COMPENDIUM OF
OPINIONS

Volume XXXVII

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

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(This thirty seventh volume contains opinions finalised between February 12, 2017 and February 11, 2018. The opinions finalised upto September 1981 are contained in Volume I. The opinions finalised thereafter upto February 11, 2017 are contained in Volumes II to XXXVI.)

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Foreword

Financial reporting conveys to the stakeholders, a depiction of an entity's critical financial information, including assets, liabilities, income, expenses, etc. Financial reporting requires preparation of financial statements in accordance with generally accepted accounting principles (GAAPs). The users of financial statements often feel the need of interpreting GAAPs including Accounting Standards, Ind ASs, Guidance Notes, Pronouncements issued by ICAI, etc. for applying and implementing them in relevant situations. GAAPs are ever evolving with constant changes in the world of accounting. These changes and evolvements sometimes bring complexities, involving diverse interpretations and application of individual judgements, thus exposing unseen challenges. An authoritative and accurate guidance is indispensable at such an hour.

The Council of the Institute has constituted the Expert Advisory Committee to offer the requisite and appropriate guidance to the members of the Institute when challenged with strenuous issues on accounting and/or auditing principles. The Committee came into being in the year 1975 and since then, has been consistently providing independent and objective guidance in the form of opinions to the members of the Institute. Over the period, the role of the Committee has also been acknowledged by various Regulatory and Government authorities, such as, Ministry of Corporate Affairs (MCA), Security and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), etc. when these are posed with intricate accounting issues.

With an intention to promulgate the enormous knowledge and research contained in the opinions issued by the Committee, the volumes of Compendium of Opinions are issued from time to time. These Volumes act as a quick reference guide for multiple accounting issues faced by the accounting professionals. It gives me extreme delight to congratulate CA. Babu Abraham Kallivayalil, Chairman, CA. M.P. Vijay Kumar, Vice-Chairman and all members of the Committee for bringing out this Volume.

I am sure that like all the previous volumes, this Volume of Compendium of Opinions will also be of great relevance and significance to the members of the profession and others concerned.

New Delhi
December 16, 2020

CA. Atul Kumar Gupta
President

Preface

The Expert Advisory Committee (EAC) is absolutely delighted in presenting the thirty seventh Volume of 'Compendium of Opinions'. This volume of the Compendium of Opinions contains opinions that were finalised by the Committee in the Council Year 2017-18 under the able guidance of CA. Nihar Niranjan Jambusaria, the then Chairman of the Committee. As the Chairman of the EAC during this Council Year (2020-21), it is a matter of great delight that we have been able to issue our opinion timely with no backlog.

This Volume is a compilation of various opinions on diversified subjects relating to accounting and auditing principles. Some of the noteworthy and pertinent topics issued by the Committee are as follows:

- Treatment of contribution to Settlement Guarantee Fund under Ind AS;
- Treatment of financial liability under Ind AS 32 and Ind AS 109;
- Amortisation of goodwill in respect of subsidiaries and jointly controlled entities;
- Treatment of investments in units of equity and debt mutual funds under Ind AS 109;
- Treatment of disputed Principal and Interest in respect of cases pending before regulatory authorities;
- Classification of grant related to assets in the statement of cash flows;
- Recognition and valuation of Carbon Emission Reductions (CERs);
- Accounting treatment of temporary income in relation to construction contract;
- Accounting for software income;
- Amortisation of expenses incurred on business requirements at the time of formation;
- Making provision for non-approved cost;
- Accounting treatment of CWIP held on behalf of GoI and funds received from the GoI;

- Accounting treatment of amount invested in LIC's leave encashment plan;
- Consideration of Capital Reserve, Risk Fund & Reserve for calculation of Net Worth;
- Recognition of DTL on Special Reserve created for deduction u/s 36(1)(viii) of the IT Act.

It may be noted that the opinion or views expressed by the EAC represent the opinion or views of the members of the Committee and not the official opinion of the Council. The opinions are finalised by the Committee based on the facts and circumstances of the query as supplied by the querist, the relevant laws and statutes, and the applicable accounting/auditing principles prevailing on the date on which a particular opinion is finalised. The date of finalisation of each opinion is indicated along with the respective opinion. The opinions must, therefore, be read in the light of any amendments and /or developments in the applicable laws/statutes and accounting/auditing principles subsequent to the date of finalisation of the opinions.

EAC answers the queries as per the Advisory Service Rules framed by the Council which are available on the website of the Institute.

All Volumes of the Compendium of opinions are available under a single link on the website of the Institute with advance search facility. Opinions on any subject can be accessed by inserting the relevant key words. EAC opinions are also available of the Digital learning platform of the Institute. We are sure these features are a great advantage to our members are other stake holders.

We recollect with gratitude the able guidance and support to the Committee by CA. Atul Kumar Gupta, President, ICAI and CA. Nihar Niranjan Jambusaria Vice-President, ICAI. I wish to place on record the unstinted support extended by CA. M. P. Vijay Kumar Vice-Chairman EAC without whose active involvement, we would not have been able to issue our opinions promptly. We would like to acknowledge the tireless efforts and great expertise contributed by all the members and special invitees of the Expert Advisory Committee both past and present in finalization of opinions. I wish to sincerely thank Council Colleagues in the Committee, viz Shri Chandra Wadhwa (Government Nominee), CA. Tarun Jamnadas Ghia, CA. G. Sekar, CA. Anuj Goyal, CA. Dheeraj Kumar Khandelwal, CA. (Dr.) Debashis Mitra, CA. Prakash Sharma, CA. Prasanna Kumar D.,

CA. Satish Kumar Gupta, CA. Pramod Jain, CA. (Dr.) Sanjeev Kumar Singhal, CA. Hans Raj Chugh, and CA. Dayaniwas Sharma. We are privileged to have Ms. Ritika Bhatia, Director Commercial of C&AG as part of the Committee.

