and the product produced from the said technology, but it may result into some profit element. The company has, however, stopped these purchase and sale activities in the current year.

4. Since its incorporation, the company has been preparing Income and Expenditure Account. As per the querist, the auditors have stated that they cannot express their opinion in the statutory audit report on the Income and

[1] Opinion finalised by the Committee on 24.8.2009

Expenditure Account. The auditors have stated that as per section 227(2) of the Companies Act, 1956, the auditor of the company has to express his opinion on the Balance Sheet and the Profit and Loss Account and any other document declared by the Companies Act to be part of or annexed to the Balance Sheet and the Profit and Loss Account.

5. The querist has further stated that as per clause 117 of the Articles of Association of the company, "at every annual general meeting of the Company held in pursuance of article 58, the Board of Directors of the Company shall lay before the Company a Balance Sheet and Income and Expenditure Account and Profit and Loss Account", and clause 119 of the Articles of Association prescribes the contents of the Income and Expenditure Account and Profit and Loss Account. Thus, according to the querist, as per the Articles of Association, the company is also required to prepare Income and Expenditure Account.

B. Query

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

(a) Which financial statement should now be prepared by the company – whether the company should prepare 'Profit and Loss Account' or whether it should continue to prepare 'Income and Expenditure Account'.

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

C. Points considered by the Committee

7. The Committee, while answering the query, has considered only the issues raised in paragraph 6 above and has not examined any other issue that may arise from the Facts of the Case. From paragraph 5 above, it appears to the Committee that as per its Articles of Association, the company is required to prepare both Income and Expenditure Account and Profit and Loss Account. However, the company is preparing only Income and Expenditure Account.

8. The Committee notes from the Facts of the Case that the company is registered under section 25 of the Companies Act, 1956. The Committee also notes clause 113 of the Articles of Association of the company

(separately provided by the querist for the perusal of the Committee) which states as below:

> "113. No dividends in any form or shape shall be paid to members so long as the licence granted by the Government of India under Section 25 of the Act remains in force and is not rescinded or withdrawn."

From the above, the Committee is of the view that the objective of the company is not to earn profits for distribution among its members. The profits earned, if any, will be used for the furtherance of the objectives of the company. The Committee is also of the view that even a not-for-profit organisation may earn profits for its sustenance. Accordingly, even if the company in the present case earns profits, in the view of the Committee, the company is not carrying on business 'for profit'.

9. The Committee notes section 210(2) of the Companies Act, 1956, which states as below:

> "(2) In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of a profit and loss account, and all references to "profit and loss account", "profit" and "loss" in this section and elsewhere in this Act, shall be construed, in relation to such a company, as references respectively to the "income and expenditure account", "the excess of income over expenditure", and "the excess of expenditure over income"."

From the above, the Committee is of the view that reference to 'Profit and Loss Account' in section 227(2) of the Companies Act, 1956, shall be construed, in the case of the present company, as reference to 'Income and Expenditure Account'. Accordingly, the company should prepare only the Income and Expenditure Account instead of the Profit and Loss Account even though the Articles of Association of the company require preparation of the both.

D. Opinion

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

(a) The company should prepare Income and Expenditure Account in place of Profit and Loss Account.

(b) Preparation of Income and Expenditure Account in place of Profit and Loss Account by the company, will not tantamount to violation of or deviation from the Companies Act, 1956, or any Accounting Standard.

Query No. 22

Subject: Adjustments to the cost of fixed asset subsequent to capitalisation - nature thereof and effect on depreciation.[1]

A. Facts of the Case

1. A company is a public sector undertaking engaged in refining of crude oil. The company had initially set up a crude oil refinery of 3 million metric tonnes per annum (MMTPA), called Phase 1, at a capital cost of Rs 2,600 crore. This was commissioned in March 1996. Thereafter, the company had set up an additional refinery of 6 MMTPA as Phase 2 project in the same complex with a capital outlay of Rs 3,700 crore. This was commissioned in April 2001. Both the refineries were set up with capital items – both indigenously procured as well as imported components. The import of capital goods is governed under the Customs Act, 1962 and attracts customs duty at the applicable rates.

2. As per the querist, Customs Notification No. 11/97 dated 1st March, 1997 (as amended) allowed import of goods for setting up of new refinery or for substantial expansion at nil rate (zero duty) with Countervailing Duty (CVD) of 10%. At the same time, customs tariff rate (project duty) for import of capital goods for projects was 20% with CVD of 13%. During the period of the project imports, the duty structure was varying from period to period. During Phase 2 construction, the company paid customs duty at the rate of 0% and CVD of 10%. The entire amount of customs and other applicable duties was debited to 'Assistant Commissioner (AC) Customs Account' as advance pending capitalisation by crediting bank account.

[1] Opinion finalised by the Committee on 15.12.2009

3. The querist has informed that the customs authorities initially admitted the Bills of Entry (BEs) filed as per Notification No. 11/97. However, authorities later disputed the filing of BEs and claimed that the company was not eligible for concessional customs duty under the said notification. Therefore, the company was asked to pay the duties as per the project rate of customs duty applicable for project import of capital goods. To avoid delay in project execution, the company started indicating this duty structure in the BEs and made payment as demanded by authorities under protest. These amounts were also debited to 'AC Customs Account' as advance pending capitalisation.

4. Aggrieved by the actions of the Customs authorities, the company filed a writ petition in the High Court of Karnataka. The High Court of Karnataka passed an interim order pending final decision by the Customs authorities, directing the company to deposit 50% of the duty applicable as per project rate as deposit and balance 50% by way of bank guarantee and reverted the case to appeal authorities of Customs. As per the directives of the High Court's interim order, the company deposited 50% of the applicable customs duty computed at project rate and applicable CVD after taking into account the amounts already paid, and recorded the same in the books of account by crediting bank account and debiting 'AC Customs Account' as advance pending capitalisation.

5. In February 2001, the Phase 2 refinery was capitalised. Pending final order of the Customs, Excise & Service Tax Appellate Tribunal (CESTAT), the company completed the capitalisation based on 'best estimate' with the available information. The accounting treatment followed for customs and other duties is as enumerated below:

(a) The amount outstanding to the debit of AC Customs Account was transferred to Capital Work-in-Progress (CWIP) Account.

(b) Based on the BEs filed with the Customs authorities and the amount of CVD indicated in the BEs at 13%, 100% of the amount of CVD was transferred to MODVAT/CENVAT Credit Receivable Account by crediting CWIP. This was done considering the fact that MODVAT/CENVAT credit needs to be claimed within the stipulated time period and delay in the claim, pending decision, would have resulted in total loss of MODVAT/CENVAT credit claims, if claim for benefit of Notification No. 11/97 was not to be allowed.

(c) From the CWIP Account, the additional duty paid (i.e., the difference between the 50% of the project duty paid and the applicable duty as per the Notification No. 11/97) was transferred to the 'Receivable from Customs Account' by crediting the CWIP Account and debiting the 'Receivable from Customs Account'.

6. During the year 2005-06, the company received the decision from CESTAT, which upheld the appeal of the company and held that the company was eligible to import under Notification No. 11/97 as 'setting up of new refinery'. As a result of this decision, authorities completed the assessment of BEs considering the applicable duties under Notification No. 11/97. As the company had earlier claimed and accounted for MODVAT/CENVAT credit as per project rate of duty, the department assessed the BEs and allowed the refund claims assessing higher CVD than applicable CVD which was lower and adjusted the refund amount accordingly. The querist has stated that the accounting for MODVAT/CENVAT credit receivable at higher rate based on the project rate of duty than the actual amount of MODVAT/CENVAT credit eligible at 10% resulted in lower capitalisation to the extent of Rs. 9.46 crore.

7. The querist has also stated that some of the customs duty payments which were transferred to CWIP Account as per paragraph 5(a) above, were not transferred to the 'Receivable from Customs Account' and accordingly, the actual deposit amount determined as refundable on final assessments was higher as compared to the balance in the 'Receivable from Customs Account'. Since the balance in CWIP Account after transferring to the 'Receivable from Customs Account' and 'MODVAT/CENVAT Credit Receivable Account', was capitalised, this resulted in a higher transfer to the 'Asset Account'. Accordingly, this has resulted in higher capitalisation by Rs. 4.78 crore.

8. In the year 2006-07, on receipt of final assessment orders from the Customs authorities, the company passed the following rectification entries:

- On account of higher MODVAT/CENVAT credit claimed by the company amounting to Rs. 9.46 crore: Since this had resulted in lower capitalisation, 'Asset Account' was debited and the 'Receivable from Customs Account' was credited.
- On final assessment, the deposit amount payable to the company by the Customs department was higher by Rs. 4.78 crore as

compared to the balance available in the books of account: Since this resulted in higher capitalisation, 'Receivable from Customs Account' was debited by crediting 'Asset Account'.

The net impact on fixed asset due to these rectification entries passed in the year 2006-07 was Rs. 4.68 crore.

9. The querist has stated that as per paragraph 6 of Accounting Standard (AS) 6, 'Depreciation Accounting', the cost of fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar other factors. The querist has also stated that paragraph 25 of AS 6 states, inter alia, that where the historical cost of the asset has undergone a change due to the circumstances specified in paragraph 6 of AS 6, depreciation on the revised unamortised depreciable amount is to be provided prospectively over the residual useful life of the asset. Accordingly, as per the querist, the rectification entries carried out by the company on the basis of the decision of CESTAT were considered as changes due to the circumstances specified in paragraph 6 of AS 6 and depreciation on the additional amount capitalised on account of the circumstances explained above, was provided prospectively over the residual useful life of the asset.

10. The government auditors from the C&AG's office, while conducting the audit under section 619(4) of the Companies Act, 1956, observed that the above case did not fall under 'changes in duties or similar factors', as the change in historical cost occurred not due to an event which occurred during the relevant accounting year (2006-07) but due to the fact that the company had claimed higher MODVAT/CENVAT credit benefit, without corresponding amount being capitalised in the previous year. Moreover, this change in cost has not occurred due to change in duty structure, either by the statute or consequent to the Tribunal Order.

B. Query

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

(i) Whether changes in the cost of fixed assets arising out of CESTAT order and subsequent assessment fall within the purview of paragraph 6 of AS 6 as changes subsequent to acquisition or construction on account of changes in duties or other similar factors.

(ii) Whether computation of depreciation on such changes prospectively over the residual useful life of the asset is in order.

(iii) Whether subsequent adjustment to capitalisation as indicated in paragraph 10 above can be treated as 'change in cost' due to reasons given in paragraph 6 of AS 6 and consequent benefit of paragraph 25 of AS 6 can be availed.

C. Points considered by the Committee

12. The Committee notes that the basic issues raised by the querist relate to nature of the adjustment to the cost of the relevant fixed assets due to order of the Tribunal and subsequent assessment of BEs, and the manner of giving consequent effect to depreciation. Therefore, the Committee has examined only these issues and has not touched upon any other issue that may arise from the Facts of the Case, such as, timing of recognition of MODVAT/CENVAT credit receivable in the books of account and the propriety of the amount claimed by the company in respect thereof, various accounting entries passed by the company, difference in the date of capitalisation and the date of commissioning of the project, etc. The Committee's opinion contained herein is purely from an accounting point of view. The Committee has not examined the laws relating to excise/customs duty.

13. The Committee notes paragraphs 6 and 25 of AS 6 as reproduced below:

> "6. ... The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors."
>
> ***"25. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset."***

The Committee also notes paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets' 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:
>
> ...
>
> 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."

14. The Committee notes that at the time of capitalisation in the year 2001, the company applied the concessional rates as per Notification No. 11/97 (paragraph 5 above). Thus, the fixed assets were capitalised taking into account the concessional duties which was also the final order of the CESTAT received later. Upon receipt of final assessment, the company, in the year 2006-07, made two adjustments to the cost of fixed assets, viz., setting right the under-capitalisation of Rs. 9.46 crore (paragraph 6 above) and setting right the over-capitalisation of Rs. 4.78 crore (paragraph 7 above). The discussion regarding the two adjustments is contained in paragraphs 15 and 16 below.

15. As regards the first adjustment of Rs. 9.46 crore, the Committee notes that the under-capitalisation arose due to transfer of full CVD to MODVAT/ CENVAT Credit Receivable Account from the CWIP Account instead of the amount of CVD which had actually been paid and debited to CWIP Account. The Committee is of the view that this is not a case of change in the cost due to change in import duties or similar factors. It is a case of an error which should be rectified. Accordingly, paragraphs 6 and 25 of AS 6 are not relevant for determining the manner of giving effect to depreciation adjustment arising out of setting right the under-capitalisation of Rs. 9.46 crore.

16. As regards the second adjustment of Rs. 4.78 crore, the Committee notes that the over-capitalisation arose due to non-transfer of some duties from CWIP Account to Receivable from Customs Account. The querist has not furnished any reason for such non-transfer. The Committee presumes that this is a case of omission. Consequently, in the view of the Committee, the adjustment of Rs. 4.78 crore is also a case of error which should be rectified. Accordingly, paragraphs 6 and 25 of AS 6 are not relevant for

determining the manner of giving effect to depreciation adjustment arising out of setting right the over-capitalisation of Rs. 4.78 crore.

17. The Committee notes the following paragraphs of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies':

> ***"4.3 Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."***
>
> ***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***

Since the adjustments of Rs. 9.46 crore and Rs. 4.78 crore, mentioned in paragraphs 15 and 16 above, respectively, are rectification of errors, the consequent adjustment to depreciation amount should be treated as prior period item. Accordingly, adjustment to depreciation should be calculated with retrospective effect (and not prospective effect) and disclosed in accordance with AS 5.

D. Opinion

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

(i) Changes in the cost of fixed assets arising out of CESTAT order and subsequent assessment do not fall within the purview of paragraph 6 of AS 6 as changes subsequent to acquisition or construction on account of changes in duties or other similar factors, as explained in paragraphs 15 and 16 above.

(ii) Computation of depreciation on such changes prospectively over the residual useful life of the asset is not in order.

(iii) See (i) and (ii) above.

Query No. 23

Subject: Accounting treatment of premium paid for restructuring/ prepayment of loan.[1]

A. Facts of the Case

1. A company was incorporated in the year 1976 as a wholly owned Government of India enterprise under the administrative control of the Ministry of Power to plan, promote, investigate, survey, design, construct, generate, operate and maintain hydro and thermal power stations and to explore and utilise the power potential of North East in particular. The company is presently running three hydro projects and two thermal projects in north-eastern States and is catering to the demand of north-eastern States only. The company's shares are not listed with any stock exchange. The authorised and paid up share capital of the company as on 31.03.2008 are Rs. 3500 crore and Rs. 3178.93 crore, respectively. The turnover of the company for the year ending 31.03.2008 is Rs. 860.31 crore.

2. With a view to take the benefit of reduction of interest rates in general, the company has undergone restructuring of loans availed from financial institutions for financing of capital assets. The querist has informed that the purpose of restructuring of loan was to convert high interest cost bearing loan into low interest cost bearing loan. At the time of restructuring, the construction of the assets was already complete and the assets were in use. The details of the restructuring scheme have been provided by the querist as follows:

Financial Institution (FI) - I		**Financial Institution (FI) - II**	
Date of restructuring	Loan liability on the date of restructuring	Date of restructuring	Loan liability on the date of restructuring
31.01.03	Rs.183,36,35,919		
12.06.03	Rs.262,14,84,888	15.07.03	Rs.117,01,33,328
15.07.04	Rs.229,46,77,380	31.03.04	Rs.112,27,99,991

[1] Opinion finalised by the Committee on 15.12.2009

In case of loan from FI - II, rate of interest was ranging from 11.50% to 14.00% before restructuring. After restructuring, interest rate was ranging from 9.50% to 11.50%. The interest rates on loans from FI – I were as follows:

Date of restructuring	Interest rate before restructuring	Interest rate after restructuring
31.01.03	12%	9%
12.06.03	11% to 12%	9%
15.07.04	8.50% to 10.50%	4.25% to 8.25%

3. The querist has further stated that the company, as per its accounting policy, treats the premium paid for restructuring the loan availed from financial institutions for reduction in interest rates as deferred revenue expenditure and the same is written off over the balance tenure of loan.

4. The querist has stated that in case any loan is repaid in full in a year, prepayment charges paid are written off in the year of repayment itself. Through a separate letter, the querist has, however, informed that the prepayment charges are treated as deferred revenue expenditure.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting policy adopted by the company is in compliance with the existing Accounting Standards and the generally accepted accounting principles. If not, the querist has sought advice with respect to the modifications required.

C. Points considered by the Committee

6. The Committee, while answering the query, has considered only the issues raised in paragraph 5 above and has not touched upon any other issue that may arise from the Facts of the Case.

7. The Committee notes that paragraph 3.1 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006, provides that "***<u>Borrowing costs</u> are interest and other costs incurred by an enterprise in connection with the borrowing of funds."***

Further, the Standard contemplates "amortisation of discounts or premiums relating to borrowings" as a component of borrowing costs (paragraph 4(b) of AS 16). Thus, the borrowing costs comprise the amount of premium amortised during the period. The Committee notes from the above that since the restructuring premium in the present case is incurred in connection with the borrowings of the company, it is a borrowing cost as per the provisions of AS 16. The Committee also notes that although as per AS 16, borrowing costs include amortisation of discounts or premiums relating to borrowings, it does not prescribe amortisation of such costs.

8. Now, the question arises as to how such premium should be recognised in the financial statements of the company. In this regard, the Committee notes that as per the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, in case an expenditure meets the definition of the term 'asset' and the recognition criteria thereof, the same should be recognised as an asset; failing which, the expenditure should be expensed in the profit and loss account in the year in which the expenditure is incurred. 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))

9. On the basis of the above, the Committee is of the view that the premium paid towards restructuring of a loan meets the definition of an asset since it is paid in consideration of paying lesser interest in future and, therefore, is a resource controlled by the entity having future economic benefits. In substance, it can be considered as an advance payment of interest whose benefit will be realised over the tenure of the loan. The Committee is, therefore, of the view that following the principle of 'accrual', viz., "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" (paragraph 10(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'), since the premium paid for restructuring of the loan is related to and incurred for the purpose of reduction in the interest over the balance tenure of the loan, the asset, i.e., the premium paid should be amortised over the balance tenure of the loan on straight line basis or by using effective interest rate method. The periodic amortisation of the premium should be recognised in the profit

and loss account of the relevant period as the construction of the assets is already complete.

10. Insofar as the pre-payment charges for the loan are concerned, the Committee notes that the querist has given contradictory statements in paragraph 4 above with respect to the accounting treatment followed by the company. The Committee is of the view that in order to determine the accounting treatment, the substance of the transaction should be seen. In substance, if the prepayment of loan is extinguishment of the existing liability, to the extent these charges are incurred towards extinguishment of the existing loan liability, the same should be expensed in the statement of profit and loss as these charges would not have any future economic benefit. However, in case, in substance, the prepayment of loan is not extinguishment of the existing liability, it should be considered as restructuring of the liability and accordingly, the treatment prescribed in the above paragraphs should be followed.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that the accounting policy of the company treating the premium paid on restructuring and prepayment charges as deferred revenue expenditure, is not in compliance with the existing generally accepted accounting principles. The premium paid for restructuring should be amortised over the balance tenure of the loan on straight line basis or by using effective interest rate method, as discussed in paragraph 9 above. In respect of the prepayment charges, the Committee is of the opinion that if prepayment of the loan is, in substance, extinguishment of the existing loan liability, the same should be expensed in the statement of profit and loss. However, in case, in substance, the prepayment of loan is not extinguishment of the existing liability, it should be considered as restructuring of the liability and accordingly, the treatment prescribed for premium paid on restructuring should be followed, as discussed in paragraph 10 above. The accounting policy should be modified accordingly.

Query No. 24

Subject: Treatment of goodwill (arising on consolidation) and reserve arising on revaluation of the properties of the subsidiary in the consolidated financial statements pursuant to testing of impairment as per AS 28.[1]

A. Facts of the Case

1. A private limited company (hereinafter referred to as the 'parent') incorporated under the Companies Act, 1956, acquired 90% equity in another company (hereinafter referred to as the 'subsidiary') on September 30, 2006.

2. The querist has stated that at the time of acquisition, the fixed assets of the 'subsidiary' *and its subsidiaries were not revalued* (although the book value of some of the fixed assets was far lower than their fair value) (emphasis supplied by the querist). The difference in the carrying value of net assets as per the newly acquired subsidiary's financials on the date of acquisition and acquisition price, which was substantial, was recognised as goodwill in the consolidated financial statements (CFS) of the parent company. The acquisition was thus, recorded as below in the CFS of the parent company:

	(In Rs. Lakh)
Bank	-750
Land	+100
Goodwill	+500
Building	+100
Net Current Assets	+50

3. The subsidiary, subsequently, on March 31, 2008, revalued certain class of the fixed assets (primarily land and building) to reflect the true and fair view of such fixed assets and a revaluation reserve for the differential amount was created in the books of the subsidiary. The querist has stated that the accounting treatment of revaluation has been done as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. The depreciation over the revalued amount will be charged against the revaluation reserve and will not be debited to the profit and loss account of the subsidiary. The effect of the revaluation was also considered for the purpose of consolidation in the

[1] Opinion finalised by the Committee on 15.12.2009

CFS of the parent company to represent the true financial position of the group assets.

4. As per the querist, the revaluation of such assets was done by professional valuer who provided valuation to the management with fair value as at two dates, viz., (a) as at the date of acquisition (September 2006) and (b) as on 31st March, 2008. The professional valuer, in his report, has revalued the net value of land and building as below:

		(In Rs. Lakh)
Land	As at Sep. 30, 2006	300
	As at March 31, 2008	450
Building	As at Sep. 30, 2006	150
	As at March 31, 2008	200

5. The parent company has a policy of testing the goodwill for impairment arising on consolidation, which represents the difference between the amount paid for acquisition of controlling stake and the net carrying value of assets as per subsidiary's financial statements on the date of such acquisition. As on 31st March, 2008, it carried out impairment analysis of the cash-generating unit (CGU) consisting of the subsidiary company as a whole, and finds that:

(i) There is no impairment of goodwill in case no entries relating to revaluation of assets are passed.

(ii) There is no impairment of goodwill even in case the entries relating to revaluation of land and building to the extent of the post-acquisition appreciation in value are passed in the financials.

(iii) There is slight impairment of goodwill post-acquisition in case the entries relating to revaluation of land and building to the full extent (including appreciation gains related to pre-acquisition period) are passed in the financials.

The net present value (NPV) of the cash flows representing 'value in use' from the CGU is lesser than the carrying amount of goodwill and other assets (including revalued assets), leading to impairment. The querist has also stated that there is no impairment loss in the subsidiary as a whole as the subsidiary does not have goodwill in its balance sheet. The loss is arising only in the consolidated financial statements of the parent company.

Auditor's analysis and suggestion

6. The querist has stated that the statutory auditors of the parent company have opined that the fixed assets have been revalued as at March 31, 2008 and such revaluation complies with Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which, inter alia, states as below:

> ***"27. When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed.***
>
> ***28. The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class."***

The auditors are of the view that paragraphs 58 and 59 (reproduced below) of Accounting Standard (AS) 28, 'Impairment of Assets', do not apply to the case in true sense as there is no impairment loss:

> ***"58. An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard.***
>
> 59. An impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset."

The auditors are further of the view that the revaluation of land and building and to the extent that revaluation gain is identified with the pre-acquisition period, the goodwill amount should be reduced so as to reflect true and fair view. According to them, in case the company recognises the revaluation reserve and also keeps the goodwill in the books (to the extent it related to revaluation gain relating to pre-acquisition period), it would lead to financials of the company not reflecting the true and fair view.

7. As per the querist, the company is of the view that paragraph 14 of Accounting Standard (AS) 21, 'Consolidated Financial Statements', clearly and unambiguously states as follows:

> "14. The parent's portion of equity in a subsidiary, at the date on which investment is made, is determined on the basis of information contained in the financial statements of the subsidiary as on the date of investment. *... "*

Thus, the querist has stated that, under AS 21, *the measurement of goodwill* (or capital reserve, as the case may be) *at the date of acquisition* of a subsidiary *is based on the carrying amount* of the subsidiary's assets and liabilities as per the books of account of the subsidiary *as at the date of acquisition* (emphasis supplied by the querist).

8. The querist has stated that as per the auditor, the goodwill of Rs. 500 lakh appearing in the consolidated financial statements actually comprises three elements:

		(In Rs. Lakh)
(a)	Difference between book value and fair value of land on the date of acquisition	200
(b)	Difference between the book value and fair value of buildings	50
(c)	'True' goodwill (balancing figure)	250

Thus, on recognition of revaluation gain as on March 31, 2008, the company must reduce its goodwill and revaluation reserve to the extent of Rs. 250 lakh, so that true and fair view is not impaired and the net worth of the group is correctly stated. Based on this, the various assets and goodwill will appear as under in the CFS:

	(In Rs. Lakh)
Goodwill	250
Land	450
Building	200
Other net current assets	50
Revaluation reserve	200

9. Auditors have also opined that the excerpts from AS 21 and AS 28 reproduced above need to be construed and read in a manner so as to

reflect a fair presentation of the underlying economic position as well as resources of the group.

10. The auditors have also suggested another methodology where, in their opinion, to ensure that true and fair view of the financials of the group is correctly stated, the increase in the value of land and building should not be recognised to the extent this belongs to pre-acquisition period. In such a case, the various assets and goodwill will appear as under in CFS:

	(In Rs. Lakh)
Goodwill	500
Land	250
Building	150
Other net current assets	50
Revaluation reserve	200

11. The company (parent) is, however, of the view that keeping in view the given accounting guidance, the various assets and goodwill in the CFS should be reflected as below:

	(In Rs. Lakh)
Goodwill	500
Land	450
Building	200
Other net current assets	50
Revaluation reserve	450

As soon as the group recognises the goodwill and the revaluation gains (leading to an increase in the carrying value of the assets of CGU), as per above, given the 'value in use' of CGU, in the view of the querist, there is an impairment of goodwill to the extent of 100 and thus, following additional entry may be passed:

Profit & Loss Account	Dr.	100
To Goodwill		100

12. Notwithstanding the above economic arguments, the company feels that treatment at paragraph 7 above is inconsistent with AS 21 which requires the differences between book values and fair values of recognised assets and liabilities of a subsidiary as at the date of acquisition to be merged into a single figure of goodwill (goodwill would also include unrecognised assets and liabilities of subsidiary and any true goodwill). However, the company

does recognise the fact that what auditor is saying makes economic sense as prima facie some of the revaluation has arisen from and belongs to the pre-acquisition period.

B. Query

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

(i) Whether the parent company should revalue the figures of fixed assets of the aforesaid subsidiary in the CFS of the company, considering that the revaluation increase up to the date of acquisition (September 2006) is already included in goodwill appearing in consolidated balance sheet (as per paragraph 10 above).

(ii) Whether the parent company would be justified in setting off the goodwill arising on consolidation as on date of acquisition with the increase in the fair value of land and building on the same date in the consolidated books of account as at March 31, 2008, as suggested by the auditors in paragraph 8 above.

(iii) Whether the parent company should revalue the figures of fixed assets of the aforesaid subsidiary in the CFS of the company, considering the revaluation increase up to 31st March, 2008, and reflect the corresponding revaluation reserve, keeping the goodwill appearing in consolidated balance sheet on the date of acquisition intact (as per paragraph 11 above). Further, whether the parent company should reflect the impairment of goodwill through profit and loss account.

C. Points considered by the Committee

14. The Committee, while answering, has considered only the issues raised in paragraph 13 above and has not examined any other issue that may arise from the Facts of the Case, such as, appropriateness of the revaluation of assets and accounting thereof in the books of the subsidiary, accounting for depreciation on the revalued assets, whether or not the goodwill arising on consolidation should be amortised, etc. Further, the Committee has not gone into the computation/determination of specific amounts of the various items, such as, goodwill, land and buildings, etc., that should appear in the financial statements. The Committee has also not examined the

appropriateness of considering the whole subsidiary as a CGU and presumes that the company has correctly identified the subsidiary as a whole, as a CGU. The Committee also presumes that the amount of goodwill in the CFS has been arrived at by the parent company correctly in accordance with the Accounting Standard (AS) 21, 'Consolidated Financial Statements'.

15. As far as recognition of goodwill arising on consolidation is concerned, the Committee notes paragraph 14 of AS 21 as reproduced in paragraph 7 above and paragraph 13 thereof as reproduced below:

> ***"13. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:***
>
> ***(a) the cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;***
>
> ***(b) any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the consolidated financial statements;***
>
> ***(c) when the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements;***
>
> ***...***
>
> ***Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations."***

Thus, any excess of the cost to the parent of its investment in subsidiary over the parent's portion of equity determined on the basis of the carrying amount of assets and liabilities in the financial statements of the subsidiary as on the date of acquisition of equity interest in the subsidiary is recognised as goodwill in the consolidated financial statements. Accordingly, the Committee is of the view that goodwill as on the date of consolidation is determined on the basis of the carrying amount of assets and liabilities appearing in the financial statements of the subsidiary as on the date of acquisition and the same cannot be adjusted against the revaluation increase on account of increase in fair value of assets upto the date of acquisition not recognised in the financial statements as being argued in the Facts of the Case.

16. As far as impairment of goodwill in the consolidated financial statements is concerned, the Committee notes that AS 28 requires impairment of goodwill to be tested as part of impairment testing of the cash-generating unit(s) to which it relates. In this connection, the Committee notes the following paragraphs from AS 28:

> "79. Goodwill arising on acquisition represents a payment made by an acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that individually do not qualify for recognition in the financial statements. Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognised in accordance with paragraph 87."
>
> ***"87. An impairment loss should be recognised for a cash-generating unit if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:***
>
> > ***(a) first, to goodwill allocated to the cash-generating unit (if any); and***

> ***(b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.***

These reductions in carrying amounts should be treated as impairment losses on individual assets and recognised in accordance with paragraph 58."

"***58. An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard."***

On the basis of the above, the Committee is of the view that since as per the facts of the case supplied by the querist, the goodwill appearing in the consolidated financial statements is allocated to the subsidiary as a whole forming a CGU, the carrying amount of the cash-generating unit including goodwill, should be compared with the recoverable amount of that unit, and then, the impairment loss, if any, should be allocated to reduce the carrying amount of the goodwill and the balance, if any, to other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit. In case the asset to which the impairment loss has been allocated is carried at a revalued amount, to that extent, the impairment loss should be treated as a revaluation decrease and the balance, if any, should be recognised as an expense in the statement of profit and loss.

D. Opinion

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

(i) The parent company should give full effect of the revaluation made by the subsidiary in the consolidated financial statements. It should not, on its own, revalue the figures of the fixed assets of the subsidiary in the consolidated financial statements on the ground that the revaluation increase upto the date of acquisition is already included in goodwill appearing in consolidated financial statements as stated by the querist in paragraph 10 above.

(ii) No, the goodwill arising on consolidation as on the date of acquisition cannot be adjusted for the increase in the fair value of land and building on the date of acquisition in the consolidated financial statements as at March 31, 2008, as suggested by the auditors in paragraph 8 above.

(iii) The parent company should give full effect of the revaluation made by the subsidiary upto the date of consolidation in the consolidated financial statements reflecting the corresponding revaluation reserve. Impairment of goodwill should be accounted for as discussed in paragraph 16 above.

Query No. 25

Subject: Determination of depreciation in case of revaluation and revision in the useful life of land and buildings.[1]

A. Facts of the Case

1. A nationalised bank is covered under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, and is regulated by the Reserve Bank of India. The equity of the bank is listed on the Bombay Stock Exchange and the National Stock Exchange. The querist has stated that for accounting purposes, the provisions of the Banking Regulation Act, 1949, are broadly applicable to the bank.

2. The bank purchased freehold land and building in the year 1950 costing Rs. 50 lakh (land Rs. 20 lakh and building Rs. 30 lakh) and accounted for the same separately as 'freehold land' and 'bank's own premises', respectively. On 'bank premises' component, the bank is charging depreciation @ 5% on written down value basis. In the year 2008, the property has been revalued at Rs. 100 lakh (land Rs. 80 lakh and building Rs. 20 lakh) and the revaluation reserve has been created for Rs. 60 lakh towards land and Rs. 18.50 lakh towards building, assuming the written

[1] Opinion finalised by the Committee on 15.12.2009

down value of building at Rs. 1.5 lakh. The valuer has estimated the useful life as 25 years.

3. The bank also purchased a leasehold land in the year 1990 with lease period of 99 years and paid Rs. 99 lakh. The bank subsequently constructed building thereon in June 1992 costing Rs. 50 lakh. The cost of land is debited to 'leasehold land' and construction cost to the 'bank's own premises'. The bank is amortising lease rent @ Rs. 1.00 lakh per annum and is charging depreciation @10% on building since 31.03.1993 on written down value basis. The property has been revalued at Rs. 140 lakh (land Rs. 100 lakh and building Rs. 40 lakh).

4. The querist has also informed that the bank owns more than 200 properties purchased in different years and all the properties have been revalued in the year 2008.

B. Query

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

(i) Under the facts described in paragraph 2 above, what should be the applicable rate of depreciation?

(ii) Under the facts described in paragraph 3 above, what should be the applicable depreciation rate on both original cost and revalued portion,

  (a) if the valuer has estimated the remaining useful life as 40 years?

  (b) if the valuer has not given any useful life and the management, as a policy, is not determining the useful life of the land and buildings?

(iii) Whether different rates of depreciation will be applicable on the 200 properties purchased in different years and revalued in the year 2008. If yes, what is the mechanism to be followed for implementation?

C. Points considered by the Committee

6. The Committee has considered only the issues raised by the querist in paragraph 5 above and has not touched upon any other issue that may

arise from the Facts of the Case, such as, treatment of revaluation reserves, etc. Further, while formulating its opinion, the Committee has restricted itself to describing the accounting principles that should be considered for determining the rate of depreciation and has not gone into the calculation of depreciation rate for various assets.

7. The Committee notes that the Reserve Bank of India, vide its circular No. DBOD. No. BP. BC. 89 /21.04.018/2002-03 dated March 29, 2003 regarding Guidelines on compliance with Accounting Standards (AS) by banks, has advised all scheduled commercial banks to ensure strict compliance with the accounting standards issued by the Institute of Chartered Accountants of India, with effect from the accounting year ending March 31, 2003. Accordingly, the Committee is of the view that the Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) and other generally accepted accounting principles (GAAPs) would be applicable to the bank in the present case.

8. The Committee notes the introduction paragraph and the definition of the term 'depreciable assets' as contained in Accounting Standard (AS) 6, 'Depreciation Accounting', issued by ICAI, as below:

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

9. From the above, the Committee notes that a depreciable asset should essentially have a limited useful life. As per the GAAPs prevalent in India, freehold land is considered to be having an unlimited life and, therefore, cost thereof is not depreciated. In the context of the leasehold land which is recognised as a fixed asset by the bank keeping in view the existing practice of reflecting leases of land in the balance sheets of the lessees, as such leases are scoped out of Accounting Standard (AS) 19, 'Leases', the Committee notes that the land in question has a lease period of 99 years. Thus, it has a limited useful life for the bank. Accordingly, the upfront amount of Rs. 99 lakh paid by the bank for the same should be amortised over its useful life, i.e., 99 years, on a systematic basis. The Committee also notes that in this case, the life of the leasehold land is predetermined by the lease agreement. Therefore, there is no question of revision of its estimated useful life unless the lease agreement is renewed or the lease terms undergo a change.

10. With respect to the building purchased/constructed by the bank, the Committee is of the view that since it fulfills the definition of the term 'depreciable assets' reproduced above, it is a 'depreciable asset'. In this context, the Committee notes paragraphs 5, 7, 11, 20 and 23 of AS 6 which provide as follows:

> "5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:
>
> (i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
>
> (ii) expected useful life of the depreciable asset; and
>
> (iii) estimated residual value of the depreciable asset."
>
> "7. The useful life of a depreciable asset is shorter than its physical life and is:
>
> (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
>
> (ii) directly governed by extraction or consumption;

(iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and

(iv) reduced by obsolescence arising from such factors as:

(a) technological changes;

(b) improvement in production methods;

(c) change in market demand for the product or service output of the asset; or

(d) legal or other restrictions."

"11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life."

"***20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset."***

"***23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life."***

11. From the above, the Committee is of the view that the rate of depreciation to be applied to a fixed asset would depend on the depreciable amount of the asset and its useful life. With respect to the 'useful life', the Committee notes that paragraph 8 of AS 6 states that determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors, including experience with similar types of assets. Further, from the above reproduced paragraph 23 of AS 6, the Committee is of the view that useful lives of buildings *may be* reviewed periodically. If the

bank does not have a policy to re-estimate the remaining useful lives of buildings periodically, the depreciable amount (as determined in accordance with paragraph 12 below) should be written off over the remaining useful life in accordance with the original estimate. The review of the useful lives should be done for a class of depreciable assets and not for randomly selected assets. In case of building constructed on the leasehold land, the useful life of the building cannot exceed the remaining lease period of land.

12. With respect to the depreciable amount of an asset, the Committee is of the view that ordinarily, the depreciable amount would be the cost thereof less the estimated residual value. In the context of revaluation of buildings by the bank, the Committee notes the following paragraphs of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the ICAI:

> ***"27. When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed."***

> ***"29. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement."***

The Committee further notes paragraph 26 of AS 6, which is reproduced below:

> ***"26. Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out."***

From the above, the Committee is of the view that while revaluing the buildings, paragraphs 27 and 29 of AS 10 as reproduced above should be kept in mind. The depreciable amount after revaluation would be the revalued amount less the estimated residual value of the building.

13. The Committee notes that AS 10 does not apply to assets under leasing rights (paragraph 5). The Committee has not examined the appropriateness of revaluation of leasehold land held by the bank as that issue has not been raised by the querist.

D. Opinion

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

(i) Under the facts described in paragraph 2 above, the rate of depreciation on building should be determined on the basis of the depreciable amount and its remaining useful life. In case the building has been revalued, the depreciable amount would be the value assigned to the building upon revaluation less its estimated residual value, provided revaluation has been done in accordance with AS 10. The useful life should be determined as explained in paragraph 11 above. Freehold land is not a depreciable asset and, therefore, the question of determination of rate of depreciation for such land does not arise (see paragraph 9 above).

(ii) Under the facts described in paragraph 3 above, with respect to determination of rate of depreciation of the building constructed on leasehold land, the principle stated in (i) above would apply. The cost of the leasehold land acquired on lease for 99 years should be amortised over its lease term on a systematic basis (see paragraphs 9 and 13 above).

(iii) The rate of depreciation of a building depends on the depreciable amount of the building and its expected useful life. Depending on the factors mentioned in paragraphs 10 and 11 above, the useful life may vary in case of each building. The depreciable amount may also vary depending on its cost of purchase/construction or its revalued amount, as the case may be, and its estimated residual value. Accordingly, the rate of depreciation may vary for each of the buildings and, therefore, should be determined individually for each property.

Query No. 26

Subject: Classification of 'Tooling' as inventory or fixed asset.[1]

A. Facts of the Case

1. A company is engaged in the business of manufacturing, trading and sale of refractories that are used for manufacture of steel using the continuous casting route. Other industries, like cement, aluminium, etc., also use these refractories in their manufacturing process. There are several types of refractories. The major type of refractories are shapes given by isostatically pressing a mixture of powder raw material bound by resin. These shapes are then fired, cured and finished before packing for despatch.