I am also thankful to the Co-opted members and Special Invitees of the Committee, viz., CA. Nilesh S. Vikamsey (Past President, ICAI), CA. (Dr.) Girish Ahuja, CA. Vivek Newatia, CA. Piyush Agrawal, CA. Venkateswarlu S., CA. Siddharth Jain, CA. Mohit Bhuteria, CA. Navneet Mehta, CA. Venugopal C. Govind and CA. K. Vishwanath for their whole-hearted support in the activities of the Committee.

I acknowledge the untiring efforts and committed support of CA. Parul Gupta - Secretary EAC, who ensured efficient and smooth disposal of queries in a timely manner. She along with CA. Vidhyadhar Kulkarni, Head, Technical Directorate, and CA. Khushboo Bansal, Sr. Executive Officer were instrumental in presenting the drafts for the consideration of the Committee and thereafter finalising it as per the decisions of the Committee.

Hope this volume will be of immense benefit to professional colleagues and other stake holders in resolving complicated issues in accounting and auditing.

New Delhi
December 14, 2020

CA. Babu Abraham Kallivayalil
C*hairman*
Expert Advisory Committee

Contents

PART I:
Opinions on Indian Accounting Standards

Query No. 1

Subject: Treatment of contribution to Settlement Guarantee Fund/Core Settlement Guarantee Fund in consolidated financial statements under Ind AS.[1]

A. Facts of the Case

1. ABC Ltd. (hereinafter referred to as the 'company') is a recognised stock exchange and offers trading services in equity, equity derivatives, debt and currency derivatives segments in India. DEF Ltd. is a wholly owned subsidiary of ABC Ltd. and is a recognised clearing corporation which carries out the clearing and settlement activities in respect of the trades executed in various market segments of ABC Ltd., such as, cash market, futures & options and currency derivatives.

2. On June 20, 2012, Securities Exchange Board of India ('SEBI') notified the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 ('the Regulations') to regulate recognition, ownership and governance in stock exchanges and clearing corporations in India. The said 'Regulations', inter alia, stated the following:

> **"39 Fund to guarantee settlement of trades**
>
> (1) Every recognised clearing corporation shall establish and maintain a Fund by whatever name called, for each segment to guarantee the settlement of trades executed in respective segment of a recognised stock exchange.
>
> (2)…
>
> (3)…
>
> (4)…
>
> (5) In the event of a clearing member failing to honour his settlement obligations, the Fund shall be utilised to complete the settlement.
>
> (6) The corpus of the Fund shall be adequate to meet the settlement obligations arising on account of failure of clearing member(s).

[1] Opinion finalised by the Committee on 23.8.2017.

(7) The sufficiency of the corpus of the Fund shall be tested by way of periodic stress tests, in the manner specified by the Board."

3. The Regulations required, inter alia, every recognised stock exchange to transfer 25% of its annual profits every year to a fund (Settlement Guarantee Fund ('SGF')) maintained by the recognised clearing corporation (subsidiary of the stock exchange), which clears and settles trades executed on that stock exchange. In order to guarantee settlement of trades, the Regulations required such recognised clearing corporation to establish and maintain a Fund, for each market segment, to guarantee the settlement of trades executed in respective segment of a recognised stock exchange.

4. The Regulations also required a recognised stock exchange to transfer its required SGF contribution to a recognised clearing corporation which carries out the clearing and settlement functions of the stock exchange. The SGF will be utilised by the recognised clearing corporation to settle the obligations in the event of a default by a clearing member i.e., clearing member failing to honor its settlement obligations (i.e., trading defaults/losses).

5. After the notification of the Regulations, SEBI in its Press Release No. 66/2012 dated June 21, 2012, announced the formation of an expert committee to look, inter alia, into matters relating to feasibility of a single clearing corporation or interoperability among multiple clearing corporations and the operational aspects of the same, norms for utilization of profits and investments by recognised clearing corporations and norms for adequacy of the core corpus of the SGF and its sourcing, including transfer of profits by stock exchanges to the SGF in the long run.

6. Subsequently, on August 27, 2014, SEBI, *vide* its circular no. CIR/MRD/DRMNP/25/2014, issued granular norms relating to *Core Settlement Guarantee Fund ('Core SGF')*, stress testing and default procedures to bring greater clarity and uniformity as well as to align with international best practices while enhancing the robustness of the present risk management system in the clearing corporations. (Copy of the Circular has been furnished by the querist for the perusal of the Committee). These norms are aimed at achieving mainly the following objectives:

(a) create a core fund (called core settlement guarantee fund), within the SGF, against which no exposure is given and which is readily and unconditionally available to meet settlement obligations of clearing corporation in case of clearing member(s) failing to honour settlement obligation,

(b) …

(c) …

(d) harmonise default waterfalls across clearing corporations,

(e) …

(f) ring-fence each segment of clearing corporation from defaults in other segments, and

(g) bring in uniformity in the stress testing and the risk management practices of different clearing corporations especially with regard to the default of members.