2. The process for giving shape to refractories entails filling the mix into a set of 'Tooling' which comprise of an outer jacket made by polyurethane and a specially designed steel/aluminium mandrel. In addition to these, there are top and bottom closure for holding the mix. Toolings are used for the manufacture of refractories according to the required specification. Manufacture of toolings requires specialised technology. Since such technology is not available in India, most of such toolings are imported from the group company in UK. In addition, there is a small portion of the tooling which is in the nature of moulds used by the Slide Gate business, Precast shapes and Crucibles. Such moulds are made of iron or wood and they are used either for casting of castables into various shapes or which enables jiggering of mix to form Crucibles. All the items of tooling have limited useful life which is approximately three years from the date they are procured and put into production process.

3. The querist has stated that the query relates to classification of 'tooling' used by the company in its manufacturing process as inventory or fixed assets, consequent to which the classification of charge for its use as tooling charges or depreciation would also get affected.

4. The 'tooling' is shown by the company as 'inventory' *net* of amortisation, in the balance sheet prepared by the company for statutory purposes. The accounting policy followed in respect of tooling by the company is as below:

> "Tooling are amortised on a straight line basis over a period of three years based on their estimated useful lives."

[1] Opinion finalised by the Committee on 15.12.2009

5. According to the querist, the company has taken into account the relevant provisions of Accounting Standards, company law, nature of the product, industry practice, etc., while determining the classification to be done for 'tooling'. The querist has mentioned that paragraph 3.1 of Accounting Standard (AS) 2, 'Valuation of Inventories', defines 'inventories' as follows:

> ***"3.1 <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."***

Further, paragraph 4 of AS 2, inter alia, states, "Inventories also encompass… consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets". The querist has also mentioned that Schedule VI[2] to the Companies Act, 1956, under Part I, 'Form of Balance Sheet', includes 'loose tools' under 'current assets'.

6. According to the querist, toolings are in the nature of loose tools as stated in AS 2 and Schedule VI to the Companies Act, 1956. These are in the nature of consumables which are consumed in the production process, like other consumables, though over a relatively longer period of 3 years and accordingly, amortised over such period. Also, 'toolings' are not in the nature of machinery spares, which are used in connection with an item of fixed asset. Consequently, these are classified by the company as inventories since inception and not as fixed assets.

7. The company's statutory auditors are of the view that such 'tooling' should be considered as fixed assets and depreciated over their useful lives in view of the following:

(i) Toolings are in the nature of moulds that are repeatedly used over their estimated useful lives averaging 36 months for

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

manufacture of refractories as per the required specification. Use of toolings is critical to the production of refractories as per the required specifications. As against this, loose tools will generally comprise of sundry small tools and equipments that are used as aids in the manufacturing process and are consumed over relatively short periods. Consequently, such loose tools are considered as current assets. In this regard, attention has been drawn to Query No.10, published in the Compendium of Opinions – Volume XVIII, issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India.

(ii) Toolings depreciate through repeated use in the manufacturing process and are not consumable in nature.

B. Query

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

(i) Whether the accounting treatment followed by the company consistently over several years would meet the requirements of the Companies (Accounting Standards) Rules, 2006.

(ii) Whether the statutory auditors' contention regarding treatment of the relevant items as fixed assets and charging depreciation thereon is the only correct accounting method to be followed.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to the classification of 'tooling' as inventory or fixed asset. 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, depreciation/ amortisation policy in respect of tooling, etc.

10. The Committee notes the definition of the term 'inventories' as reproduced by the querist in paragraph 5 above. The Committee further notes the definition of the term 'fixed assets' contained in paragraph 6.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', and the definition of the term 'depreciable assets' contained in paragraph 3.2 of Accounting Standard (AS) 6, 'Depreciation Accounting', as notified by the Central Government under the Companies (Accounting Standards) Rules, 2006:

AS 10

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

AS 6

"3.2 Depreciable assets are assets which

- ***(i) are expected to be used during more than one accounting period; and***
- ***(ii) have a limited useful life; and***
- ***(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business."***

11. The Committee notes from the above that the toolings in the present case are being held for their use in the production of refractories and are not held for sale in the normal course of business. These are expected to be used for more than one accounting period and have a limited useful life. Thus, tooling meets the definition of the terms 'fixed asset' and 'depreciable asset'. The Committee is of the view that tooling is not a consumable item, like loose tools, as argued by the querist. Unlike loose tools, the life of 'tooling' is comparatively enduring in nature and is used in manufacturing activities for more than a year. The Committee is of the view that the loose tools or consumables are generally used up/consumed in the process of production whereas toolings, like an item of plant and machinery facilitates the production. Accordingly, in the view of the Committee, it is not appropriate to classify 'toolings' as inventories. These are of the nature of fixed assets on which depreciation should be charged as per the requirements of AS 6 and the Companies Act, 1956. The Committee also notes that although the company in the instant case is classifying 'tooling' as 'inventories', the accounting treatment followed by the company in respect thereof is of the nature of the accounting for a fixed asset as cost of the 'tooling' is being amortised over its expected useful life.

D. Opinion

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

(i) The company's accounting treatment of treating the 'toolings' as inventories is not appropriate and does not meet the requirements of the Companies (Accounting Standards) Rules, 2006.

(ii) The statutory auditors' contention regarding treatment of the 'toolings' as fixed asset and charging depreciation thereon is the correct accounting treatment and that should be followed by the company as discussed in paragraph 11 above.

Query No. 27

Subject: Virtual certainty for the purpose of recognition of deferred tax assets.[1]

A. Facts of the Case

1. A company is a subsidiary of a foreign company, which through its subsidiaries, owns 75% of the company's share capital. The company primarily deals with consumer durables white goods, such as, refrigerators, washing machines, air conditioners, microwave ovens, etc. The company also exports home appliances to various parts of the world.

2. The querist has stated that the company had recognised deferred tax asset in the year 2001 as per the requirements of Accounting Standard (AS) 22 , 'Accounting for Taxes on Income', which became mandatorily applicable to the company in that year. Since then the company has been reviewing the carrying amount of deferred tax assets based on reversal/occurrence of timing differences over years. The gross deferred tax assets as recognised

[1] Opinion finalised by the Committee on 15.12.2009

by the company primarily represent carried forward losses and unabsorbed depreciation which are available for set off in future years for tax purposes. The querist has provided a summary of profits earned, accumulated balance of profit and loss account, net deferred tax assets in company's books over the past years, etc., as follows:

(Rs. lakh)

Period end	Profit/ (loss) before tax	Book profit/ (loss) before adj. of deferred tax assets	Profit/ (loss) after tax	Taxable Income/ (Loss) as per Income-tax	Carried forward Profit/ (Loss) as per books	Carried forward Profit/ (Loss) as per Income-tax	Unabsorbed depreciation	Net deferred tax assets
December 31, 2002	852.76	1014	864.81		6296			4263.71
March 31, 2004*	(5014.13)	(4980)	(3364.99)	(6336)	3306	(30712)	28395	5879.05
March 31, 2005	(6721.82)	(9939)	(9979.95)	(10831)	(6674)	(41543)	32678	5837.85
March 31, 2006	(5333.07)	(5648)	(3809.71)	(4494)	(10484)	(46037)	35399	7676.51
March 31, 2007	(563.59)	(832)	(531.62)	1304	(10365)	(44733)	35399	7976.47
March 31, 2008	2880.78	2605	3231.71	5998	(7134)	(38735)	35399	8603.01
March 31, 2009	8619.47	8429	7051.70	8304	(82)	(30431)	30227	7325.27
Quarter ended June 30, 2009	7070.30	7005	4622.60	6574	4541	(23857)	23653	4943.28
Quarter ended September 30, 2009	-	3947**	-	4726	5709***	(19131)	18927	3489

* The year-end was shifted to March.

** After considering MAT Surcharge and Cess of Rs. 346 lakh.

*** After appropriation of dividend on preference capital of Rs. 1130 lakh and tax thereon of Rs. 192 lakh.

According to the querist, it is apparent from the above that the company earned profits in the year 2002 and was in losses in the subsequent four years. Due to external market environment, the company suffered losses in the past that resulted into negative accumulated profit and loss balance as shown above. The above mentioned accumulated balance of profit and loss account is after considering the impact of recognition of deferred tax assets on carried forward losses and unabsorbed depreciation.

3. The querist has further stated that the company has recognised the deferred tax assets on the basis of past profitability trends and is confident that subsequent realisation of the deferred tax assets as created is virtually certain in the near future based on existing business model of the company and the same has also been disclosed in detail in the notes to accounts to the financial statements of respective years.

4. According to the querist, the auditors of the company have been, since the year 2004, qualifying their opinion in respect of recognition of deferred tax assets as they are of the opinion that the basis as considered by the company for recognition of deferred tax assets to determine virtual certainty is not in line with the requirements of AS 22 and Accounting Standards Interpretation (ASI) 9[2], 'Virtual certainty supported by convincing evidence', issued by the Institute of Chartered Accountants of India. The querist has reproduced ASI 9 as below:

"ISSUE

1. Paragraph 17 of AS 22 requires that "***Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised".***

2. The issue is what amounts to 'virtual certainty supported by convincing evidence' for the purpose of paragraph 17 of AS 22.

[2] The ASI has been withdrawn by the Council of the Institute of Chartered Accountants of India and the Consensus portion thereof has been added as 'Explanation 1' to the paragraph 17 of AS 22.

CONSENSUS

3. Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans.

4. Virtual certainty is not a matter of perception and it should be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

BASIS FOR CONCLUSIONS

5. In a situation where an enterprise does not have unabsorbed depreciation or carry forward of losses, the degree of certainty required under AS 22 for recognition of deferred tax asset is 'reasonable certainty'. In contrast, as a measure of greater prudence, AS 22 prescribes a much higher level of certainty, i.e., virtual certainty, for recognition of deferred tax asset in a situation where an enterprise has unabsorbed depreciation or carry forward of losses. Therefore, the level of certainty required for recognition of deferred tax asset in a situation where an enterprise has unabsorbed depreciation or carry forward of losses is much more than the situation where the enterprise does not have the same.

6. Projections on the basis of future actions of an enterprise cannot be considered as convincing evidence since the enterprise may change its plans on the basis of subsequent developments."

5. As per the querist, the company has started earning profits from the year 2007 and has been consistently earning profits since last seven quarters.

Moreover, the profit expectation as set out by the company in its annual budgets has also been exceeded/achieved. The querist has provided the details of profits earned and budgeted profits of the company in the said period as follows:

(Rs. lakh)

Quarter ended	Profit before tax	Profit after tax	Budgeted PAT for the period	Deferred taxassets
December 2007	937.10	840.13	790	7,976.47
March 2008	1,048.53	1,654.46	1,078	8,603.01
June 2008	4,540.96	4,457.43	3,354	8,603.01
September 2008	256.54	174.34	(208)	8,603.01
December 2008	770.00	691.16	588	8,603.01
March 2009	3,050.05	1,727.42	1,347	7,325.27
June 2009	7,070.30	4,622.60	4,272	4,943.28

The querist has stated that as evident from the above profit trend, corresponding reversal of deferred tax assets during the above period, and keeping in view future profit projections, the management of the company feels that there is sufficient convincing evidence that recognised deferred tax asset would be realised in future years.

6. The querist has also stated that strict interpretation of ASI 9 suggests that convincing evidence can only be supported by firm sales orders or profits earned in subsequent period, whereas, in case of consumer goods industries, like in the case of the company, the concept of firm sales order does not exist. Thus, in the view of the querist, presence of convincing evidence should be inferred from facts like:

(a) Current product pricing and profitability trends;

(b) Company's market share; and

(c) Growth forecast based on Gross Domestic Product (GDP) estimates.

Moreover, according to the querist, the company's performance over the past years and market share along with industry growth should also be considered. ASI 9 enumerates availability of order books as a convincing evidence to establish virtual certainty. As the order book is available only in certain industries, the intent of ASI 9 would not have been to restrict industries, like consumer goods industries, retail industries, service industries, automobiles and ancilliaries, etc., which are primarily not operating on long order books. Thus, as per the querist, for such industries, factors, as discussed above, should be considered to establish whether convincing evidence exists or not. Availability of an order book is one of the examples and not the sole criterion to be considered as convincing evidence to establish virtual certainty under ASI 9. Paragraph 3 of ASI 9 states that determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case to case basis. The company has shown consistent performance in the last two years as discussed above and this trend should also be considered as a convincing evidence to establish that it is virtually certain that the company will have sufficient future taxable income to realise its deferred tax assets.

7. The querist has stated that the past trend indicates that deferred tax assets as created, will be realised within the next 12-18 months. Accordingly, in the view of the querist, virtual certainty should be based on exploration of the most recent profit trends which have been consistent with a robust growth record and not merely on forecasts of performance, such as, business plans. The querist has also submitted that all the accumulated book losses have already been liquidated and the company has positive carried forward profit in the books of account as on 30th June, 2009.

B. Query

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

(i) Where it appears to be evident that the balance of the already recognised deferred tax assets will get realised in the next 12-18 months and as this period falls within the ambit of short term, whether such realisation can be considered as virtually certain and recognition of deferred tax assets by the company on this basis as justified.

(ii) Whether in the case of the company, the auditor's report needs to be qualified on recognition of deferred tax assets and whether such a qualification is also required to be considered to compute the distributable profits of the company as per section 205 of the Companies Act, 1956. The company has issued 10% cumulative redeemable preference shares in earlier years and dividend payable as on 31st March, 2009 on the same is Rs. 5,700 lakh. Since the company had a distributable profit before considering the impact of the above mentioned qualification till the quarter ended 30th June, 2009, whether the company can declare interim dividend in the year 2009-10 to pay part of accumulated dividend on preference shares.

C. Points considered by the Committee

9. The Committee, while answering the query, has considered only the issues raised in paragraph 8 above and has not examined any other issue that may arise from the Facts of the Case. The issue raised in paragraph 8(ii) above regarding computation of distributable profits and declarlation of interim dividend as per the requirements of the Companies Act, 1956 is a legal interpretation of the Companies Act, 1956, which the Committee is prohibited from answering as per Rule 2 of its Advisory Service Rules. Accordingly, the Committee refrains from answering the same.

10. The Committee notes paragraphs 17 and 18 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', which are reproduced below:

> ***"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.***
>
> 18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

11. The Committee further notes that the consensus portion of ASI 9 issued by the Institute of Chartered Accountants of India reproduced in paragraph 4 above has subsequently been incorporated as 'Explanation 1' to paragraph 17 of AS 22 notified under the Companies (Accounting Standards) Rules, 2006. The Committee notes that it, inter alia, provides that "virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered *certain*" (emphasis supplied by the Committee). The Committee also notes that the 'Basis for Conclusions' contained in ASI 9, makes a distinction between 'reasonable certainty' and 'virtual certainty'. It states that in a situation where unabsorbed depreciation and carried forward losses exist, it is the 'virtual certainty' which is required for recognition of deferred tax asset. The Committee is of the view that factors, such as, company's market share, growth forecast based on GDP system indicating the earning of profit, and the confidence of the company that subsequent realisation of the deferred tax assets is virtually certain in near future, as mentioned by the querist to be convincing evidence, are only factors that may be taken into consideration for future projections. These may, at best, indicate a 'reasonable certainty' of future profitability. However, in the present situation of unabsorbed depreciation or carry forward of losses, as per paragraph 17 of AS 22, the Standard requires 'virtual certainty' supported by 'convincing evidence'. In the view of the Committee, the factors as stated above by the querist, cannot be considered as convincing evidence of virtual certainty as contemplated in the Explanation to paragraph 17 of AS 22 (erstwhile ASI 9).

12. The Committee also notes that in the absence of any confirmed sales orders as on the date of the balance sheet, the company has not forwarded any support in favour of any existing convincing evidence that sufficient future taxable income will be available. The Committee is of the view that in the case of the company, even though it is engaged in the sale of consumer durables, it is possible to have confirmed sales orders on the date of the balance sheet in the form of domestic orders from dealers or export orders. The Committee, however, wishes to point out that deferred tax assets can be created in respect of unabsorbed depreciation and brought forward losses to the extent that future taxable income will be available from future reversal of any deferred tax liabilities recognised at the balance sheet date. To that extent, it would not be necessary to consider virtual certainty supported by convincing evidence.

D. Opinion

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

(i) The company is not justified in recognising deferred tax assets on unabsorbed depreciation and brought forward losses as per tax laws in its accounts merely on the basis of financial future projections and its confidence of availability of taxable income. However, to the extent of the availability of future taxable income, if any, by virtue of the future reversal of any deferred tax liability recognised at the balance sheet date, the deferred tax assets can be recognised. Please refer to paragraphs 11 and 12 above.

(ii) In the case of the company, the auditor's report needs to be qualifed as the company is not justified in recognising deferred tax assets. As stated in paragraph 9 above, the issue relating to computation of distributable profits and declaration of interim dividend as per the requirements of the Companies Act, 1956, is not answered in accordance with Rule 2 of the Advisory Service Rules of the Committee.

Query No. 28

Subject: Accounting for foreign exchange variation prior to commencement of commercial operation.[1]

A. Facts of the Case

1. A company is in the process of setting up a refinery in the State of Madhya Pradesh. The said refinery will have an installed capacity of 6 million metric tonnes per annum (MMTPA).

[1] Opinion finalised by the Committee on 15.12.2009. Subsequent to the issuance of this opinion, Notifications No. G.S.R. 225 (E) dated 31st March, 2009, G.S.R. 913 (E) and G.S.R. 914 (E) dated 29th December, 2011 issued by the Ministry of Corporate Affairs (MCA) came into effect, which may affect the opinion expressed herein.

2. The querist has informed that since the company is yet to commence its commercial operations, no profit and loss account has been prepared by the company and only the necessary details as per Part II of Schedule VI[2] to the Companies Act, 1956 have been disclosed in schedule F to the financial statements as 'pre-operative expenditure pending capitalisation'. The expenditure incurred during the construction period is classified as 'pre-operative expenditure pending capitalisation' and income earned during the construction period has been applied to reduce the capital cost of the project.

3. The company is procuring items relating to plant and machinery for construction of refinery from foreign vendors. The transaction is recorded in 'Systems, Applications & Products' (SAP) on despatch of the material (FOB basis) at the rate prevailing on the transaction date. Subsequently, the payment is settled in foreign currency through bank (letter of credit) which is normally a date later than the transaction date. The difference in foreign exchange variation between the transaction date and the settlement date is presently booked under 'pre-operative expenditure pending capitalisation'.

4. The querist has reproduced paragraph 13 of Accounting Standard (AS) 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', issued by the Institute of Chartered Accountants of India (ICAI), which states that "***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***". As per the querist, since paragraph 15 of AS 11 (revised 2003) deals with 'Net Investment in a Non-integral Foreign Operation', the same is outside the scope of reference of this query. The querist has also reproduced paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which, inter alia, states that "the cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving

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

at the purchase price. ... 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".

B. Query

5. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee regarding accounting treatment of foreign exchange variation as to:

(i) whether the foreign exchange variation is to be accumulated till the commencement of production and then written off to the profit and loss account in terms of AS 11, or,

(ii) whether the foreign exchange variation being directly related to procurement of fixed asset is to be capitalised along with the cost of the same asset in terms of AS 10, or,

(iii) whether the foreign exchange variation is to be treated as indirect expenses relating to project and accumulated as pre-operative expenditure pending capitalisation and allocated over the assets of the refinery.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to accounting for foreign exchange differences arising on settlement of liability for procurement of items of plant and machinery from abroad prior to the commencement of commercial operation. 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, accounting for income and expenditures other than the above-mentioned foreign exchange variation during the construction period before commencement of commercial operation, appropriateness of recording of transactions on despatch of materials, etc. Keeping in view the fact that the querist has referred to AS 11 (revised 2003) and in the absence of any information to the contrary, the Committee presumes that the foreign exchange transactions were entered into after 1.4.2004 by the company, i.e., the date of applicability of AS 11 (revised 2003). It is also presumed that the financial year is the accounting year of the company. It is further presumed that as is the normal practice in case of letters of credit, the period of credit is less than 12 months.