7. As can be observed, the norms mentioned in paragraph 6 above amongst various matters related to stress testing and default waterfalls, *also* aimed to create a core fund namely the Core Settlement Guarantee Fund (Core SGF) *within the SGF* (emphasis supplied by the querist). Further, as stipulated, no exposure is to be given and the fund is readily and unconditionally available to meet settlement obligations of clearing corporation in case of clearing member(s) failing to honor settlement obligations.

8. As per the Circular cited in paragraph 6 above, the clearing corporation (CC) shall have a fund, called Core SGF, for each segment of each recognised stock exchange (SE) to guarantee the settlement of trades executed in respective segment of the stock exchange. In the event of a clearing member failing to honor settlement commitments, the Core SGF shall be used to fulfill the obligations of that member and complete the settlement without affecting the normal settlement process.

9. The corpus of the fund should be adequate to meet out all the contingencies arising on account of failure of any member(s). The risk or liability to the fund depends on various factors such as trade volume, delivery percentage, maximum settlement liability of the members, the history of defaults, capital adequacy of the members, the degree of safety measures employed by the CC/SE etc. A fixed formula, therefore, cannot be prescribed to estimate the risk or liability of the fund. However, in order to assess the

fair quantum of the corpus of Core SGF, CC should consider the following factors:

- Risk management system in force
- Current and projected volume/turnover to be cleared and settled by the CC on guaranteed basis
- Track record of defaults of members (number of defaults, amount in default)

10. As per the circular cited in paragraph 6 above, the contributions of the following three contributors to Core SGF in respect of any market segment shall be as follows:

(a) **Clearing Corporation (DEF Ltd.) contribution**: Contribution to Core SGF shall be at least 50% of the Minimum Required Corpus (MRC). This contribution will be made by clearing corporation from its own funds.

(b) **Stock Exchange (ABC Ltd.) contribution**: Stock Exchange contribution to Core SGF shall be at least 25% of the MRC. This can be adjusted against transfer of profit by Stock Exchange under SGF (see paragraph 3 above).

(c) **Clearing Member primary contribution**: Total contribution from clearing members shall not be more than 25% of the MRC. Further, clearing corporation shall have the flexibility to collect contribution from clearing members either upfront or staggered over a period of time. In case of staggered contribution, the remaining balance shall be met by Clearing Corporation to ensure adequacy of total Core SGF corpus at all times. Such Clearing Corporation contribution shall be available to the Clearing Corporation for withdrawal as and when further contributions from clearing members are received.

11. The management of Core SGF and access to the same are as follows:

- The Defaulter's Committee/SGF utilisation Committee of the Clearing Corporation shall manage the Core SGF.
- The CCs shall follow prudential norms of Investment policy for Core SGF corpus and establish and implement policies and procedures to ensure that Core SGF corpus is invested in highly

liquid financial instruments with minimal market and credit risk and is capable of being liquidated rapidly with minimal adverse price effect.

- The instruments in which investments may broadly be made are Fixed Deposit with Banks (only those banks which have a net worth of more than INR 500 Crore and are rated A1 (or A1+) or equivalent, Treasury Bills, Government Securities and money market/liquid mutual funds subject to suitable transaction/ investment limits and monitoring of the same. The CCs shall further ensure that the financial instruments in which the Core SGF corpus is invested remain sufficiently diversified at all times.
- SEBI may prescribe the investment norms in this regard from time to time.
- CC may utilise the Core SGF in the event of a failure of member(s) to honour settlement commitment.

12. Subsequently, SEBI, in its Circular No. SEBI/HO/MRD/DRMNP/ CIR/2016/54 dated May 4, 2016, notified that the amounts carried forward in the 'Provisions' in respect of the period up to March 31, 2015 shall be transferred by the Stock Exchange to the Core SGF maintained by the Clearing Corporation within one month of the date of issuance of the said Circular and that the amounts in respect of the period from April 1, 2015 till the date of amendment of the Regulation 33 of the Regulations shall be transferred within such time as to be specified by SEBI. (Copy of the Circular has been furnished by the querist for the perusal of the Committee).

13. Further, as per the Circular cited in paragraph 12 above, "the unutilized portion of contribution made by the stock exchange towards the Core SGF, for any segment(s), maintained by the Clearing Corporation, as available with the Clearing Corporation, shall be refunded to the stock exchange, in case the stock exchange decides to close down its business or decides to avail the clearing and settlement services of another Clearing Corporation for that segment(s), subject to its meeting all dues of the clearing corporation". In the latter case, the stock exchange will have to transfer such amount to another clearing corporation.

14. In ABC Ltd's standalone financial statements, the company records the contribution to the Core SGF as an item of expenditure by debiting the

same to the statement of profit and loss based on the understanding stated below:

(1) The sum of money paid by the Stock Exchange to the Core SGF of the Clearing Corporation is something which has irreversibly and irretrievably gone out of the control of the Stock Exchange.

(2) Thus, whatever corpus is available with the Fund, it is completely ring-fenced at all times with both the contributing parties, namely, the Stock Exchange and the Clearing Corporation permanently and irrevocably losing their entire domain and control over the funds contributed by them.

(3) Also, in the Regulations and the SEBI's Circular, there is no mechanism by which any contribution made to the Core SGF can come back to the contributors- whether the contribution is made by the Stock Exchange or the Clearing Corporation, except on closure of business as mentioned above.

(4) Another significant feature of the SEBI's Circular is that the MRC of Core SGF mentioned in paragraph 10 above can only go up and can never be lower than the high water mark reached. To illustrate, if the high water mark is Rs. 100 reached in (say) February 2015 and Rs.20 is utilized in the month of March 2015, then not only the utilization has to be made good but if the MRC is determined at, say, Rs.103 in the next month not only would Rs. 20 be required to be contributed to make up for the utilization but Rs 3 added to bring it up to the level determined by applying the norms prescribed in the Circular.

(5) More pertinently, though the SEBI's Circular dated May 4, 2016 contemplates a refund if and when a stock exchange closes down its business; but that is a contingency which arises at the time when its business is closed and not when it is *a going concern*.

(6) In any event, it is SEBI which is the deciding and paramount authority as to the amount, contributions, investment, utilization and use of the Core SGF.

(7) The establishment, administration and management of the Core SGF is in due compliance with the SEBI directives with all the

substantive powers such as deciding the structure, the purpose, the composition and contribution, investment of the funds as well as the utilization of the funds etc. lying fully with SEBI, including giving various directives, as SEBI deems it appropriate, from time to time.

(8) In view of the above, the Core SGF is considered and disclosed as a separate Fund, independent of its contributing entities and their own funds, in the financial statements. This is considered to be befitting and ascribed as a matter of accounting prudence and conservatism, ABC Ltd. has been charging the contribution made to the Core SGF to its statement of profit and loss in both the standalone and consolidated financial statements.

15. The Central Board of Direct Taxes ('the CBDT') has notified the Core SGF set up by DEF Ltd., under clause (23EE) of section 10 of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'). Under clause (23EE) of section 10 of the Act, income by way of contributions received from a recognised stock exchange, a recognised Clearing Corporation and the members thereof are exempt from taxation. Further, any specified income of such Core SGF set up by a recognised clearing corporation in accordance with the Regulations is also exempt from tax under clause (23EE) of section 10 the Act. As per the above Income-tax regulations:

— The amount of contributions received and related income accumulated in the Core SGF in DEF Ltd.'s financial statements from contributions made by ABC Ltd. and members will be exempt from current taxation;

— DEF Ltd.'s own contribution into the Core SGF is tax deductible in DEF Ltd.'s standalone financial statements; and

— The SGF contribution paid by ABC Ltd. to DEF Ltd. towards Core SGF is allowed as a current tax deduction in ABC Ltd.'s standalone financial statements.

16. The querist has separately clarified the following:

(i) CBDT has specifically notified the Core SGF set up by DEF Ltd. under clause (23EE) of section 10 of the Act. The purpose and the idea of notifying the Core SGF, according to the querist, specifically appears to be with a purpose of treating it as a separate entity independent and regardless of where it is created and who are its contributors. This understanding gets further affirmed by the fact that the Finance Act, 2017 has stipulated that every notified Core SGF is required to obtain a separate PAN and also to file a separate return of income, again independent and regardless of where it is created and who are its contributors.

(ii) It is mandatory to maintain Core SGF as per SEBI guidelines as long as DEF Ltd. continues to carry on business as a Clearing Corporation and ABC Ltd. carries on the business as Stock Exchange. In other words, the clearing corporation and stock exchange would stand to lose their recognition by SEBI, if Core SGF Fund is closed. Hence, on a going concern basis, Core SGF cannot be closed. More importantly, though the SEBI circular dated May 4, 2016 contemplates a refund, if and when a stock exchange closes down its business, such closure is a contingency. However, till such time the Stock Exchange and /or the Clearing Corporation continues to carry on its business as a going concern, the contributions made by them to the corpus of the Core SGF cannot come back, once contributed.

(iii) Since currently Core SGF is not a separate legal entity, the investments are held in the name of DEF Ltd. This is especially so, since, it is a regulatory requirement to provide KYC documents, especially PAN, for such investments. While this was the situation till March 2017, going forward, post the obtaining of a separate PAN, a possibility is being explored to hold the investments pertaining to the Core SGF directly in the name of Core SGF. Nevertheless, even today, all the funds pertaining to Core SGF are maintained in separate bank account designated for the Core SGF in the books of the clearing corporation. All investments/redemptions pertaining to the funds of Core SGF are carried out from the designated bank account only. Also, all investments/funds pertaining to Core SGF are not only identified separately for accounting purposes but are also disclosed separately in the financial statements of the clearing Corporation. This is mainly due to the fact that Core SGF is completely ring-fenced at all times with all the contributing parties permanently and irrevocably losing domain and control over the funds contributed by them.

(iv) According to the default waterfall mechanism prescribed in SEBI's Circular mentioned in paragraph 6 above, in case where the Core SGF is not sufficient to meet the settlement default, then, resources of the Clearing Corporation may be utilised only with the approval of SEBI. However, there is no such requirement for Stock Exchange. Accordingly, the resources available with DEF Ltd. may have to be utilised (post and as approved by SEBI) in the event the amounts available with Core SGF are not sufficient to meet the settlement default. However, it is important to note that ABC Ltd. is not required to utilise any of its own resources over and above the contributions already made by ABC Ltd. to the Core SGF.