7. The Committee notes paragraph 13 of AS 11 (revised 2003), issued by the Institute of Chartered Accountants of India, reproduced by the querist in paragraph 4 above, which requires that in respect of transactions in foreign currency entered into on or after 1.4.2004, the exchange differences arising on the settlement of monetary items should be recognised as income or as expense in the period in which they arise. The Committee notes that the said Standard was notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, which came into effect in respect of accounting periods commencing on or after 7th December, 2006. The notified AS 11 contains a footnote that 'the accounting treatment of exchange differences contained in this Standard is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956'. In this respect, the Committee notes that the relevant provisions of Schedule VI, as aforesaid, were contained in the second paragraph[3] of 'Instructions in accordance with which assets should be made out' in Part I of Schedule VI to the Companies Act, 1956, which is reproduced below:

> "Where the original cost aforesaid and additions and deductions thereto, relate to any fixed asset which has been acquired from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the assets (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset."

The Committee further notes that the ICAI issued an announcement in November 2003, 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign

[3] The said paragraph of Schedule VI has subsequently been omitted vide Notification No. G.S.R. 226(E) dated 31st March, 2009 issued by the Ministry of Corporate Affairs.

Exchange Rates, vis-à-vis, Schedule VI to the Companies Act, 1956', stating that a company adopting the treatment prescribed in Schedule VI will be considered to be complying with AS 11 for the purposes of section 211 of the Companies Act. This announcement has been withdrawn by the ICAI in view of the above-mentioned footnote to the notified AS 11. Accordingly, the accounting treatment of exchange differences contained in the notified AS 11 (and not the requirements of Schedule VI) are applicable in respect of accounting periods commencing on or after 7th December, 2006.

8. From the above, the Committee is of the view that in respect of the transactions in foreign currencies entered into on or after 1.4.2004, the exchange differences arising on settlement of liabilities (on account of items of plant and machinery procured from abroad),

(i) during the period 1.4.2004 to 31.3.2007 (presuming that financial year is the accounting year), requirements of Schedule VI would be applicable, and

(ii) during the accounting periods commencing on or after 1.4.2007, the requirements of notified AS 11 (i.e., AS 11 (revised 2003)) would be applicable.

Accordingly, in respect of transactions in foreign currencies entered into on or after 1.4.2004, the exchange differences arising during the period 1.4.2004 to 31.3.2007 on settlement of monetary liability (letter of credit) incurred for procurement of items of plant and machinery from abroad should be adjusted to the cost of the related fixed assets. However, in accordance with AS 11 (revised 2003), the foreign exchange differences arising on or after 1.4.2007, should be charged/credited to the profit and loss account in the period in which the same arise. The Committee is of the view that for this purpose profit and loss account will have to be prepared by the company even during the construction phase.

9. The Committee is further of the view that while applying the above accounting treatment, paragraph 4(e) (read with its Explanation) of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006, which states that borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs, needs to be duly considered.

10. With respect to the argument forwarded by the querist with regard to paragraph 9.1 of AS 10, the Committee notes that the Announcement, 'Clarification on Status of Accounting Standards and Guidance Notes', issued by the Institute of Chartered Accountants of India, inter alia, states as below:

> "In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard."

The Committee notes that AS 10 became mandatory in respect of accounting periods commencing on or after 1.4.1991, whereas, AS 11 (revised 2003) became mandatory with effect from 1.4.2004. Keeping in view the above Announcement, the Committee is of the view that the provisions of AS 11 (revised 2003) would prevail over the provisions of AS 10, wherever relevant.

D. Opinion

11. On the basis of the above, in respect of transactions in foreign currencies entered into on or after 1.4.2004, regarding the foreign exchange differences arising on settlement of letter of credit for import of items of plant and machinery, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

(i) The foreign exchange differences should not be accumulated till the commencement of production for writing off to the profit and loss account in terms of AS 11.

(ii) The foreign exchange differences arising

  (a) during the period 1.4.2004 to 31.3.2007 should be adjusted to the cost of the relevant fixed asset, and

  (b) during the accounting periods commencing on or after 1.4.2007, should be charged (/credited, as the case may be,) to the profit and loss account, in the period in which the same arise.

While applying the above accounting treatment, the requirements of paragraph 4(e) (read with its Explanation) of AS 16 should also be taken into consideration.

(iii) The foreign exchange differences should not be treated as indirect expenses relating to project and, therefore, should not be accumulated as pre-operative expenditure pending capitalisation for allocation over the assets of the refinery.

Query No.29

Subject: Treatment of preliminary expenses incurred on incorporation of a company.[1]

A. Facts of the Case

1. A company was incorporated in May 2008 as a wholly owned subsidiary of a Government of India enterprise under the administrative control of the Ministry of Oil and Natural Gas to implement city gas distribution by participating in the bidding process of Petroleum & Natural Gas Regulatory Board (PNGRB) and also to set up CNG stations across the National Highway Corridor. The company got the authorisation from PNGRB in the 1st round of bidding to implement city gas distribution in four cities. The company's shares are not listed on any stock exchange. The authorised and paid up share capital of the company as on 31.03.2009 are Rs. 200 crore and Rs. 5 lakh, respectively. The company is in the implementation stage of the project of city gas distribution and CNG Corridor Project, and had not started its commercial production till 31.03.2009 and as such, its turnover is nil for the said accounting year.

2. The company has spent an amount of Rs. 1.26 crore towards incorporation expenses during the period 27.05.2008 to 31.03.2009. The querist has stated that since the company has not started commercial

[1] Opinion finalised by the Committee on 15.12.2009

production, the 'Statement of Incidental Expenditure During Construction' has been prepared instead of profit and loss account, complying with the specific requirements of Part II of Schedule VI[2] to the Companies Act, 1956, giving suitable disclosure of specific items of expenditure.

3. According to the querist, the amount of Rs. 1.26 crore spent for incorporation of the company (preliminary expenses) was charged to the Statement of Incidental Expenditure During Construction (IEDC) in terms of Accounting Standard (AS) 26, 'Intangible Assets', as these expenditures cannot be treated as intangible assets. The total amount of IEDC consisting of preliminary expenditure and other pre-operative expenses have been allocated to capital work-in-progress (CWIP) on capital outlay basis to be capitalised in future and will become part of fixed assets on capitalisation. As per the querist, this was done in line with the provisions of paragraph 56 of AS 26 and paragraph 9.3 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006, which according to the querist, state that the expenditure incurred on start-up costs including preliminary expenses can also be treated as a component of cost of fixed assets. The querist has also stated that start-up cost includes expenses incurred for formation of company (preliminary expenses) as per paragraph 56 of AS 26.

4. The expenditure other than those expenditure which are of capital nature, are booked by the company under incidental expenditure during construction (IEDC) and shown under CWIP. As per the querist, this IEDC forms part of the project cost and on completion of the project is apportioned to ultimate assets on pro-rata basis in compliance with paragraph 9.2 of AS 10.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment of preliminary expenses adopted by the company is in compliance with the existing Accounting Standards and other generally accepted accounting principles. If not, how the same should be treated in the books of account in the current accounting year.

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

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to accounting treatment of expenses incurred on incorporation of the company. 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, treatment of other pre-operative expenses which are not incurred on incorporation of the company, etc.

7. The Committee notes paragraph 56 of AS 26 which is reproduced 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. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:
>
> (a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);
>
> (b) expenditure on training activities;
>
> (c) expenditure on advertising and promotional activities; and
>
> (d) expenditure on relocating or re-organising part or all of an enterprise."

The Committee notes from the above that the start-up costs referred in AS 26 relates to costs of starting up an activity that may include incorporation expenses incurred in bringing an enterprise into existence as a separate legal entity, as well as expenditures for commencing new operations or launching new products. The Standard lays down a general rule that expenses of such nature should be expensed as no intangible asset or other asset is acquired or created that can be recognised, unless such expenditure is required to be capitalised as a part of the cost of a fixed asset as per AS 10. In this regard, the Committee notes the requirements of AS 10 notified under the Companies (Accounting Standards) Rules, 2006, which are contained in paragraph 9.3 of the Standard. The said paragraph is reproduced below:

> "9.3 The expenditure incurred on *start-up and commissioning of the project*, including the expenditure incurred on test runs and experimental production, is usually capitalis]ed as an indirect element of the construction cost. ..." (Emphasis supplied by the Committee.)

8. From the above, the Committee is of the view that the above reproduced paragraph of AS 10 refers to those start-up costs which are incurred on the start-up and commissioning of a *capital project* before the commencement of commercial production, such as, expenditure on test runs, etc., and not on incorporation of the enterprise. Thus, in the view of the Committee, the start-up costs of the nature of incorporation expenses incurred for bringing the enterprise into existence in its corporate form cannot be said to be attributable to bringing an asset/project into existence. Accordingly, the same cannot be capitalised even as an indirect element of cost of the asset/ project. Thus, in the view of the Committee, the requirements of AS 26 would apply to the expenditure incurred on incorporation of the company and not the requirements of AS 10. Accordingly, in accordance with AS 26, such expenditures should be expensed by way of a charge to the profit and loss account in the period in which these are incurred. 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. Further, since in the year of incurrence, the expenditure on incorporation of the company has been treated incorrectly by the company, the same should be rectified in the current year as a 'prior period item' 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'. The Committee notes that paragraph 15 of AS 5 requires that "***the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived***".

9. The Committee also notes from the Facts of the Case that the querist has also referred paragraph 9.2 of AS 10 for apportionment of the IEDC

comprising incorporation expenses to ultimate assets on pro-rata basis (paragraph 4 above). The Committee is of the view that paragraph 9.2 of AS 10 is applicable only when the expenses are attributable to construction of a project or to the acquisition of a fixed asset or bringing the asset(s) to its(their) working condition. As discussed in paragraph 8 above, the incorporation expenses cannot be said to be related to bringing an asset/ project into existence and accordingly, the said paragraph of AS 10 also does not apply in the present case.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that the accounting treatment of preliminary expenses constituting the expenses incurred on incorporation of the company, as adopted by the company, is not in compliance with the existing Accounting Standards and other generally accepted accounting principles. The same should be expensed by way of a charge to the profit and loss account in the period in which the same is incurred. Since the same has been treated incorrectly by the company in the year of incurrence, it should be rectified in the current year and disclosed appropriately as a prior period item in accordance with AS 5.

Query No. 30

Subject: Applicability of paragraph 4(e) of AS 16 during operations stage of a project in respect of loans transacted prior to April 1, 2004.[1]

A. Facts of the Case

1. A Government of India enterprise incorporated under the Companies Act, 1956, is engaged in the business of transmission of power from the generating units in the central sector to various State Electricity Utilities. To meet its expansion plan, funds are also borrowed in foreign currency from

[1] Opinion finalised by the Committee on 15.12.2009

foreign financial institutions and banks. The company's accounting policy regarding paragraph 4(e) of Accounting Standard (AS) 16, 'Borrowing Costs', is as under:

> "Foreign exchange rate variation (FERV) (unfavourable) on foreign currency borrowing, to the extent it does not exceed the difference between the local currency borrowing cost and foreign currency borrowing cost, is treated as borrowing cost".

2. Every year/quarter, FERV on the foreign currency loans is bifurcated into two parts, first part being the difference between the local currency borrowing cost and foreign currency borrowing cost and the second part being the amount exceeding such difference. The first part is considered as borrowing cost and accounted for as per the provisions of AS 16, i.e., included in the capital cost during construction period and charged to revenue after the project is ready for use. The other part is considered as FERV and is accounted for as per the provisions of Accounting Standard (AS) 11 (1994), 'Accounting for the Effects of Changes in Foreign Exchange Rates' or Accounting Standard (AS) 11 (2003), 'The Effect of Changes in Foreign Exchange Rates', depending upon the loan agreement date.

3. The querist has stated that the above accounting policy and practice has been followed after obtaining various opinions and clarifications from Expert Advisory Committee and Accounting Standards Board of the Institute of Chartered Accountants of India.

4. During the supplementary audit of accounts for the financial year 2008-09, the government auditors issued a 'half margin' stating that "the above accounting policy of the company is not in accordance with Accounting Standard issued by ICAI as paragraph 4(e) of AS 16 is applicable during construction stage only and not during operation stage". This 'half margin' was in respect of loans contracted prior to April 1, 2004. The complete half margin and the reply given by the management of the company is given in Annexure I.

5. On this matter, additional sub-direction was issued to the statutory auditors asking for comment on "whether accounting of Foreign Exchange Rate Variation (FERV) in respect of foreign currency loans contracted prior to April 1, 2004 is in line with AS 16, as paragraph 4(e) of the said Standard is applicable during construction stage only". The auditors' reply is given in Annexure II.

6. The querist has stated that the contention of the government auditors, as revealed during the discussions, is that in the case of loans transacted prior to April 1, 2004, in respect of which AS 11 (1994) is applicable, there appears to be a contradiction in the sense that during operation period the entire FERV gain shall be adjusted to the carrying cost (capital cost of related fixed assets), whereas, a part of FERV loss (considered as borrowing cost in view of paragraph 4(e) of AS 16) shall be taken to the profit and loss account as borrowing cost. The querist has stated that the view of the Accounting Standards Board of the ICAI on this matter is that "though AS 11 (1994) did not specifically exclude foreign exchange differences covered by paragraph 4(e) of AS 16 from its scope, pursuant to the issuance of AS 16 in 2000, such foreign exchange difference automatically gets covered in AS 16 instead of AS 11 (1994), since from that date, such foreign exchange differences are considered as borrowing costs and not foreign exchange difference." The querist has stated that as per the government auditors, the above contradiction is not there in the case of loans transacted on or after April 1, 2004 in respect of which AS 11 (2003) is applicable. In respect of such transactions, during operation period, the entire FERV loss (whether considered as borrowing cost or otherwise) as well as the FERV gain shall be charged to revenue. According to the government auditors, the contradiction in respect of loan contracted prior to April 1, 2004, can be removed if the methodology suggested by them is followed, i.e., paragraph 4(e) of AS 16 is applied during construction stage only and not during operation stage. By this method, the entire amount of FERV loss or gain shall be adjusted in the carrying cost during operations stage of the project in case of loans transacted prior to 01/04/2004. Similarly, in case of loans transacted after 01/04/2004, the entire amount of FERV loss or gain shall be taken to revenue.

7. The querist has stated the 'half margin' was dropped on the company's assurance that the matter will be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India.

B. Query

8. The querist has requested the Expert Advisory Committee to examine the above mentioned accounting policy and the accounting treatment and give its opinion on whether or not paragraph 4(e) of AS 16 is applicable during the operations stage of a project.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to the applicability of paragraph 4(e) of AS 16 during operations stage of a project in respect of foreign currency loans transacted prior to April 1, 2004. Therefore, the Committee has considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, treatment of FERV gain, treatment of FERV loss on loans transacted after April 1, 2004, applicability of paragraph 4(e) of AS 16 to foreign currency loans transacted after April 1, 2004, etc.

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

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

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

> "Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates (revised 2003), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1–4–2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable."

From the above, the Committee is of the view that in respect of foreign exchange differences arising on loans transacted prior to April 1, 2004, the provisions of AS 11 (1994) will be applicable.

11. The Committee notes that AS 16 came into effect in respect of accounting periods commencing on or after April 1, 2000, i.e., after the date

AS 11 (1994) became applicable, i.e., April 1, 1995. The Committee also notes that the 'Clarification on Status of Accounting Standards and Guidance Notes' issued by the Council of the ICAI states, inter alia, as below:

> "In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard."

Thus, in the view of the Committee, requirements of AS 16 would supersede the requirements of AS 11 (1994) wherever applicable.

12. The Committee notes that paragraph 4(e) of AS 16 provides that borrowing costs include "exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs". The said paragraph applies to those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowing costs to be accounted for under this Standard and the remaining exchange difference (arising on loans transacted prior to April 1, 2004), if any, is accounted for under AS 11 (1994) irrespective of the stage of completion of the relevant assets. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

13. With respect to the treatment of borrowing costs, the Committee notes that paragraph 6 of AS 16 provides as below:

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

The Committee notes that the requirements with respect to cessation of capitalisation of borrowing costs are contained in paragraph 19 of AS 16, which provides as under:

> "19. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete."

14. From the above, the Committee is of the view that in respect of a project, capitalisation of borrowing costs should cease in respect of various qualifying assets under that project when substantially all the activities necessary to prepare the respective qualifying assets for their intended use are complete. Accordingly, the Committee is of the view that borrowing costs, covered under paragraph 4(e) of AS 16, cannot be capitalised after the commencement of operations.

D. Opinion

15. On the basis of the above, in respect of the issue raised by the querist regarding FERV arising on foreign currency loans transacted prior to April 1, 2004 after the commencement of commercial operations, the Committee is of the opinion that the FERV loss to the extent covered under paragraph 4(e) of AS 16 should be treated as borrowing cost which should be expensed in the period in which the same is incurred.

Annexure-I

Replies to Government Audit Observations on the Annual Accounts for the year 2008-09 :

Government Audit Observation	Management's Reply
H.M. No. 2 **Profit & Loss Account** **Interest & Finance charges (Schedule 25): Rs. 2532.09 crore**	
Above includes Rs. 390.29 crore being the amount of Foreign Exchange Rate Variation (FERV) on the foreign loan limited to domestic borrowing cost. As per Accounting Standard No. 11 (revised 1994) issued by the Institute of Chartered Accountants of India (ICAI), FERV on the foreign loans should be adjusted in the carrying cost of the assets. However, as per Accounting Policy No. 8.3 of the Company, FERV (Unfavorable), on foreign currency borrowings, to the extent it does not exceed the difference between the local currency borrowing cost and foreign currency borrowing cost, is treated as borrowing cost as per clause 4(e) of the Accounting Standard No.16. Accordingly, the Company has treated an amount of Rs. 390.29 crore as borrowing cost in respect of loans contracted prior to April 1, 2004. The above Accounting Policy of the Company is not in accordance with Accounting Standard issued by ICAI as clause 4(e) of the Accounting	As per Accounting Standard No. 11 (revised 1994) issued by the Institute of Chartered Accountants of India (ICAI), FERV on the foreign loans should be adjusted in the carrying cost of the assets. However, clause 4 (e) of AS-16 provides that "borrowing cost may include……' exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs clause 4 (e) '. This implies that part of FERV, to the extent defined under clause 4 (e) of AS-16, shall be considered as borrowing cost (to be accounted for as per AS-16) and not FERV (to be accounted for as per AS-11). Accounting Standard Board vide its letter dated 4th April, 2005 has further clarified that paragraph 4 (e) of AS-16 shall be applicable for AS-11 (1994) also. The relevant extracts of the letter is reproduced below:- " The Board was of the view that though AS 11 (1994) did not

Standard No.16 is applicable during construction stage only and not during operation stage. This has resulted in overstatement of Interest & Finance charges and understatement of profit for the year by Rs.390.29 crore. Fixed assets are also understated to that extent.	specifically exclude foreign exchange differences covered by paragraph 4 (e) of AS 16 from its scope; pursuant to the issuance of AS 16 in 2000, such foreign exchange difference automatically gets covered in AS 16 instead of AS 11 (1994), since from that date, such foreign exchange differences are considered as borrowing costs and not foreign exchange difference." Once a part of FERV (to the extent defined under clause 4 (e) of AS-16) is included under borrowing cost, it is to be accounted for as per the provisions of AS-16. AS-16 as well as ASI-10 (interpretation for clause 4 (e) of AS-16) do not anywhere state that **clause 4 (e) as well as the whole of AS 16 are applicable only during construction stage and not during operation stage.** Therefore, the Accounting Policy No. 8.3 of the Company is in accordance with the provisions of relevant Accounting Standards. Therefore, Audit is requested to drop the Half Margin.

Annexure-II

Reply of the Statutory Auditor

The provisions of AS 11 (revised 1994) 'Accounting for the Effects of Changes in Foreign Exchange Rates' shall be applied in accounting for transactions in foreign currency.

The said Accounting Standard specifies about

- Recording of transactions on initial recognition
- Reporting effects of changes in exchange rates subsequent to initial recognition
- Recognition of exchange differences with respect to transactions entered in foreign currency on or after 1-4-1995 to 31-03-2004.

Under the said provisions of AS 11 (revised 1994), exchange differences arising on repayment of liabilities which were incurred for acquisition of fixed assets shall be adjusted to the carrying cost of the assets incurred for the purpose of accounting for fixed assets.

Accounting Standard (AS) 16 'Borrowing Costs' came into effect for accounting periods commencing on or after 01-04-2000. As per the said standard '**Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds**'.

As per Para 4(e) **Borrowing Costs includes** 'exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.'

Subsequently, ASI 10 interpreted paragraph 4(e) of AS 16 in November 2003. Based on the said ASI 10 the FERV (unfavourable) on foreign currency (FC) borrowings, to the extent it does not exceed the difference between the local currency borrowing cost and foreign currency borrowing cost is treated as borrowing cost by the company vide Accounting policy 8.3.

Nowhere in AS 16, it is mentioned that the provisions are not applicable to operations stage.

As per the generally accepted accounting principles, the borrowing cost on the loans (be it INR loan or FC Loans) during operations stage is charged to the P&L Account. Therefore the company has rightly accounted for the borrowing costs (including the component of 4(e) of AS 16).

Further the Accounting Standards Board vide their letter dated 4th April 2005 on the subject matter clarified the position beyond doubt and the relevant portion of the said letter is as under:

"The Board was of the view that though AS 11 (1994) did not specifically exclude foreign exchange differences covered by paragraph 4 (e) of AS 16 from its scope; pursuant to the issuance of AS 16 in 2000, such foreign exchange difference automatically gets covered in AS 16 instead of AS 11 (1994), since from that date, such foreign exchange differences are considered as borrowing costs and not foreign exchange difference." We are also informed by the company that they are referring this matter to the Institute of Chartered Accountants of India for their Expert opinion.

The company's accounting policies on foreign currency transaction including Accounting policy No. 8.3 in our opinion, are in tune with AS 11 (Revised 1994), AS 16 read with ASI 10; AS 11 (revised 2003) and the clarifications issued by the EAC of ICAI from time to time

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Query No. 31

Subject: Disclosure in the cash flow statement of borrowings and loan disbursements and related repayments in case of a financial institution.[1]

A. Facts of the Case

1. A Government of India undertaking, incorporated under the Companies Act, 1956 in the year 1987, is a dedicated financial institution engaged in the financing of power sector in India. The company is also notified as a public financial institution under section 4A of the Companies Act, 1956.

[1] Opinion finalised by the Committee on 15.12.2009

The company is mainly engaged in providing loans and other non-fund based products to various power utilities.

2. The company prepares its cash flow statement using the indirect method as per Accounting Standard (AS) 3, 'Cash Flow Statements'. While preparing the draft financial statements for the financial year 2008-09, according to the querist, the company being a financial institution, disclosed the net cash outflows/inflows from loan disbursements made to/principal repayments received from the borrowers under the head 'cash flows from financing activities' in the cash flow statement prepared in accordance with the indirect method as per AS 3. The company also disclosed the net cash inflows/ outflows from loans borrowed from/principal repayments made to lenders under the head 'cash flows from financing activities'.

3. The government auditors during the audit of the draft financial statements observed that the "amount of Rs. XXXX crore on account of loans disbursed (net) shown under 'cash flow from financing activities' should be shown under 'cash flow from operating activities' in terms of paragraph 14 of AS 3". Reference was also made to paragraph 14 of AS 3 which provides that "an enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise".

4. The querist has stated that AS 3 defines operating activities as "***the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities".*** The querist has also stated that paragraph 12 of AS 3 further explains that cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. According to the querist, for a financial institution, main revenues are generated from interest on the loans advanced, unlike manufacturing companies, which generate revenues from sale of goods. Also, paragraph 20 of AS 3 provides as under:

> "20. Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

(c) all other items for which the cash effects are investing or financing cash flows.

…"

Therefore, according to the querist, for a financial institution, since the operating revenues (i.e., interest on loans, etc.) are generated from the loans disbursed, the loan disbursements made/repayments received from the borrowers should be classified as cash flows from the operating activities.

5. The querist has also mentioned that AS 3 defines financing activities as ***"activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise",*** which generally arise from the issue of shares, bonds, debentures and such type of instruments. Since the borrowings of a company, i.e., bonds and loans raised are to be classified as financing activities as stated in AS 3, it is not prudent to classify the loan disbursements to / repayments received from borrowers under the operating activities since both are interdependent in nature for a financial company. Further, as per the querist, if loan disbursements to /repayments received from borrowers are classified under the cash flows from operating activities, and the borrowings of a company are classified as financing activities, the net operating cash flows will show huge negative cash flows which imply that the operational performance/capability of the company is very weak as is also described in paragraph 11 of AS 3, which, inter alia, states that "the amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing" and similarly, net cash flows from the financing activities will show huge excessive cash inflows year on year. Therefore, in the view of the querist, loan disbursements to / repayments received from borrowers should ideally be shown under the financing activities along with the borrowings of a company, i.e., bonds and loans raised.

6. The querist has expressed his view that the classification of the loan disbursements to/repayments received from borrowers under the head 'cash flows from operating activities' resulting in huge negative net operating cash flows will

- not present a true and fair view of the financial statements thereby contradicting the fundamental qualitative characteristics of financial statements, namely, understandability and relevance, and
- indicate that a cash rich company having a net worth of around Rs. 10, 800 crore has not generated sufficient cash flows to maintain the operating capability, pay dividends, repay loans and make new investments without recourse to external sources of financing.

7. The querist has also stated that the industry practice is also such that even some of the leading financial institutions are classifying increase/ decrease in both the loan assets (disbursed to borrowers) and loan liabilities (borrowings of a company) under the head 'cash flows from financing activities'.

B. Query

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

(i) Whether it is correct to classify the amounts of loans disbursed to and the repayments received from the borrowers under the head 'cash flows from operating activities', and the amounts of loans raised from and the repayments made to the lenders under the head 'cash flows from financing activities', as per the indirect method of preparation of cash flow statement as per AS 3.

(ii) If not, what is the correct method of disclosure of the amounts of loans disbursed to and the repayments received from the borrowers, and the loans raised from and the repayments made to the lenders, as per the indirect method of preparation of cash flow statement as per AS 3.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to the disclosure of loan disbursements to and repayments received from the borrowers and that of loans raised from and repayments made to the lenders by the company (a financial institution) in the cash flow statement. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, classification and disclosure of interest paid on the loans raised by the company, etc.

10. As far as disclosure of cash flows arising from loan disbursements to and repayments from the borrowers is concerned, the Committee notes the definition of 'operating activities' (reproduced in paragraph 4 above) and paragraph 14 of AS 3 (reproduced in paragraph 3 above). The Committee notes that the Standard explicitly states that cash flows arising from loans advanced by a financial enterprise should be classified as operating activity as these relate to main revenue-producing activities of the enterprise. As far as classification of these activities under 'financing activities', as being argued by the querist, is concerned, the Committee notes the definition of 'financing activities' (reproduced in paragraph 5 above) and paragraph 17 of AS 3 which provides as follows:

> "17. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:
>
> (a) cash proceeds from issuing shares or other similar instruments;
>
> (b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
>
> (c) cash repayments of amounts borrowed."

From the above, the Committee is of the view that the basic objective of the financing activities is to finance the business of the enterprise irrespective of its nature of operations. An activity could be classified as financing activity only if it meets this definition. Since the loans disbursed and the repayments received do not result in changes in the size and composition of the owners' capital and borrowings of the company, these cannot, in any case, be classified as financing activities.

11. With respect to the disclosure of cash flows arising from loans raised and repayments made to the lenders by the company (a financial institution) in the cash flow statement, the Committee notes the definition of 'financing activity' and paragraph 17 of AS 3 (reproduced in paragraph 10 above). From the above, the Committee is of the view that the cash flows from loans raised and bonds issued and cash repayments of the amounts borrowed in case of all enterprises (financial or non-financial) have to be classified under 'financing activities' as the definition of 'financing activities' as per AS 3 does not make any distinction between financial and non-financial enterprises or between the funds raised for operating activities or investing activities. Accordingly, in case of a financial enterprise, even though the 'loans raised and repayments made' and 'loan disbursements and repayments received' are interdependent, the former cannot also be classified as 'operating activity' for the purposes of AS 3.

D. Opinion

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

(i) Yes, it is correct to classify the amounts of loans raised from and the repayments made to the lenders under the head 'cash flows from financing activities' and the amounts of loans disbursed to and the repayments received from the borrowers under the head 'cash flows from operating activities', as per the indirect method of preparation of cash flow statement as per AS 3. For the purpose of the preparation of cash flow statement, the aforesaid amounts would be arrived as increase/decrease in the borrowings and loans & advances outstanding in the two balance sheets relevant for the Cash Flow Statement.

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

Query No. 32

Subject: Provision for disputed interest liability on term loan. [1]

A. Facts of the Case

1. An unlimited liability company 'D' was promoted by entities 'E', 'G' and 'B' along with 'X' State Power Development Corporation Limited in early 1990s to set up an integrated power plant in two phases (Phase I : Block 1; and Phase II : Blocks 2 & 3 along with an integrated 5 MMTPA Liquified Natural Gas (LNG) terminal in the State. The project was planned based on Reliquified Natural Gas (RLNG) as primary fuel and Naphtha / HSD as secondary fuel. Phase I of the project commenced operations on Naphtha in May 1999 and thereafter the operations were suspended in May 2001 due to disputes between company 'D' and 'X State Electricity Board' (XSEB) arising out of

(a) operational compliances,

(b) lesser build-up in power demand and resulting default by XSEB in power purchase, and

(c) higher fuel cost as well as higher fixed cost.

2. This dispute led to stoppage of operation of Phase I of the plant and suspension of erection and commissioning activities of Phase II. In respect of Phase II of the project, Block 2 was under commissioning stage and few erection works and commissioning of Block 3 were pending. Substantial work was also pending at the LNG Receiving Terminal and marine facilities when all the construction activities of the project were stalled in May 2001.

3. The querist has stated that the Government of India (Union Cabinet), in its meeting held on 2nd November, 2004, constituted an Empowered Group of Ministers (EGoM) to revive the project while addressing all issues pertaining to company 'D'. To finalise a viable restructuring plan for the project, EGoM proposed the following:

- Indian Financial Institutions (IFIs) to negotiate and buy-out debt of offshore stakeholders, i.e., foreign banks, Overseas Private Investment Corporation (OPIC) and Export Credit Agencies (ECAs).

[1] Opinion finalised by the Committee on 22.1.2010

- Government guaranteed bonds to be issued by a Financial Special Purpose Vehicle (FSPV) to be promoted by IFIs for the purpose of buying out the above-mentioned debts.

- Negotiations and settlements to buy-out non-debt claims and equity of entities 'G', 'B' and overseas private investment corporation by the IFIs.

- Project assets of company 'D' proposed to be transferred to a new Project SPV (PSPV) on sale/ auction basis through Debt Recovery Tribunal (DRT) process. The Project SPV would be capitalised by way of equity / advance bid-security from two companies, A and B. In addition, Indian lenders would also infuse fresh equity which would enable settlement of non-debt claims and help restart/ complete the project. Promoted by the two companies A and B, company 'R' was incorporated on 8th July, 2005 to undertake the construction and completion of the project and to manage the project facilities. Following the out of court settlement between company 'D' and XSEB, the assets of company 'D' were transferred to company 'R' at a price of Rs. 8,485 crore in October 2005 through the Debt Recovery Tribunal (DRT) process on sale basis.

- PSPV to undertake construction and completion of the project and operate and manage the project facilities.

- XSEB to offtake power from the project on a long-term take-or-pay basis at a plant load factor (PLF) of 80%.

- Indian lenders' debt to be assumed by the Project SPV on restructured terms.

4. Based on the scheme, as mentioned above, the dispute between company 'D' and XSEB was resolved following an out of court settlement, and 'consent terms' in this regard were filed in the Supreme Court on putting a stop to all legal proceedings in India and abroad in respect of this dispute.

5. The Board of company 'R' approved on 15th September, 2005, an investment of Rs. 10,038 crore for acquiring the existing assets of the project at Rs. 8,485 crore and additional investment of Rs. 1,553 crore for completion of balance works, for project revival, including interest during construction (IDC) of Rs. 683 crore. Company 'R' also executed the Common Term Loan

Agreement (CTLA) with the existing lenders on 28.09.2005 for Rs. 7,011.85 crore. The details of the project cost and its financing are stated by the querist to be as follows:

Components of Project Cost	**Amount in Rs. crore**
Consideration amount paid to IFIs for assets of company 'D' acquired by company 'R' (paid from equity of Rs. 1,424 crore*+ Term loan of Rs. 7,011 crore of IFIs) [*Seems to be Rs. 1,474 crore]	8,485
Cost of revival of the project assessed by the lenders to be funded through fresh loan	870
IDC on the term loan of Rs. 7011 crore of lenders	175
Additional IDC on the said term loan to be adjusted against increase in cost up to the commercial operation date as per Clause 1 (g) of CTLA	466
Interest on the fresh loan of Rs. 870 crore	42
Total	**10,038**

Project Cost Financed as follows :

	Rs. crore
Equity	
A	500
B	500
IFIs	500
(Less cash in hand)	(-) 26
Debt	
Existing IFI Loan	7,011
Additional Loan for revival	870
Interest During Construction (IDC) on existing loans till Commercial Operation Date (COD) as per CTLA	175
Additional IDC on existing loans	466
IDC on fresh loans	42
Total	**10,038**

6. To assess the revival cost of the project, 'T' was hired as consultant by lenders. Based on T's assessment, at the point of execution of the CTLA, the total cost of revival was estimated at Rs. 870 crore, which consisted of Rs. 214 crore for power block and Rs. 656 crore for LNG block. T's estimates, as per the querist, were based on walk-down visual survey and not on detailed inspection.

7. R-LNG was expected to be made available from June 2006 and all the power blocks were expected to be operational by November 2006. At the time of execution of CTLA itself, there was a dispute on revival cost as assessed by lenders' consultants and as assessed by companies A and B (promoters). As against the lenders' consultants estimated cost of revival Rs. 870 crore, companies A and B were of the view that revival cost of the project would be around Rs. 2,000 crore. Due to this, some clauses were added in the agreement to cap the revival cost at Rs. 870 crore and any increase in the said revival cost was to be adjusted from additional IDC.

8. The relevant provisions of the CTLA relating to IDC, additional IDC, COD and completion cost are given hereunder:

- Clause 1(A)(c) – *Additional IDC* means the interest, until the Block Commercial Operation Date of third block of the power plant, in addition to the IDC.

- Clause 1(A)(g) - *Block Commercial Operation Date* shall mean

  (i) in relation to the first block of the power plant, 1st September, 2006,

  (ii) in relation to the second block of the power plant, 1st October, 2006; and

  (iii) in relation to the third block of the power plant, 1st November, 2006

  or such other later date in relation to (i), (ii) or (iii) as may be determined by mutual agreement between the borrower and the lenders.

- Clause 1(A)(m) – *Commercial Operation Date* shall mean the Block Commercial Operation Date for the third block of the power plant as declared by the borrower after demonstrating the

Maximum Continuous Rating or Installed Capacity (each as defined or construed in accordance with the PPA) through a successful trial run after notice to the Offtaker, in relation to the third block of the power plant.

- Clause 1(A)(o) – *Completion Cost* means the aggregate of amounts payable (excluding any Interest During Construction) by the borrower for the completion of the Project.
- Clause 1(A)(s) *Construction Period* means the time period commencing from the date of first disbursement till the Commercial Operation Date.
- Clause 1(A)(jj) – *IDC* means the interest until the Block Commercial Operation Date of the third block of the power plant aggregating to amounts not less than Rs.175 crore collectively for all the lenders and individually with respect to each lender (detail provided).
- Clause 1(A)(ll) – *Interest During Construction* means the aggregate of the following incurred during the construction period:

  (i) IDC;

  (ii) Additional IDC; and

  (iii) Fees, interest, costs and commissions payable by the borrower to its financiers or its credit enhancers in relation with the finance availed by the borrower.
- Clause 1(A)(iii) *Project* means the development, construction, commissioning, operation and maintenance of 2150 MW (net capacity) gas based power plant and a 5.0 million tones per annum (MTPA) LNG Terminal at Guhaghar, Ratnagiri district in the State.
- Clause 1(A)(jjj) *Project Cost* means the amounts expended for the acquisition, construction and completion of the Project (including interest during construction) to the extent of Rs. 10,038 crore.
- Clause 6(a) provides – Save and except as mentioned below, interest at the Interest Rate shall be payable on the Loans:

IDC shall be payable by the borrower to the lenders on the Interest Payment Dates. Without prejudice to the foregoing, on the Interest Payment Date immediately following the Commercial Operation Date, Additional IDC, if any, shall be payable by the borrower to the lenders (other than one of the lenders), which amounts shall be determined as follows:

if the Completion Cost is Rs. 870 crore, the additional IDC shall be Rs. 466 crore; and if the Completion Cost increases from Rs. 870 crore, the amounts constituting the Additional IDC payable by the borrower shall be decreased by such increase in amount.

The querist has stated that *the amount of additional IDC of Rs. 466 crore mentioned in the agreement has been calculated on the assumption of commercial operation dates as per clause 1(A)(g) of the agreement, as quoted above. As commercial operation dates of all the blocks have changed, the calculation of additional IDC needs to be revised on the basis of actual commercial operation dates.* (Emphasis supplied by the querist.)

- Clause 6(b) provides – The Loans shall carry the following rate of interest **("Interest Rate")**:

  (i) On and from the date falling (i) eleven (11) calendar months; (ii) twelve (12) calendar months; and (iii) thirteen (13) calendar months respectively, from (A) the date of first disbursement of Loan or (B) upon the Borrower receiving possession of the Project Assets as per the Consent Terms, whichever is later, notwithstanding anything, the Block Proportionate Loans (other than the Loan from one of the lenders) relevant to each block of the power plant shall carry a rate of interest of 9% p.a. with monthly rests.

  (ii) The Part A Loan from one of the lenders shall carry a rate of interest of 8.5% p.a. with monthly rest.

  (iii) The Part B Loan from one of the lenders shall carry a rate of interest of 9.76% p.a. payable annually.

- Clause 7 provides –

  (i) The borrower shall pay to each lender, interest on the Loan of that lender for the Interest Period at the Interest Rate plus interest tax and other statutory levies as applicable from the date of disbursement of each tranche of such Loan. The borrower shall pay the lenders, accrued (and theretofore unpaid) interest on the loan on the Interest Payment Dates. The first Interest Payment Date in relation to the Part B Loan from one of the lenders shall be April 1, 2008.

  (ii) All interest payable pursuant to this Agreement shall accrue from day to day and shall be calculated on the basis of a year of 365 days.

  (iii) The borrower acknowledges that the Facility provided under this Agreement is for a commercial transaction and waives any defenses available under usury or other laws relating to the charging of interest and other monies payable hereunder.

- Clause 23 of CTLA states –

  (i) As a result of increase in Completion Cost, if the Project Cost exceeds Rs. 10,038 crore, the lenders shall take suitable financial structuring to ensure that Project Cost does not exceed Rs. 10,038 crore.