(v) The entire domain and control regarding Core SGF is with SEBI. Further, once the contributions are made to the Core SGF, the contributors completely lose domain and control over the funds and the amount contributed to the Core SGF can only be utilised for the object of the fund and cannot be utilised for any other purpose. It may, therefore, as per the querist, be considered that the Clearing Corporation manages the Core SGF in a fiduciary capacity only. It has absolutely no discretion/authority of its own to manage, utilise, invest, divest, etc. It has to strictly follow the guidelines issued by SEBI from time to time. In other words it is merely carrying out the activities, administratively, with regard to Core SGF on behalf of SEBI.

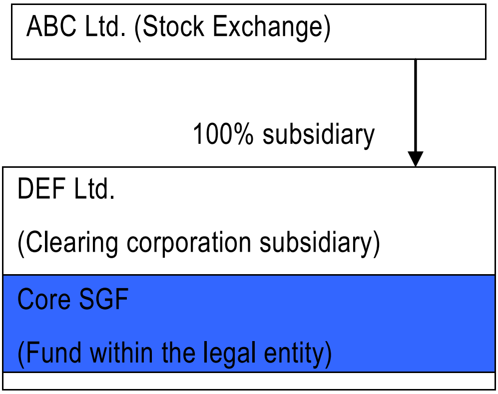
17. As per the querist, there can be two treatments for the contribution to SGF/Core SGF in the consolidated financial statements prepared under Indian Accounting Standards (Ind AS) as described in paragraphs 18 and 19 below.

18. *Option I*:

- In ABC Ltd's standalone financial statements, the company records the contribution to the Core SGF as an item of expenditure by debiting the same to the statement of profit and loss based on the understanding stated in points (1) to (8) mentioned in paragraph 14 above.

- With the same principles and understanding, the contribution towards the SGF/Core SGF is recorded as an expense in ABC Ltd.'s standalone Ind AS financial statements, as such amount meets the definition of 'provision' under Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets', based on the following:
  - — there is a present obligation (legal/statutory) to transfer 25% of profits to the Core SGF maintained in another legal entity – DEF Ltd., a subsidiary of ABC Ltd.;
  - — it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation by paying to DEF Ltd. (cash moves out from ABC Ltd. to DEF Ltd.); and
  - — reliable estimate can be made of the amount.
- As per the Regulations, the unutilized portion of contribution into the Core SGF shall be refunded to the stock exchange only on closure of business or if stock exchange decides to avail the clearing and settlement services of another clearing corporation. In the latter case, the stock exchange will have to transfer such amount to another Clearing Corporation. The refund event i.e., winding up operations/changing Clearing corporation (i.e., DEF Ltd. in this case) is not considered virtually certain. Accordingly, no contingent asset shall be recognised.
- The above expense recorded in ABC Ltd.'s standalone financial statements is not eliminated and continues to be recorded as an expense in ABC Ltd.'s consolidated financial statements also (including presentation as Core Settlement Guarantee Fund balance in the consolidated balance sheet separately between equity and liability – a mezzanine presentation). This is based on the premise that the contribution to the Core SGF is regulatory in nature and has restricted use and purpose i.e., the amounts of the Core SGF can be utilised for settling the obligations in the event of a default by clearing member/clearing member failing to honor its settlement obligations (trading defaults/losses).
- Also, the company has lost its domain and control over the Fund unless it is assumed that the company is not a going concern (i.e., funds are refunded to the company on closure of business).

- Both ABC Ltd.'s and DEF Ltd.'s contributions accumulated in the Core SGF balance will be presented as Core Settlement Guarantee Fund balance separately between equity and liability i.e., mezzanine presentation on ABC's consolidated balance sheet.



19. *Option II*:

a) Under Ind AS 110, 'Consolidated Financial Statements', consolidated financial statements are prepared keeping in view the economic entity model. This requires recording of assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries as those of a *single economic entity*.

b) Based on the above, intra-group transactions are to be eliminated in consolidated financial statements. In this regard, since ABC Ltd., DEF Ltd. and the Core SGF fund are all part of the consolidated ABC Group (in accordance with all requirements of Ind AS 110), in ABC's consolidated financial statements, the SGF contribution expense recorded by ABC Ltd. in its standalone financial statements paid/payable to DEF Ltd.'s Core SGF should be eliminated against the corresponding credit balance of Core Settlement Guarantee Fund recorded by DEF Ltd. in its standalone financial statements. This intra-group transaction does not survive in the consolidated financial statements as:

1) it is not an expense and liability to an entity outside the consolidated ABC Group;

2) there exists no present obligating event relating to

member losses on account of settlement obligations at the reporting date (trading defaults/losses) for which any provision is required. Consequently, the current liability pertaining to any such contributions payable by ABC Ltd. towards the Core SGF maintained within DEF Ltd. and appearing in ABC Ltd.'s standalone financial statements should also get eliminated in the consolidated financial statements of ABC Group. There should not be an expense or a liability payable to a consolidated entity within the Group as per Ind AS 110. This accounting in the consolidated financial statements will also be consistent with the accounting followed by DEF Ltd. in its standalone financial statements in respect of DEF Ltd.'s own share of contribution towards the Core SGF. DEF Ltd. records such contributions as an appropriation from reserves (and not an expense), since, the Core SGF is a fund within the legal entity DEF Ltd. (the Core SGF Fund is not a separate legal entity). DEF Ltd.'s accounting in its standalone financials statements is considered appropriate under Ind AS.

c) It is also to be noted that under Ind AS, a credit balance on the balance sheet would either be classified as equity (see Ind AS 32, 'Financial Instruments: Presentation') or as a liability (see Ind AS 32, Ind AS 109, 'Financial Instruments' and Ind AS 37). There is no conceptual basis to present an item on the balance sheet between equity and liability (mezzanine) under Ind AS. For example, under Ind AS, minority interest which could have earlier been presented as a mezzanine item on the balance sheet under previous Indian GAAP, is required to be presented as non-controlling interest within equity under Ind AS.

Thus, ABC Ltd. has charged the contribution made to Core SGF to the statement of profit and loss and also reported and disclosed the Core SGF separately in its consolidated financial statements with the understanding that the Core SGF is regulatory in nature and the amount pertaining to Core SGF is required to be ring-fenced at all times from its contributors. Also, on a going concern basis, the amount contributed to the Core

SGF has irreversibly and irretrievably gone out of the control of the contributors. Both ABC Ltd. and DEF Ltd. have lost domain and control over the funds once contributed by them to the Core SGF. Further, as stated above, all the powers related to the establishment, management and administration of Core SGF and deciding on the structure, contribution, composition, investment etc. lie solely with SEBI.

There are two matters which merit attention here in relation to deferred tax accounting under Option II described in (d) and (e) below.

d) ABC Ltd. is allowed current tax benefit in its standalone financial statements in respect of the SGF contribution expense recorded in its standalone financial statements. Since, this expense gets reversed and credited in the consolidated profit and loss, ABC Ltd. will record a corresponding deferred tax liability to the extent of related current tax benefit in the consolidated financial statements. This deferred tax liability will get reversed either if and when trading settlement defaults/losses occur and to the extent it is in respect of the said losses, the same is recognised as an expense in the consolidated statement of profit and loss (as at that time there will be no tax deduction available for such expense) or when ABC Ltd. discontinues business and the contributions are refunded to ABC Ltd. resulting in taxable income.

e) DEF Ltd. is also allowed current tax benefit in its standalone financial statements. Based on conclusion in (d) above in case of ABC Ltd., a deferred tax liability will also be recorded for DEF Ltd.'s own contribution toward Core SGF. This deferred tax liability will get reversed either if and when and trading settlement defaults/losses occur and to the extent it is in respect of the said losses, the same is recognised as an expense in the consolidated statement of profit and loss (as that time there will be no tax deduction) or when DEF Ltd. discontinues business at which time such amounts become taxable.

Based on the above, accounting treatment under Option II is as described in (f)-(j) below:

f) Core SGF expense recorded in ABC Ltd.'s separate financial statements pertaining to its contribution paid to its subsidiary DEF Ltd. towards the Core SGF will get eliminated on consolidation (being an intra-group transaction);

g) Both ABC Ltd.'s and DEF Ltd.'s contributions into Core SGF will be presented as a special reserve and restricted cash/investments separately in the consolidated financial statements. There would be an explanatory note in the financial statements that such special Core SGF reserve/funds can be used for specified/restricted purposes (resulting in alignment of accounting policies within the ABC group);

h) Core SGF contributions received from clearing members will continue to be presented as current liability (as the amounts are refundable on demand) and amounts invested from such contributions will be presented as restricted cash/investments.

i) Upon recognition of expense in the consolidated financial statements, similar amounts will be appropriated back from the special reserve to free reserve (both within equity).

j) Deferred tax liability will be recorded in consolidated financial statements of ABC group and DEF Ltd.'s standalone financial statements to the extent of current tax benefit availed (see (g) and (h) above).

B. Query

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

(i) Whether the accounting for contribution to Settlement Guarantee Fund/Core Settlement Guarantee Fund in the consolidated financial statements of the company ABC Ltd. as a charge to the statement of profit and loss will be correct and consistent with the accounting mentioned in Option I above.

(ii) In case the answer to (i) above is in the negative, then, whether the company can follow the accounting as explained under Option II above i.e., elimination of expense related to contribution to SGF/Core SGF by ABC Ltd. to its subsidiary DEF Ltd. in the consolidated financial statements of ABC Ltd. under Ind AS.

C. Points considered by the Committee

21. The Committee notes that the basic issue raised in the query pertains to treatment of the contributions made by ABC Ltd. (hereinafter referred to as the 'company'/ 'Stock Exchange') to SGF/Core SGF in line with the Regulations prescribed by SEBI in the consolidated financial statements of the company in the context of Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, treatment of contributions in the financial statements of DEF Ltd. (hereinafter referred to as the 'subsidiary'/'Clearing Corporation'), accounting for the company's share of income of the SGF/Core SGF, if any, determination of the amount to be contributed to SGF/Core SGF, legal interpretation of and compliance with SEBI's Circulars and provisions of Income-tax Act, 1961, current and deferred tax accounting, etc. The Committee expresses its views purely from accounting angle. The Committee notes that the querist has made references to contributions to both SGF/Core SGF and makes reference to 'ring-fencing' in the case of Core SGF, which is mentioned as 'Fund within SGF'.