  (ii) In case the Completion Cost increases by more than 10% of Rs. 870 crore, it is agreed between the parties that Central Electricity Authority (for the power plant) and the Lenders LNG Engineer (for the LNG facilities) shall be engaged for reviewing the cost for completion. The borrower shall accept the recommendations, if any, pursuant to such review, made by the Central Electricity Authority (for the power plant) and the Lenders LNG Engineer (for the LNG facilities). The Lenders LNG Engineer and the Central Electricity Authority shall be appointed at the expense of the borrower for the aforesaid purpose.

- Clause 28(ii) of the CTLA states – Each lender shall have the right to set off against amounts payable by the borrower to the Secured Parties under the Financing Documents.

9. As stated in paragraph 5 above, the interest during construction was provided in the CTLA, as follows:

	Rs. crore
Interest during construction (IDC) on existing loans till Commercial Operation Date (COD) as per CTLA	175
Additional IDC on existing loans	466
IDC on fresh loans	42
Total	**683**

10. As per present assessment, the revival cost of the project has been estimated at Rs. 2,364 crore instead of Rs. 870 crore assumed in the CTLA. Commercial operation dates (CODs) of power blocks have also been revised as follows :

	As per CTLA	**Revised as**
First Power Block	1st Sept., 2006	1st Sept., 2007
Second Power Block	1st Oct., 2006	21st Nov., 2007
Third Power Block	1st Nov., 2006	yet to be declared

11. As per clause 1(A)(c) of the CTLA, Additional IDC means the interest, until the Block Commercial Operation Date of the third block of power plant, in addition to the IDC. Further, clause 6(a) of CTLA, inter alia, provides that "if the Completion Cost is Rs. 870 crore the additional IDC shall be Rs. 466 crore; and if the Completion Cost increases from Rs. 870 crore, the amounts constituting the Additional IDC payable by the Borrower shall be decreased by such increase in amount." The querist has stated that *the amount of additional IDC of Rs. 466 crore mentioned in CTLA has been calculated on the assumption of commercial operation dates of September, October and November 2006. The CTLA provides that actual commercial operation date would be mutually agreed by lenders and borrower. As commercial operation dates of all the blocks have changed, the calculation of additional IDC needs to be revised on the basis of actual commercial operation dates.*

(Emphasis supplied by the querist.) As per the above clause, increase in completion cost has to be adjusted from additional IDC in terms of CTLA. Additional IDC has to be revised in view of revised commercial operation dates.

12. As mentioned in paragraph 3 above, EGoM is reviewing the revival of the project. In terms of clause 23 of CTLA, as stated above, it is provided that as a result of increase in completion cost, if the project cost exceeds Rs. 10,038 crore, the lenders shall take suitable financial structuring to ensure that project cost does not exceed Rs. 10,038 crore. This matter has also been deliberated in EGoM and other meetings at various levels in the Government wherein representatives of promoters and lenders participated.

13. According to the querist, in view of the increase in the revival cost and change in commercial operation dates, the lenders are required to revise the amount of additional IDC and complete the suitable financial structuring to ensure that project cost does not exceed Rs. 10,038 crore as per CTLA. Company 'R' is of the view that in terms of the CTLA, increase in revival cost is to be reduced from revised additional IDC as per CTLA. As the increase in revival cost is more than the additional IDC, no additional amount of IDC is payable to the lenders. Thus, it is observed by the querist, that till the above activity and financial restructuring is complete, IDC beyond Rs. 175 crore is not due and thus, not provided for in the books of account.

14. Lenders are, however, of the view that the rate of interest applicable to the loans and the manner in which it would accrue and be payable, during the originally envisaged implementation period and thereafter, is firmly set out in clauses 6(a), 6(b)(i) and 7 of the CTLA, and that company 'R' needs to provide for interest on the loans, post the originally envisaged commercial operation dates, in its books of account, on the basis of the contractual arrangement prevailing at this juncture between the company and the lenders. Lenders are of the view that unless the interest liability, which is known, firm and can be quantified, is provided for in the books of account, the financial statements of the company would not be deemed to present a true and fair view of the state of affairs of the company, as per the provisions of the Companies Act, 1956 and the relevant Accounting Standards. It has been further observed by the lenders that various options for restructuring to maintain long-term viability of the project are being discussed under the aegis of the Government of India and a final view is yet to emerge in the

matter and not_charging interest on the loans, post the originally envisaged commercial operation date, is not an option that is under consideration/ discussion. Hence, not providing for interest in the books of account on the assumption that loan/interest would be waived is neither correct nor appropriate.

15. As per the querist, the same view, as mentioned in paragraph 14 above, was taken by the lenders at the time of finalisation of annual accounts of the company for the year ended 31st March, 2007. During the course of review of the annual accounts by the C&AG, on a reference from C&AG, lenders' views were informed vide letter dated 4th February, 2008. As required by C&AG vide its letter dated 6th February, 2008, company 'R' submitted its reply vide letter dated 8th February, 2008 to the C&AG, reiterating that, in terms of the applicable Accounting Standards, the company has not provided any interest liability beyond the originally envisaged commercial operation date of 30th September, 2006, till the matter of financial restructuring is under consideration of the Government of India. This was accepted by the C&AG.

16. Thus, company 'R' is of the view that the annual accounts of the company have been drawn up in accordance with the provisions of the Companies Act, 1956 and the applicable Accounting Standards. The annual accounts of company 'R' for the year ended 31st March, 2007 were duly audited by a firm of Chartered Accountants appointed by the C&AG, and the same position was also accepted by the C&AG during the course of review of the annual accounts for the same period. There is no change in the position in respect of drawl of annual accounts for the year ended 31st March, 2008. It may be pertinent to mention that necessary disclosure in the annual accounts in the notes to accounts has been made, as stated below :

> Note No. 1 : The company took over the project of erstwhile …(name of company 'D') as per the decree of the Court. Pending completion of revival works of Power Blocks and LNG facilities as a whole, provisional completion cost of the project as approved by Empowered Group of Ministers (EGoM)/ Government of India (GoI) was Rs. 100,380 million + Rs. 2,650 million on account of XSEB's equity for consideration other than cash. Further, as per Common Term Loan Agreement (CTLA) dated 28th September, 2005 between the lenders and the company, the lenders have given the commitment that, "as a result of

increase in completion cost, if the project cost exceeds Rs. 100,380 million, the lenders shall take suitable financial structuring to ensure that the project cost does not exceed Rs. 100,380 million". The revival cost of Rs. 8,700 million, estimated at the time of take over of assets, has now been estimated Rs. 23,640 million (without IDC) and in view of this increase, financial restructuring of the project is under consideration of lenders/GoI.

Note No. 2 : In terms of the CTLA with banks and financial institutions, loans aggregating Rs. 70,119 million were given to the company, and the commercial operation dates of power blocks I, II & III were scheduled on 1st September 2006, 1st October 2006 and 1st November 2006 respectively. In line with these commercial operation dates, interest during construction (IDC) on the loan of Rs. 70,119 million was quantified at Rs. 1,750 million. In addition, additional IDC was quantified at Rs. 4,660 million with the provision in CTLA that, "if the completion cost is Rs. 8,700 million the additional IDC shall be Rs. 4,660 million and if the completion cost increases from Rs. 8,700 million, the amount constituting the additional IDC payable by the borrower shall be decreased by such increase in amount".

Considering the current estimated completion cost of Rs. 23,640 million (without IDC) and financial restructuring of the project being under consideration of the lenders/GoI, company's liability of interest on the loans of Rs. 70,119 million, beyond Rs. 1,750 million, which was the agreed IDC, has not been recognised as contingent or firm liability by the company and has, therefore, not been provided for in the accounts. The amount not so recognised is estimated at Rs. 8,420 million.

B. Query

17. The querist has sought the opinion of the Expert Advisory Committee as to whether the annual accounts of the company which have been drawn, as stated above, have been drawn in accordance with the provisions of the Companies Act, 1956 and the applicable Accounting Standards on the subject.

C. Points considered by the Committee

18. The Committee notes that the basic issue raised by the querist relates to appropriateness of non-provision of interest beyond the originally

scheduled (block) commercial operation date. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case.

19. From the Facts of the Case, the Committee notes that there is a dispute between the company and its lenders on the need for making provision in the financial statements for interest on term loan beyond the originally scheduled (Block) commercial operation date. The Committee also notes that the C&AG agreed with the contention of the company in not making the provision.

20. At the outset, the Committee wishes to point out that the Committee refrains from interpreting the terms of the Common Term Loan Agreement ('CTLA') since that is beyond the scope of the Committee's advisory role. Similarly, the Committee refrains from expressing any view involving legal implications, such as, the consequences of CTLA not foreseeing and providing a remedy to the shifting of Block Commercial Operation Date.

21. The Committee notes that paragraph 46 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, inter alia, states that the application of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of the financial position, performance and cash flows of an enterprise.

22. As per paragraph 10 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', issued by the Institute of Chartered Accountants of India as well as notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules'), 'accrual' is one of the fundamental accounting assumptions. As per the accrual concept, revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. The Committee notes that there is a dispute between the company and its lenders as to whether interest after the originally scheduled commercial operation date accrues or not till the financial restructuring is over.

23. The Committee notes the following paragraphs from Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute of Chartered Accountants of India as well as notified under the 'Rules':

"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

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

10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

10.4 A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made."

"10.6 Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

10.7 Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."

"14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

> ***(b)*** ***it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
>
> ***(c)*** ***a reliable estimate can be made of the amount of the obligation.***

If these conditions are not met, no provision should be recognised.

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

> (a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
>
> (b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event."

"18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. ..."

"26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote."

"29. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made)."

"66. For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

67. An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

68. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability

at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

> ***(a)*** ***an estimate of its financial effect, measured under paragraphs 35-45;***
>
> ***(b)*** ***an indication of the uncertainties relating to any outflow; and***
>
> ***(c)*** ***the possibility of any reimbursement.***

..."

"71. Where any of the information required by paragraph 68 is not disclosed because it is not practicable to do so, that fact should be stated.

72. In extremely rare cases, disclosure of some or all of the information required by paragraphs 66-70 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed."

24. From the above, the Committee is of the view that the company should, based on all the available evidence, assess whether there is a present obligation or a possible obligation towards the interest liability beyond the originally scheduled commercial operation date. If it is considered probable (i.e., more likely than not) that a present obligation towards interest liability exists at the balance sheet date and it is probable that the said obligation will be settled and a reliable estimate can be made, the company should recognise a provision for the interest liability and make related disclosures. If, however, it is considered that the recognition criteria for making a provision are not met, then, the company should not make a provision for the disputed interest liability. In that situation, the company should disclose the same as a contingent liability, with relevant disclosures in this regard as per AS 29, unless the possibility of an outflow of resources embodying economic benefits is remote.

D. Opinion

25. On the basis of the above, and while refraining from interpreting the terms of the Agreement and also refraining from expressing any view involving legal implications, the Committee is of the opinion that the company should, based on all the available evidence, assess whether there is a present or possible obligation towards the interest liability beyond the originally scheduled commercial operation date. If it is considered probable that a present obligation exists at the balance sheet date and the said obligatin will be settled, of which a reliable estimate can be made, the company should recognise a provision for the interest liability and make related disclosures. If, however, it is considered that the recognition criteria for making a provision are not met, then, the company should instead, disclose the same as a contingent liability, with relevant disclosures in this regard as per AS 29, unless the possibility of an outflow of resources embodying economic benefits is remote. If the above-said requirements are complied with, the Committee is of the opinion that the annual accounts of the company would be considered to have been drawn in accordance with the provisions of the Companies Act, 1956 and the applicable Accounting Standards.

Query No. 33

Subject: Accounting for rescheduling of lease rentals.[1]

A. Facts of the Case

1. A non-listed company registered under the Companies Act, 1956 (hereinafter referred to as 'the company'), is a subsidiary of a listed public limited company. The company is a Non-Banking Financial Company (NBFC) registered with the Reserve Bank of India. The company has a network of branches over a large part of India to carry on its business and hence, takes on lease, various properties for its branches. The company is not in the business of leasing and renting.

[1] Opinion finalised by the Committee on 22.1.2010

2. The querist has stated that the company has entered into a lease agreement which has the following main features:

(i) The lease agreement is for a period of nine years.

(ii) The rent for the first three years is at market rate on the date of lease agreement and has an escalation clause applicable after every three years.

(iii) The lessee has the option to exit from the agreement by giving 3 months' notice.

3. The querist has stated that in the current scenario, the real estate rates in India as well as abroad have undergone various changes due to global financial meltdown and the fall in the equity markets. The property rates have gone down substantially in the range of 30% to 40% and are expected to go down further. Consequently, the rent agreed initially has turned out to be substantially high with respect to the current circumstances. The company has been successful in renegotiating the lease rentals of its premises downwards. The issue has arisen as to the accounting for lease rentals with respect to the lease period.

4. The original lease deed was entered into on 5.10.2006. The original and renegotiated terms of the contract are as follows:

Original lease deed:

Term	Rent
20.11.2006 to 19.11.2009	Rs.70,000 per month
20.11.2009 to 19.11.2012	Rs.80,500 per month*
20.11.2012 to 19.11.2015	Rs.92,575 per month*
(*escalation of 15%)	

The lessor was paid rent upto December 31, 2008. The lease deed was renegotiated and the revised supplementary lease deed was entered into on 16.02.2009. The revised terms of the lease deed are as follows:

01.01.2009 to 31.12.2009	Rs.56,000 per month
01.01.2010 to 31.12.2013	Rs.61,600 per month*
01.01.2014 to 19.11.2015	Rs.67,760 per month*
(*escalation of 10%)	

5. The company has accounted for lease rentals since the inception of

the lease on a straight line basis with respect to the original lease term. The querist has reproduced the following paragraphs of Accounting Standard (AS) 19, 'Leases', which, according to the querist, have an impact on the issue at hand:

> ***"3.6 The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise."***
>
> ***"23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.***
>
> 24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis."

The querist has also mentioned that the Expert Advisory Committee (EAC) has issued an opinion on a similar accounting issue, which is published as Query No. 1 of Compendium of Opinions - Volume XXVII.

6. According to the querist, the accounting for lease rent escalations would be governed by paragraph 23 of AS 19. As per the querist, in accordance with paragraph 23, an entity should account for lease rentals in the following manner, which should be recognised as an expense in the statement of profit and loss:

(i) on a straight line basis over the lease term, or

(ii) another systematic basis if it is more representative of the time pattern of the user's benefit.

The querist has stated that in the given case, the lease term would be the entire nine year period as the entity has already decided the same at inception. As per the querist, the above-mentioned opinion issued by the

EAC requires an entity to account for the lease rentals on a straight line basis over the lease term under similar circumstances. The opinion does not consider the situation which has now arisen due to changes in the economic scenario and the likelihood of the downward renegotiation of lease rentals of the premises.

7. The querist has stated that the benefit that is derived by leasing a property can be generally measured from the market rates for similar properties. For example, if the market rate of a property in a year is Rs. 100, the benefit derived from the property is Rs. 100. In case the market rate falls to Rs. 80 in the next year, the benefit derived would be Rs. 80. Accordingly, under the current circumstances, the company believes that the fact that it will derive the same benefit throughout the lease term does not hold good due to the changed circumstances of a significant fall in the market rates and hence, the opinion issued by EAC (referred in paragraph 5 above) based on different circumstances, cannot be applied in this case.

8. The querist has also stated that in the current scenario, since the company has been able to successfully renegotiate rent, it can be reasonably assumed that the rent actually paid by the company reflects the benefit that accrues to the entity and accordingly, the rents actually paid should be debited as expense to the profit and loss account. Further, the company feels that the current scenario is such that the terms in the lease deed have a very high probability of being renegotiated in future. Thus, in the view of the querist, the aforesaid agreed rentals in the agreement are likely to be renegotiated as a further fall is expected.

B. Query

9. Under the aforesaid facts and circumstances, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the principle of recognising lease rentals over the lease term on a straight line basis is correct. If not, then what should be the basis of accounting for such lease rentals.

(ii) Whether the monthly rental should be accounted for at the value of actual lease rent paid in such a case.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to

accounting for lease rentals in the case of an operating lease, where the company has been successful in renegotiating/amending the lease rentals over the remaining period of lease and where it is expected that the terms in the lease deed have a high probability of being renegotiated in future. 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, propriety of determining the lease in the present case as an operating lease as per the requirements of AS 19, legal implications, if any, arising out of such renegotiations in the lease deed, etc.

11. The Committee notes paragraph 23 of AS 19 as reproduced by the querist in paragraph 5 above. The Committee is of the view that as per the principles of AS 19, any departure from the straight-line basis of recognition of lease expense under an operating lease must reflect the time pattern of the user's benefit, which, in the view of the Committee, should be considered from the angle of *use* of the leased asset in physical terms rather than the benefit derived from the angle of market rates of leased properties as being argued by the querist. Since the leased property in the instant case would be used by the lessee throughout the lease term on a consistent basis, even though the lease rentals have been reduced due to economic slow down, the Committee is of the view that the lease expense over the lease term should be recognised on a straight line basis. The Committee also notes that volatility in the lease rentals due to economic changes or the expectations that the lease rentals would further go down does not affect the physical use of the property and, therefore, such considerations cannot form the basis for any departure from the straight line basis of recognition of lease rentals over the lease term in case of an operating lease. Also, the Committee is of the view that since the terms of a lease deed are legally binding on both the parties to the agreement, merely an expectation of deviation from the terms of the lease deed in future should not be considered while accounting for lease rentals.

12. With respect to accounting for lease rentals in the case of the existing operating lease, the Committee notes that due to economic changes, lease rentals have been re-negotiated and for the revised terms of the contract, a supplementary lease deed has been entered into. The Committee is of the view that for the purpose of accounting, the revised lease rentals should be taken into account for determining the charge to the profit and loss account over the lease period of 9 years. Keeping in view the requirement of straight line basis for recognition of lease rentals over the lease term as per paragraph

23 of AS 19 as discussed in paragraph 11 above, the Committee is of the view that lease rentals payable over the whole period of 9 years should be considered for determining the annual charge to the statement of profit and loss on this account. Accordingly, the lease rentals paid under the original lease deed and the revised lease rentals payable over the remaining period of the lease as per the supplementary lease deed, should be considered for determining the amount of annual charge on account of lease rentals on straight line basis. Any resultant adjustments on account of lease rent already recognised in past should be recognised in the current year's profit and loss account.

D. Opinion

13. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 9 above under the facts and circumstances of the case:

(i) The principle of recognising lease rentals over the lease term on a straight line basis is correct.

(ii) The monthly rental cannot be accounted for at the value of actual lease rent paid. See paragraphs 11 and 12 above.

Query No. 34

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

A. Facts of the Case

1. A government company is 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

[1] Opinion finalised by the Committee on 22.1.2010

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 listed with the Bombay Stock Exchange and the National Stock Exchange.

2. The company has a three-tier organisation structure consisting of projects/stations, regional headquarters and corporate office. The company has six regions with the regional headquarters located across the country and also a hydro region headquarter located centrally. The projects/stations are grouped under different regions and report to the corporate office through the regional headquarters. The regional headquarters provide various services to the projects under construction and the operating stations under their jurisdiction. The company has also established two transport and customs clearance (T&CC) offices to facilitate the timely receipt of imported goods for the projects/stations.

3. The company is undertaking construction of a number of new power projects at the greenfield sites as well as expansion of existing projects. Some of the key activities related to the construction projects, such as, design & engineering, award of major contracts, post-award contract management, project monitoring, etc., are performed centrally at the corporate office. The company has seven coal mining blocks and similar activities for the development of these mines are also performed centrally at corporate office. The company has established departments mainly for performing these activities for the construction/expansion of power projects and development of mining projects at its corporate office with a view to benefit from the pooling of highly skilled manpower in these areas and also to achieve economy in expenditure. As a result, according to the querist, certain expenditures required for construction/expansion of the projects are incurred centrally instead of at individual project locations.

4. The querist has stated that till the financial year 2007-08, in accordance with paragraph 5 read with paragraph 7 of the Guidance Note on Treatment of Expenditure during Construction Period[2], issued by the Institute of Chartered Accountants of India (ICAI), expenses of the corporate office, regional headquarters and T&CC offices were allocated to the operating stations and projects under construction in the proportion of sales to annual

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

capital outlay. The amounts allocated to the operating stations were recognised in the profit and loss account. The amounts allocated to the projects under construction, along with the project's expenses considered as 'incidental expenditure during construction', were apportioned to different assets in the proportion of accretion to capital work-in-progress during the year and capitalised. The accounting policies of the company in this regard for the year 2007-08 were as under:

> "Expenses common to operation and construction activities are allocated to profit and loss account and incidental expenditure during construction in proportion of sales to annual capital outlay in the case of corporate office and sales to accretion to capital work-in-progress in the case of projects."
>
> "Incidental expenditure during construction (net) including corporate office expenses (allocated to the projects prorata to the annual capital expenditure) for the year, is apportioned to capital work-in-progress on the basis of accretions thereto."

5. The querist has also stated that consequent to the withdrawal of Guidance Note on Treatment of Expenditure during Construction Period by the Institute of Chartered Accountants of India (ICAI) during the year 2008-09, the company constituted a committee comprising members from cross functional areas to:

(a) identify the expenditures of the related departments of corporate office, regional headquarters (RHQs) and T&CC offices whose services are specifically attributable to construction of projects considering the provisions of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006, and

(b) allocate such expenses to the projects under construction/ expansion.

As per the querist, the said committee was guided by the provisions of paragraph 9.2 of AS 10 which states that expenses which are specifically attributable to the construction of a project or incurred for acquisition of a fixed asset or incurred for bringing the asset to its working condition, can only be included as a part of the cost of construction project or as a part of the cost of the fixed asset. Paragraph 9.2 of AS 10 is reproduced as below:

"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."

6. Considering the above mentioned provisions, the said committee reviewed the services rendered by various departments located at the corporate office to the construction/ expansion projects. Based on such review, the committee identified that the following departments provide services mainly for construction/execution activities of the projects:

(a) Corporate Monitoring Group (CMG)

(b) Corporate Engineering Department

(c) Corporate Contract Services Department

(d) Finance Concurrence Department

(e) Hydro Region Headquarter for construction of hydro projects; and

(f) Coal mining department rendering services to coal mining projects.

According to the querist, the committee recommended that the expenditure of the above departments be allocated to the projects under construction/ expansion on the basis of annual capital expenditure for the period considering the following principles:

Sl	Name of the Department	Allocated to
1	CMG, Engineering, Contracts and Finance Concurrence Group	Thermal, Gas, Hydro & Coal Mining Units
2	Hydro Region	Hydro Units
3.	Coal Mining	Coal Mining Units

As regards other departments, the committee noted that other departments are either providing common services to projects under construction/ expansion and projects in operation or providing services for operating stations only and hence, the committee recommended that expenses of these departments may be charged to the statement of profit and loss. Accordingly, the expenditure of engineering, contracting, project monitoring, hydro region headquarter, coal mining and finance concurrence departments were considered as expenditure during construction and for allocation to the projects under construction/expansion on a systematic basis, i.e., capital expenditure incurred during the year at these projects. Expenses of other departments providing common services were charged to the statement of profit and loss. Further, accounting policy of the company for allocation of administration and general overhead expenses to the units for the financial year 2008-09 was as under:

> "Administration and general overhead expenses attributable to construction of fixed assets incurred till they are ready for their intended use are identified and allocated on a systematic basis to the cost of related assets."

7. During supplementary audit of accounts under section 619(3)(b) of the Companies Act, 1956, the government auditor observed as below:

> "With the withdrawal of Guidance Note on Treatment of Expenditure During Construction Period by the ICAI, the accounting is to be done as per AS 10, which stipulates that administration and other general overhead expenses are usually excluded from the cost of fixed assets since they do not relate to a specific fixed asset. 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.
>
> The company has allocated expenses relating to five divisions on the ground that they perform functions relating to construction only. However, the expenses do not pertain to any one project. Hence, allocation of the expenses was not in accordance with AS 10."

8. The company is of the view that the employees posted in engineering, contracts, project monitoring, hydro region headquarters, coal mining and finance concurrence departments at corporate centre are engaged in the activities of project engineering and design, procurement, contract management and project monitoring, etc. which are essential activities for the construction of projects/coal mine development. Since the activities of

the identified departments were directly related to the construction of projects, capitalisation of these expenses is in accordance with the requirements of AS 10. The fact that these activities are performed centrally at the corporate centre does not change their basic character which is that such expenditure is incurred for the construction of fixed assets. The allocation to the individual projects based on the capital expenditure incurred during the year is a reasonable basis and is not prohibited under AS 10. Charging of the expenditure of the departments engaged in project engineering, design, procurement, contract management and project monitoring activities, etc. to profit and loss account merely because they are involved with more than one project would not be in accordance with paragraph 9.2 of AS 10.

B. Query

9. Considering the above facts, the querist has sought the opinion of the Expert Advisory Committee as to whether allocation and capitalisation of expenses related to the identified departments of corporate office and the regional headquarters which are engaged in project engineering, designing, contract management and project monitoring activities etc. to/at the projects under construction/expansion is correct.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to the accounting treatment of expenditure incurred at various departments performing centralised functions identified by the company for the construction/expansion of power projects. 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, specific basis of allocation of the common expenditures incurred at these departments over various projects/ assets, propriety of accounting treatment followed by the company before financial year 2008-09, accounting for expenditure incurred by other departments providing common services to projects under construction/ expansion and projects in operation, etc. The Committee has also not considered the issue with respect to the development of mining projects as special considerations may apply to those projects. Further, as the querist has referred to only AS 10 in the context of construction/expansion and development of power projects, the Committee presumes that the underlying assets in all cases are 'fixed assets' covered under the provisions of AS 10. As the exact nature of the activities being performed by various departments

is not clear from the nomenclature of the departments, the Committee's opinion contained hereinafter is based on the general principles to be followed while accounting for expenditure incurred at departments engaged in providing services to the construction/expansion of power projects. The exact expenditures that are to be capitalised will have to be determined on the basis of the said principles. The Committee also notes that while the querist has enumerated six departments that are stated by the querist to be engaged in the functions relating to construction activities, the government auditor has made his observation in respect of allocation of expenses relating to five divisions. However, that does not affect the opinion of the Committee expressed hereinafter.

11. 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 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. 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."

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

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

> "9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset."

From a wholesome 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/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'. In the extant case, the Committee is of the view that it should be seen that whether the expenses incurred on the activities of the various departments are directly attributable to the construction as discussed above. Accordingly, if the expenses incurred at the various departments are directly attributable to construction, these can be capitalised with the cost of the concerned fixed asset(s)/ project(s).

12. As regards basis of allocation of the expenses of these departments that can be allocated and capitalised to various projects or assets under construction, the Committee is of the view that the same should be allocated selecting an appropriate basis that reflects the extent of usage of service rendered by the department to the construction of the project.

D. Opinion

13. On the basis of the above and subject to the considerations contained in paragraph 10 above, the Committee is of the opinion on the issue raised in paragraph 9 above that capitalisation of expenses related to various departments of corporate office and the regional headquarters to the projects/

assets under construction/expansion would be correct provided the expenses incurred on the activities of these departments can be considered to be directly attributable to the construction of project(s)/ fixed asset(s) for bringing it(them) to its(their) working condition as discussed in paragraph 11 above.

Query No. 35

Subject: Capitalisation of expenditures in respect of projects under construction.[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 revenue of the company comes mainly from sale of electricity generated by power station. Apart from power stations, which generate electricity and thereby revenue, the company has a number of hydro projects under construction stage. The company has a head office and a number of regional offices for administration of these projects/power stations. According to the querist, all the power stations/projects under construction/regional offices are independent accounting units. Similarly, head office is also an independent accounting unit. As per the querist, the activities of head office/ regional office may be segregated into specific and general. The querist has stated that 'specific' implies the activities carried out at the head office which exclusively/mainly pertain to construction projects or power stations. Such activities are carried out by dedicated divisions, while under the 'general' activities, the head office carries out various functions, such as, finance, human resource (HR) and company secretariat, etc., which can not be exclusively associated with any project.

2. The querist has stated that all expenditures incurred at power stations which are in the nature of operation and maintenance, employee cost and interest cost, etc., are charged to the profit and loss account. Upto the financial year 2007-08, in respect of projects under construction, incidental

[1] Opinion finalised by the Committee on 22.1.2010

expenditure net of miscellaneous income used to be carried as 'Incidental Expenditure during Construction' and capitalised on commissioning of the project as per the following accounting policy:

> "Projects under commissioning and other capital work-in-progress are carried at cost. In respect of projects under construction, incidental and attributable expenses (net of incidental income) including interest and depreciation on fixed assets in use during construction are carried as part of Incidental Expenditure during Construction to be allocated on major immovable project assets other than land and infrastructural facilities, on commissioning of the project."

3. The querist has further stated that till the financial year 2007-08, all the expenditure incurred at head office after netting off any miscellaneous income was used to be debited to power stations and projects under construction on a systematic basis as per the following accounting policy:

> "Corporate office expenses are allocated as under:
>
> (a) On power station @ 1% of sale of energy for the year excluding taxes and duties.
>
> (b) In case of construction contract works awarded to and executed by the corporation @ 5% of the project expenditure incurred during the year except in case of contracts of rural electrification & Pradhan Mantri Gram Sadak Yojna (PMGSY), where allocation of expenditure in respect of dedicated division is made on the basis of services rendered.
>
> (c) The balance expenditure is allocated to construction projects in the ratio of net capital expenditure incurred during the year."

Similarly, a systematic allocation of regional office expenses among construction projects and power stations was being followed. As such, expenditure of regional office and head office allocable to power station was getting charged to the profit and loss account of the power station. Such expenditure allocated to projects under construction got capitalised as incidental expenditure during construction and became part of 'Capital Work in-Progress' in construction phase and thereafter as 'Fixed Asset' of that project.

4. According to the querist, the accounting policies as given in paragraphs 2 and 3 above were in line with the Guidance Note on Treatment of Expenditure during Construction Period,[2] issued by the Institute of Chartered Accountants of India, which was withdrawn in the financial year 2008-09. Subsequent to its withdrawal, a need was felt by the company to review the aforesaid accounting policies. The issue was discussed with the company's statutory auditors and it was agreed that for capitalisation of expenditure incurred during construction (whether at project or at regional office or at head office), provisions of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', shall be followed. The relevant provisions of AS 10, notified under the Companies (Accounting Standards) Rules, 2006 have been reproduced by the querist as below:

> "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."* (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[3]. *Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset.* Any internal profits are eliminated in arriving at such costs." (Emphasis supplied by the querist.)

5. The querist has stated that keeping in view the above, the accounting policies referred to in paragraphs 2 and 3 above have been replaced with a new accounting policy which is reproduced as below:

> "Projects under commissioning and other capital work-in-progress are carried at cost. Administration and general overhead expenses attributable to construction of fixed assets are identified and allocated

[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.

[3] To be read as 9.4.

on systematic basis on major immovable assets other than land and infrastructural facilities."

In line with the above accounting policy, the following accounting treatment was finalised:

At Construction Projects

(a) *Direct administration and other general overhead in construction projects:*

To be carried as expenditure during construction and to be capitalised at the time of commissioning of the project.

(b) *Expenses not directly related to construction of projects like training and advertisement expenses:*

To be charged to the profit and loss account of the construction project and shown as loss, to be absorbed in the profit and loss account of the company as a whole.

At Head Office/Regional Office

For treatment of administration and other general overhead of head office and regional office and allocation thereof among projects:

(1) Divisions/departments of head office were identified based on the functions.

(2) Broadly, the divisions/departments have been divided into following categories:

   (a) Group of divisions/departments, whose services can be directly identified:

      (i) Divisions/departments rendering services mainly to construction projects;

      (ii) Divisions/departments rendering services mainly to power stations;

      (iii) Divisions/departments rendering services mainly to project management/consultancy works.

(b) Support divisions, like finance, human resource and information technology & communication, etc. which render services to all the divisions /projects/units but services cannot be identified directly with any division/project/unit.

(c) Other divisions, like corporate communication, vigilance, company secretariat, training & human development and research & development, whose functions are more of image building of the company.

(3) Expenses of divisions/departments falling under (2)(b) above are allocated to divisions under (2)(a) and (2)(c) above in the ratio of employee cost of each group of divisions to firm-up the expenditure of (2)(a) and (2)(c) above. Expenditure of category (2)(a)(i) is allocated to construction project to be carried as "Expenditure during Construction' and to be capitalised at the time of commissioning of the project. All other expenditures, i.e., (2)(a)(ii), (2)(a)(iii) and (2)(c) are charged to the profit and loss account.

6. As per the querist, accounts for the year 2008-09 were finalised using the aforesaid accounting policy and there was absolutely no issue from the statutory auditor of the company. Government auditor however raised an observation on the accounting treatment given by company in respect of administration and general overheads during the audit of accounts for the year 2008-09. The contention of the auditor was that the capitalisation of administration and general overheads of head office is not in accordance with AS 10 since the expenditure does not relate to any specific fixed asset and is general in nature. According to the querist, the auditor had not given any further justification for his observation. The management informed the auditor that capitalisation of administration and other general overheads expenditure which are directly attributable to construction of a project is in accordance with the principles enunciated in AS 10 as reproduced in paragraph 4 above.

7. Finding no consensus, the observation was however dropped on the assurance of the management that the issue arising out of withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period vis-a-vis paragraph 9.2 of AS 10 and the accounting policy of the company as referred to in paragraph 5 above shall be referred to the Expert Advisory

Committee of the Institute of Chartered Accountants of India for its expert opinion.

8. The querist has mentioned that the company is still of the opinion that its accounting policy referred to in paragraph 5 above is based on the principles of AS 10.

B. Query

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

(a) Whether the accounting policy referred to in paragraph 5 above and consequential accounting treatment given by the company is in line with the provisions of AS 10.

(b) If not, what should be the accounting treatment for such administration and general overheads of head office/regional office which can be directly associated with the construction of a project based on the services rendered by head office/regional office?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to the accounting treatment of expenditure (including administration and other general overhead expenditure) incurred at various departments/divisions of head office and regional offices performing centralised functions for the construction of power projects. 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, specific basis of allocation of the common expenditures incurred at these departments over various projects/assets, propriety of accounting treatment followed by the company before financial year 2008-09, etc. Further, as the querist has referred to only AS 10 in the context of construction of power projects, the Committee presumes that the underlying assets in all cases are 'fixed assets' covered under the provisions of AS 10. As the exact nature of the activities being performed by various departments is not clear from the Facts of the Case, the Committee's opinion contained hereinafter is based on the general principles to be followed while accounting for expenditure incurred at departments engaged in providing services to the construction of power projects. The exact expenditures that

are to be capitalised will have to be determined on the basis of the said principles.

11. 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 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. 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."

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

> "9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:
>
> (i) site preparation;
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> (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 wholesome 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 (including administration and other general overhead expenditure) to 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 above-discussed principle of 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'. In the extant case, the Committee is of the view that it should be seen that whether the expenses incurred on the activities of various departments/divisions (including administration and other general overhead expenditure) are directly attributable to the construction as discussed above. Accordingly, if the expenses incurred at the various departments/divisions (including administration and other general overhead expenditure) are directly attributable to construction, these can be capitalised with the cost of the concerned fixed asset(s)/ project(s).

12. As regards basis of allocation of the expenses of these departments that can be allocated and capitalised to various projects or assets under construction, the Committee is of the view that the same should be allocated selecting an appropriate basis that reflects the extent of usage of service rendered by the department to the construction of the project.

D. Opinion

13. On the basis of the above and subject to the considerations contained in paragraph 10 above, the Committee is of the following opinion on the issues raised in paragraph 9 above:

(a) The accounting policy and consequential accounting treatment would be in line with the provisions of AS 10 provided the expenses incurred on the activities of various departments/ divisions (including administration and other general overhead expenditure) can be considered to be directly attributable to the construction of project(s)/ fixed asset(s) for bringing it(them) to its(their) working condition as discussed in paragraph 11 above and the expenses that have been allocated and capitalised to various projects or assets under construction, have been allocated selecting an appropriate basis that reflects the extent of usage of service rendered by the department to the construction of the project.

(b) The accounting treatment for administration and general overhead expenditure incurred at head office and regional offices should also be determined on the basis of the principles explained in paragraph 11 above.

Query No. 36

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

A. Facts of the Case

1. A Government of India enterprise incorporated under the Companies Act, 1956, is engaged in the business of transmission of power from the generating units to different State Electricity Boards (SEBs) through its transmission network. With the growing investment in power sector, it also undertakes construction of new transmission systems linked with the generating units as well as systems strengthening schemes of the existing networks.

2. The querist has stated that keeping in view the large incremental capacity addition requirements of the current five year plan and to fulfill the macro objective of power sector, i.e., power to all by 2012, the company is oriented towards implementation of generation evacuation schemes,

[1] Opinion finalised by the Committee on 22.1.2010

strengthening of regional grids, development of an integrated national grid with flexibility for power transfer from one region to another and to have in place the requisite load despatch facilities for 'real time grid operation'. Thus, the major stress of the company is on construction activities.

3. The querist has further stated that the business model of the company is different from other organisations. In other organisations, construction activities are carried out in concentrated manner at one particular place and accordingly, all the ancillary activities, such as, engineering and contract related activities can also be carried out at that particular place. In the case of the company, the transmission lines and related subs-stations are to be constructed all over the country. The construction activities are scattered over a vast area. As such, it is not possible that ancillary activities, such as, engineering, pre and post award contractual activities, fund raising and payment to contractors are also decentralised along with the construction activities. Support for these activities is given by corporate office as well as respective Regional Headquarters (RHQs). Further, as per the querist, in case of other organisations, the number of construction projects being carried out are limited, say, maximum 5 to 10, whereas, in the case of the company, the number of ongoing construction projects in a year are 50 to 60. Therefore, to achieve the economies of scale, the common activities of the construction projects are carried out in a centralised manner at Corporate Centre (CC) and RHQs.

4. According to the querist, since CC and RHQs are contributing substantially to construction activities, the expenditure of CC and RHQs is to be allocated to construction activities on some rational basis. For allocating the CC and RHQ expenditure, following methodology is being followed:

> The entire expenditure of CC and RHQs is classified into different departments. After the classification, expenditure is further classified into departments exclusively looking after construction, operational activities and common activities. Expenditure relating to departments carrying out construction activities is taken as Incidental Expenditure During Construction (IEDC) whereas expenditure relating to departments carrying out O&M activities is charged to the profit and loss account directly. Expenditure relating to common departments is allocated to IEDC and profit and loss account in the ratio of capital outlay and transmission charges.

5. As per the querist, the rationale behind the allocation of common expenditure based on capital outlay and transmission charges is that the capital outlay represents the financial implication of construction activities carried out during the year and transmission charges represent the operational activities carried out during the year. If in any year, capital outlay is more, meaning thereby, more construction activities, higher amount shall be transferred to IEDC. If the construction activities are reduced, the capital outlay and consequently, amount to be transferred to IEDC will also get reduced.

6. The accounting policy representing the above methodology is disclosed in the schedule of accounting policies and is reproduced below:

(a) The common expenses (net) of corporate office and regional offices are allocated to various diversified activities of the company, viz., transmission, telecom, consultancy and accelerated power development and reform program (APDRP) in the ratio of the respective income/reimbursement of each activity.

(b) The common expenses thus allocated are further allocated to incidental expenditure during construction (IEDC) and revenue in transmission and telecom activities in the ratio of capital outlay thereof and revenue, i.e., transmission charges (excluding income tax recovery) and telecom income.