22. The Committee notes that the SEBI is the regulatory authority for the company, which is a recognised Stock Exchange and its subsidiary which is a recognised Clearing Corporation in the extant case and that the SEBI has prescribed the Regulations and issued some Circulars applicable for the company and its subsidiary, certain features of which are as follows:

(i) The company is required to transfer 25% of its annual profits every year to the SGF maintained by its subsidiary, which is a Clearing Corporation. The SGF will be utilised by the recognised Clearing Corporation to settle the obligations in the event of a default by a clearing member i.e., clearing member failing to honor its settlement obligations (i.e., trading defaults/losses). The Committee notes that the legal requirement of contributing 25% of profits was subsequently amended to be subject to SEBI's directions as may be specified from time to time.

(ii) The company, its subsidiary and members of the clearing corporation are required to contribute to MRC of the Core SGF maintained by the subsidiary, which is a Clearing Corporation.

The sufficiency of the corpus of the Fund shall be tested by way of periodic stress tests prescribed.

(iii) The company's contribution to Core SGF can be adjusted against transfer of profit by it under SGF (see (i) above).

(iv) Against the Core SGF, no exposure is given. The Core SGF is readily and unconditionally available to meet settlement obligations of Clearing Corporation in case of clearing member(s) failing to honour settlement obligation. The Core SGF is for each segment of the subsidiary, which is ring-fenced from defaults in other segments.

(v) While the management of the Core SGF rests with the Defaulter's Committee/SGF utilisation Committee of the subsidiary, it is fully in compliance with the directives issued by SEBI. SEBI is the deciding and paramount authority as to the amount, contributions, investment, utilisation and use of the Core SGF.

(vi) Unutilised portion of contributions made by the company to the Core SGF for any segment(s) will be refunded to the company only when the company decides to close down its business or decides to avail the clearing and settlement services of another Clearing Corporation for that segment(s).

From the above features of the Regulations and the Facts of the Case provided by the querist, the Committee notes that Core SGF is a Fund maintained by the company's subsidiary and is managed by a committee of the subsidiary fully in compliance with the directives of SEBI. The Core SGF is regulatory in nature and is available for restricted use and purpose. The company is required to make mandatory transfer to the Fund. The amount contributed to the Fund goes out of the control of the company. It is not refundable to the company so long it remains as a going concern. The possible event of closure of business resulting in refund from the Fund should be disregarded on 'going concern' considerations. Similarly, the possible switch over to another clearing corporation resulting in refund from the Fund is a future contingency to be disregarded. MRC is computed on a monthly basis considering all relevant factors, reflecting the quantum of risk involved.

23. From the above, the Committee is of the view that the company's contribution to the Fund represents its share of expenditure in meeting a statutory obligation. Hence, contribution to the Fund should be expensed in its stand-alone financial statements. Consequently, the said expense should be included in its consolidated financial statements also. This expense cannot be eliminated in the consolidated financial statements.

D. Opinion

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

(i) Option of accounting for the company's contribution to Settlement Guarantee Fund/Core Settlement Guarantee Fund in the consolidated financial statements of the company i.e., ABC Ltd., as a charge to the (consolidated) statement of profit and loss will be correct.

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

Query No. 2

Subject: Treatment of financial liability under Ind AS 32 and Ind AS 109.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a special purpose vehicle incorporated by consortium of (i) ABC Ltd., an ABC Group listed company (ii) XYZ Authority, a Government of Maharashtra undertaking and (iii) GEF Ltd. (technology partner).

2. Equity share capital of the company is Rs. 512 crore, held by the members of consortium as under:

ABC Ltd. – 69%

XYZ Authority – 26%

GEF Ltd. – 5%

[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

3. The company was awarded the responsibility to undertake the design, construction, operation and maintenance of the Mass Rapid Transit System (MRTS) for the Versova – Andheri - Ghatkopar corridor in Mumbai. XYZ Authority, on 7th March, 2007 granted the company a concession for a period of 35 years, for the exclusive rights to construct, operate and charge fares to users of the Mumbai Metro in accordance with the provisions of the concession agreement, at the end of which the company must transfer the rights, title and interest in the Mumbai Metro Project assets, in a serviceable condition, free of encumbrances to XYZ Authority.

4. The construction of the Metro Rail Project was completed and its commercial operations had commenced on 8th June, 2014. The project is fully operational since then.

5. Original project cost was estimated at Rs. 2,356 crore. However, due to delays, the project completion cost was escalated to Rs. 4,026 crore. The increase of Rs. 1,670 crore was financed by ABC Ltd. and a consortium of banks jointly.

6. As per agreed terms with the consortium of banks, ABC Ltd. was required to bring in funds towards promoter's share in increase in the project cost by way of interest free subordinated-debt (sub-debt). Further, repayment of this sub-debt can be made only after repayment of entire Rupee term loans to consortium of banks. The installment repayments to consortium of banks are scheduled for next 22 years, till 2037.

7. The company has received Rs. 759 crore as interest free 'subordinated-debt' from ABC Ltd. till 31st March, 2016 to fund the project requirements. (Copy of audited financial statements for financial year (F.Y.) 2015-16 has been provided by the querist for the perusal of the Committee). The sub-debt is shown under 'Note 5 – Long Term Borrowings'.