7. The querist has stated that the above-mentioned methodology and accounting policy are based on paragraphs 9.2 and 10.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006, in respect of self-constructed fixed assets (which are applicable to the business activity being undertaken by the company), as reproduced below:

> "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."

> "10.1 ... 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. ..."

According to the querist, as the company is engaged in self-construction of transmission lines and substations, the expenditure of corporate centre and RHQs is being allocated to specific assets constructed during the year.

8. During the course of supplementary audit of accounts, the government auditor raised a half-margin in respect of the above accounting policy, which is reproduced below:

> "As per paragraph 9.3[2] of the Accounting Standard (AS) 10, issued by the Institute of Chartered Accountants of India (ICAI), administration and other general overhead expenses which do not relate to a specific fixed asset should be excluded from the cost of fixed assets. However, as per accounting policy No.7 of the company, the common expenses (net) of corporate office and regional offices are allocated to various diversified activities of the company viz. transmission, telecom, consultancy & accelerated power development and reform program (APDRP) in the ratio of the respective income/reimbursement of each activity. The common expenses are further allocated to Incidental Expenditure during Construction (IEDC) and revenue in transmission and telecom activities in the ratio of capital outlay thereof to transmission charges (excluding income tax recovery) and telecom income.
>
> Accordingly, the company has allocated an amount of Rs. 384.02 crore being expenditure related to corporate office (206.33 crore) and regional offices (Rs. 177.69 crore). Out of total expenditure of Rs. 384.02 crore, an amount of Rs. 214 crore has been treated as IEDC and balance Rs. 170.02 crore has been charged to revenue. Thus, accounting policy of the company is not in accordance with AS 10 issued by ICAI as these expenditures of corporate office and regional offices do not relate to any specific fixed asset and are general in nature. As such, entire amount of Rs. 384.02 crore including Rs. 214 crore should also have been charged to revenue instead of booking under the head IEDC.

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[2] Paragraph 9.3 of AS 10, issued by the ICAI has been renumbered as paragraph 9.2 in AS 10, notified under the Companies (Accounting Standards) Rules, 2006.

This has resulted in understatement of expenses, overstatement of 'Capital Work in Progress-IEDC' and profit for the year by Rs. 214 crore."

The querist has also reproduced below the sub-directions issued by the government auditor to the statutory auditor of the company:

"After withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period[3], whether allocation of administrative and general overhead expenses pertaining to some divisions, such as, Contract Services, Monitoring, Engineering, etc., to project under construction is in line with the provisions of Accounting Standard 1 (it appears that the reference is to AS 10), since these expenses do not relate to a specific project."

9. As per the querist, the company defended the accounting policy based on the following:

(a) Auditor was requested to refer 2nd part of paragraph 9.2 of the notified AS 10, which reads as follows:

"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."

According to the querist, this clearly implies that administration and other general overhead expenses can be included in the capital cost under certain circumstances.

(b) The accounting policy is based on paragraph 10.1 of AS 10 as explained in paragraph 7 above.

(c) That out of total incidental expenditure during construction (IEDC) of Rs. 214 crore of CC and RHQs, Rs. 96 crore pertains to departments which are exclusively looking after construction activities. Balance Rs. 118 crore has been allocated out of

[3] 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.

expenditure of common departments, such as, HR, finance, vigilance, law, etc.

(d) Construction activities are predominant in the working of Corporate Centre and RHQs. This is reflected by the following :

The total number of employees engaged in CC in O&M Departments of various segments, i.e., Director (Operations) office, operation services, system operation, private investment, DMS, telecom, etc., is 176 out of total manpower of 943 employees. To support the above O&M staff of 176, manpower of common departments, such as, finance, HR, IT, materials, company secretary, vigilance, etc. shall not be more than 90, i.e., 50% of 176. Thus, if construction activities are taken out of CC working, manpower will get reduced to maximum 264 which is 28% of total manpower of CC. Thus, 72% expenditure of CC can be considered as specifically attributable to construction activities. Similarly, as per the querist, 63% expenditure of RHQs can be considered as specifically attributable to construction activities. The above, according to the querist, clearly establishes that CC and RHQs are substantially contributing to construction activities.

(e) There is no change in AS 10 which requires any change in the accounting policy of the company. If AS 10 is to be followed in the manner proposed by the auditor, i.e., 'general administration and overhead expenditure which relate to specific asset only should be included in the cost of fixed assets', then, for each project, additional manpower will have to be deployed which will carry out the support services being offered by CC and RHQs. This will increase the manpower and overhead cost and thereby increase the capital cost of the projects.

(f) A committee of senior executives of the company representing different departments was constituted to review the present accounting policy of allocation of CC and RHQ expenditure. The committee has analysed the working of different departments in detail. It has given the conclusion that:

(i) Common departments of corporate centre and RHQs are contributing to construction activities to the extent of 60 to 70%.

(ii) It will be more rational if O&M budget/expenditure and construction budget/expenditure are considered for the purpose of allocation of such expenditure (of common departments) between revenue and capital.

(g) The querist has stated that some other companies in the power sector have followed the same methodology from the current financial year which is being followed consistently by the company since the last 4-5 years. The only difference is in respect of allocation of expenditure of common departments.

(h) According to the querist, if expenditure of common departments is allocated based on the recommendation of the committee as mentioned at (f) above or based on the methodology being followed by some of the PSUs, more amount will be transferred to IEDC resulting in increase in profit. However, to maintain consistency and conservatism, it is considered prudent to follow present accounting policy in practice.

10. The querist has stated that during the discussion with the government auditor, it was agreed to refer the matter to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) and accordingly, the half-margin was dropped.

B. Query

11 (i) The querist has stated that in the Announcement regarding Withdrawal of Guidance Note on Treatment of Expenditure during Construction Period, issued by the Institute, it was stated that the Guidance Note is not relevant in the present day context. It was not explained how the Guidance Note is not relevant in the present day context. If it has been considered that the Guidance Note is not relevant considering the provisions of AS 10 or Accounting Standard (AS) 26, 'Intangible Assets', the querist has stated that these standards were applicable long before and not issued in the year of withdrawal of the Guidance Note. Considering the construction activities being carried out by the companies, such as, the company in the present case, some dispensation is to be considered by the ICAI before the withdrawal of the Guidance Note. The Committee has been requested to give its view as to whether withdrawal of the above

Guidance Note requires the companies to review its accounting policies regarding allocation of common expenditure.

(ii) Considering the nature of business of the company of substantially carrying out the construction activities, CC and RHQs contributing to construction activities to the extent of 60-70% and considering the increase in project cost in case common activities being carried out by CC & RHQ are carried by separate staff for each specific project, the querist has requested the Committee to review the above accounting policy based on the facts and circumstances of the company and give its considered opinion on the following issues:

(a) Whether no amount of expenditure incurred on common departments be allocated to project cost irrespective of the fact that these departments are substantially contributing to construction activities.

(b) Whether the accounting policy and methodology being followed for allocation of expenditure of corporate centre and regional head quarters of the company is in accordance with the generally accepted accounting principles and AS 10.

(c) If not, the methodology to be followed for allocating expenditure of CC and RHQ to IEDC, since some expenditure of CC and RHQ is essentially to be allocated to IEDC considering the construction activities being carried out.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to the accounting treatment of expenditure incurred at various departments of corporate centre and regional head quarters performing centralised functions for the construction of power transmission lines and related sub-stations (hereinafter referred to as power projects). 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 policy of the company in respect of activities other than construction of power projects, specific basis of allocation of the common expenditures incurred at various

departments of corporate centre and regional head quarters, etc. Further, as the querist has referred to only AS 10 in the context of construction of power projects, the Committee presumes that the underlying assets in all cases are 'fixed assets' covered under the provisions of AS 10. The Committee has not examined the appropriateness of classification of various departments as relating to construction activity/O&M activities/common services. The Committee's opinion contained hereinafter is based on the general principles to be followed while accounting for expenditure incurred at departments engaged in providing services to the construction of power projects. The exact expenditures that are to be capitalised will have to be determined on the basis of the said principles.

13. 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 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. 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."

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

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

> "9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset."

From a wholesome 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 Accounting Standard (AS) 16, 'Borrowing Costs'. In the extant case, the Committee is of the view that it should be seen that whether the expenses incurred on the activities of various departments are directly attributable to the construction as discussed above. Accordingly, if the expenses incurred at various departments are directly attributable to construction, these can be capitalised with the cost of the concerned fixed asset(s)/ project(s).

14. As regards basis of allocation of the expenses of these departments that can be allocated and capitalised to various projects or assets under construction, the Committee is of the view that the same should be allocated selecting an appropriate basis that reflects the extent of usage of service rendered by the department to the construction of the project.

15. With respect to the review of accounting policies by the company pursuant to withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period, 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 that these are not contrary to an Accounting Standard. Hence, the recommendations of the 'Guidance Note on Treatment of Expenditure during Construction Period' even before its withdrawal were applicable only to the extent these were not contrary to the provisions of an Accounting Standard and therefore, the question of revision of accounting policies merely on account of withdrawal of the Guidance Note, in the instant case, does not arise.

D. Opinion

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

(i) The recommendations of the 'Guidance Note on Treatment of Expenditure during Construction Period' even before its withdrawal were applicable only to the extent these were not contrary to the provisions of an Accounting Standard and therefore, the question of revision of accounting policies merely on account of withdrawal of the Guidance Note, in the instant case, does not arise. See paragraph 15 above.

(ii)(a) Allocation and capitalisation of expenses related to various departments of corporate office and the regional headquarters to the projects/assets under construction should be done provided the expenses incurred on the activities of these departments can be considered to be directly attributable to the construction of project(s)/ fixed asset(s) for bringing it(them) to its(their) working condition as discussed in paragraph 13 above.

(b)&(c) Subject to paragraph 12 above, the Committee is of the opinion that while allocating and capitalising the expenditure related to various departments of corporate office and the regional headquarters to the projects/assets under construction, it should be seen that whether the expenses incurred on the various activities of various departments at corporate centre and regional headquarters can be considered to be directly attributable to the construction of project(s)/ fixed asset(s) for bringing it(them) to its(their) working condition as discussed in paragraph 13 above and that the basis of allocation is selected on an appropriate basis that reflects the extent of usage of services rendered by the department to the construction of the project. If the above-said requirements are complied with, the Committee is of the opinion that the accounting policy and methodology of the company for allocation of expenditure would be in accordance with AS 10 and other generally accepted accounting principles.

Query No. 37

Subject: Creation of deferred tax assets.[1]

A. Facts of the Case

1. A company is a central public sector enterprise under the Ministry of Oil and Natural Gas. The querist has stated that at present, the company has five business segments as below:

(i) Manufacture and servicing of electrical switchgears,

(ii) Execution of turnkey electrical projects,

(iii) Blending of lube oil,

(iv) Repair of industrial motors, and

(v) Third party inspection agency business for power projects.

2. The company intermittently suffered losses till the financial year 2003-04. Since the financial year 2004-05, the company is earning uninterrupted profit, details of which are given below:

[1] Opinion finalised by the Committee on 22.1.2010

Financial Year	Profit before tax (Rupees lakh)
2004-05	127.87
2005-06	221.84
2006-07	230.87
2007-08	321.97
2008-09	223.10

3. The querist has stated that as a result of past losses, the accumulated balance of loss at the end of the financial year 2008-09, stood at Rs. 50.33 crore. Resultantly, the company has negative net worth of Rs. 8.02 crore as on 31st March, 2009. The company is a sick industrial company within the meaning of the Sick Industrial Companies (Special Provisions) Act, 1985 and has submitted a restructuring plan to the Government of India. These past losses have, however, given rise to accumulated business loss and unabsorbed depreciation in favour of the company as per the Income-tax Act, 1961. The details of such unabsorbed business loss as on 31.3.09 are as under:

Assessment Year	Carry forward of unabsorbed business loss (Rupees)
2001-02	3,75,68,873
2002-03	7,57,43,263
2003-04	6,44,32,749
2004-05	3,73,70,889
Total	21,51,15,774

The details of unabsorbed depreciation as on 31.3.09 are as under:

Assessment Year	Unabsorbed Depreciation (Rupees)
Upto 1996-97	2,37,35,177
1997-98	1,24,82,599
1998-99	1,43,71,486
1999-2000	1,47,52,286
2000-2001	1,66,53,260
2001-2002	1,28,06,770
2002-2003	1,01,42,664
2003-2004	74,60,148
2004-2005	56,40,969
TOTAL	11,80,45,359

4. The querist has further stated that since the financial year 2004-05, successive auditors conducting statutory audits of the company have emphasised in their audit reports that the company was not recognising effects of deferred tax in the books of account as is required mandatorily by Accounting Standard (AS) 22, 'Accounting for Taxes on Income'. Therefore, as per the querist, while preparing accounts for the financial year 2007-08, the company had to introduce tax effect accounting in its books by creating net deferred tax asset consisting of unabsorbed depreciation and provision for doubtful debts, and adjusting therefrom deferred tax liability consisting of differential effects of depreciation. The transitional adjustment for creating deferred tax asset was effected by crediting debit balance of profit and loss account.

5. According to the querist, pursuing the policy of rigid conservatism, the company chose to ignore unabsorbed business loss in deferred tax computation because unabsorbed business loss has finite time limit of carry forward, which is eight assessment years reckoned from the assessment year in which loss was suffered. Unabsorbed depreciation was, however, taken into consideration in the computation of deferred tax asset as this has no time limit for carry forward as per the Income-tax Act, 1961.

6. The querist has informed that for the financial year 2009-10, the management is virtually certain that the company will earn profit. The expectation is based on the improved order position and upward trend in the power sector in which the company operates. The querist has also pointed out that the power sector is targeting an all time high generation of over 78,000 mw in the 11^{th} plan (2007-12). In order to meet the above target, accelerated power development and reform programme (APDRP) has been revamped with an increased allocation of funds. This higher allocation is directly benefiting and will continue to benefit manufacturers of power equipments and turnkey contractors in power sector, like, the company. Besides, according to the querist, the following facts serve as convincing evidence supporting the virtual certainty perception of the company:

(i) The company, since the financial year 2004-05, is uninterruptedly making profits, the details of which have been given in paragraph 2 above.

(ii) The management, while preparing accounts of the company for the financial year 2008-09 has reviewed its going concern status and is of the opinion that there exists no indicator casting significant doubt on the company's ability to continue as a going concern. This view of the management has been endorsed by the auditors in accordance with Auditing and Assurance Standard (AAS) 16, 'Going Concern'[2], issued by the Institute of Chartered Accountants of India, and the said fact has been duly disclosed in the audit report for the financial year 2008-09.

(iii) The project division of the company has been awarded contracts worth Rs. 68.6 crore till September 2009. Turnover achieved by this segment in the financial year 2008-09 was only Rs. 4.70 crore.

(iv) The company has embarked on a new segment of operation namely testing and inspection services for power projects and upto September 2009, has been awarded contracts worth Rs. 7.00 crore.

[2] Auditing and Assurance Standard (AAS) 16 has been revised, renamed, renumbered and categorised as Standard on Auditing (SA) 570 (Revised), 'Going Concern'.

Besides the above, orders worth Rs. 8.5 crore are in the pipeline.

(v) For the switchgear segment, the orders booked along with the orders in the course of negotiation with prospective and existing customers coupled with the buoyancy in the segment indicate that the company will continue to retain its present business trend.

(vi) Electrical repair division has already booked orders worth Rs. 4.56 crore in the half year ended 30th September, 2009. The corresponding figure for the last year was Rs. 3.22 crore. Given the current positive state in the segment, it is expected that the upswing in order booking will continue.

(vii) Lube division has already bagged orders worth Rs. 81.63 lakh. The corresponding figure for the last year was Rs. 56.17 lakh.

Riding on the factors enumerated above and based on worst case scenario, as per the querist, the company presently estimates that it will continue to post profit in the coming years.

7. The querist has informed that the company is already enjoying set-off of unabsorbed business loss in income-tax assessments and the same will continue in the remaining period of three years out of the prescribed time frame of eight assessment years.

8. The querist has also mentioned in this context that the company as a strategic measure has tried to insulate itself from the risk of declining profit by resorting to diversified business activities and thereby ensuring that unforeseen loss of profit in one segment is offset by profits earned in other segments.

B. Query

9. Based on the facts and evidence adduced above, the provisions contained in paragraphs 15, 16 and 26 of AS 22 and also taking into consideration the facts that the accumulated loss of the company as on 31st March, 2009 is Rs. 50.33 crore, the company is a sick industrial company within the meaning of the Sick Industrial Companies (Special Provisions) Act, 1985, and that the company has submitted a restructuring plan to the Government of India, the querist has sought the opinion of the Expert

Advisory Committee as to whether the company should retain deferred tax assets in its books.

C. Points considered by the Committee

10. The Committee notes that the company has created deferred tax assets for the first time in the financial year 2007-08 and has raised an issue as to whether the company should retain such deferred tax assets in its books while preparing financial statements for the financial year 2008-09 considering the various facts enumerated by the querist in the Facts of the Case. Accordingly, the Committee, while expressing its opinion has 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 deferred tax assets, transitional adjustments of creation of deferred taxes in the books of account of the company, propriety of ignoring unabsorbed business losses in deferred tax computation, offsetting of deferred tax assets and deferred tax liabilities, etc.

11. The Committee notes paragraphs 15, 16 and 26 of AS 22 referred by the querist in paragraph 9 above and paragraphs 17 and 18 thereof which provide as below:

> "***15. Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.***
>
> 16. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future.
>
> ***17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.***

18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

"***26. The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available."***

12. The Committee notes from the Facts of the Case that the company has unabsorbed depreciation and carried forward losses as on 31st March, 2009. Accordingly, in the view of the Committee, the provisions contained in paragraph 17 of AS 22 instead of paragraphs 15 and 16 thereof shall apply to the present case. Thus, deferred tax asset in the present case, can be retained and carried forward only to the extent there is virtual certainty, supported by convincing evidence (rather than mere reasonable certainty), that sufficient future taxable income would be available against which such deferred tax assets can be realised.

13. The Committee further notes that AS 22 notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, contains, inter alia, an Explanation to paragraph 17 thereof regarding virtual certainty (which was hitherto contained in the consensus portion of Accounting Standards Interpretation (ASI) 9, Virtual certainty supported by convincing evidence, issued by the Institute of Chartered Accountants of India), which provides as below:

"Explanation:

> ***1. Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement based on convincing evidence and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence."***

14. On the basis of the above, the Committee is of the view that the confirmed orders secured by the company upto the reporting date, i.e., as on March 31, 2009 can only be considered while creating deferred tax asset provided these are binding on the other party and it can be demonstrated that they will result in future taxable income. However, mere projections made by the company indicating the earning of profits from future orders and upward trend in power sector, or submission of financial restructuring proposal to the Government of India or allocation of funds under APDRP, or the fact that the books of account of the company are prepared on 'going concern' basis, as mentioned by the querist, can not be considered as convincing evidence of virtual certainty as contemplated in the 'Explanation' to paragraph 17 of AS 22 reproduced above. These may, at best, indicate a 'reasonable certainty' of future profitability. Further, the mere fact that unabsorbed depreciation can be carried forward for unlimited number of years, as mentioned by the querist in paragraph 5 above, can also not be a ground for recognising a deferred tax asset since paragraph 17 of AS 22 read with its 'Explanation', requires virtual certainty supported by convincing evidence at the date of the balance sheet. The Committee also wishes to point out that a deferred tax asset can be created to the extent future

taxable income will be available from future reversal of any deferred tax liability recognised at the balance sheet date. To that extent, it would not be necessary to consider the level of virtual certainty supported by convincing evidence.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the company should retain deferred tax assets in its books only to the extent it is virtually certain, supported by convincing evidence, as on the date of the balance sheet, that sufficient future taxable income would be available against which such deferred tax assets can be realised. Factors to be taken into account for determining 'virtual certainty' are discussed in paragraph 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.