8. The querist has stated that Indian Accounting Standards (Ind ASs) have come into effect from 1st April, 2016. The company being a subsidiary of ABC Ltd. is required to adopt the Ind ASs with effect from 1st April, 2016. Sub-debt, being a financial liability, is required to be accounted and disclosed as per the requirements of Indian Accounting Standard (Ind AS) 32, 'Financial Instruments: Presentation'. As mentioned earlier, sub-debt is interest free and repayable after repayment of entire Rupee term loans to consortium of banks, i.e., after 22 years. The querist has also separately clarified that subordinated debt is also non-convertible.

9. The following accounting treatment has been considered by the company in respect of accounting treatment of financial liability of Rs.759 crore received as interest free sub-debt from ABC Ltd. (parent/holding company) in the books of the company:

A. As at 31st March, 2015 (1st April, 2015), the amount of sub-debt received from ABC Ltd. aggregated Rs. 715 crore. The querist has fair valued the same on 31st March discounting the sub-debt based on the discounting rate applicable and accounted for the said sub-debt at fair value of Rs. 42.69 crore (as against the book value of Rs. 715 crore) since the amounts are estimated to be repayable only after 22 years. The company has passed the following entry to give effect to the fair valuation:

Date	Particulars	Debit	Credit
01/04/2015	Subordinate debt from ABC Ltd.	672.31 cr	
	To Contribution received (Other equity)		672.31 cr
	(Being fair value recognized as on 31st March, 2015)		

B. Thus, sub-debt is shown at a fair value of Rs. 42.69 crore at the beginning of the financial year (F.Y.) 2015-16. During the F.Y. 2015-16, a further sub-debt of Rs. 44 crore was received from ABC Ltd. in 2 installments, which was also fair valued as mentioned above and the following entries are passed to give effect of the fair valuation:

30/06/2015	Subordinate debt from ABC Ltd.	24.01 cr	
	To Contribution received (Other equity)		24.01 cr
	(Being fair value of Rs. 1.98 crores recognized as on 30th June, 2015 for additional 26 crores received from parent company)		

31/03/2016	Subordinate debt from ABC Ltd.	16.56 cr	
	To Contribution received (Other equity)		16.56 cr
	(Being fair value of Rs. 1.44 crores recognised as on 31st March, 2016 for additional 18 crores received from parent company)		

10. The querist has also accounted for the finance costs for the unwinding of fair value as on 31st March, 2015 (1st April, 2015); 31st March, 2016 and 30th June, 2016.

11. Presently, the difference in fair value of the subordinated debt and the book value is disclosed as 'Other equity' under the heading 'Equity'.

12. Further on the basis of additional information supplied by the querist it is observed that all financial liabilities classified as subsequently measured at amortised cost.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the above accounting treatment and presentation is in line with Ind AS 32 / Ind AS 109. Also whether there is any other way of presentation for the interest free sub-debt received from the parent company.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised by the querist relates to accounting treatment and presentation of interest free sub-debt from the holding company ABC Ltd. in the books of the company. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, e.g., accounting for term loan taken from the consortium of banks, discounting rate applicable for discounting the sub-debt for arriving at its fair value or amortised cost, taxation implications including deferred tax etc. At the outset, the Committee wishes to point out that the opinion expressed, hereinafter is in the context of financial statements for the financial year 2016-17 and it is presumed from

the Facts of the Case that the company has not voluntarily opted for preparation of financial statements from the financial year 2015-16. Thus, the date of transition to Ind ASs for the company as per the requirements of Ind AS 101, First-time Adoption of Indian Accounting Standards is 1.4.2015.

15. The Committee is of the view that based on the facts available in the extant case, the interest free sub- debt received by the subsidiary company from the holding company, which is repayable after 22 years, should be treated as a financial liability. Further, the Committee assumes that there are no other factors which will render the interest free sub debt into equity or compound financial instrument.

16. The Committee notes the requirements of Ind AS 109 and Ind AS 113 as follows:

Ind AS 109

"4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:

(a) ***financial liabilities at fair value through profit or loss.*** **Such liabilities, including *derivatives* that are liabilities, shall be subsequently measured at fair value.**

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities.

..."

5.1.1 [2]**At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.**

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[2] This paragraph has been subsequently revised vide Notification No. G.S.R. 310(E) dated 28th March, 2018.

5.1.1A However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A."

"B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and Ind AS 113). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset."

"B5.1.2A The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also Ind AS 113). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

(a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability."

Ind AS 113

"60 If another Ind AS requires or permits an entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the entity shall recognise the resulting gain or loss in profit or loss unless that Ind AS specifies otherwise."

"B4 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

(a) The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

(b) …"

From the above, the Committee notes that at initial recognition, financial liability is recognized at fair value (plus transaction costs, if any in case of financial liability not at fair value through profit or loss), which is normally the transaction price. However, where the transaction price of a financial liability is different from its fair value, such as, in case of interest free loan, the same has to be valued at fair value, which, as per above-reproduced paragraph B5.1.1, can be measured at the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Further, the subsequent measurement of such financial liability shall be at amortised cost and interest shall also be accrued in each reporting period, on such amortised cost calculated on the basis of effective interest rate.

17. With regard to the difference in the fair value at the initial recognition and transaction price, the Committee notes that paragraph 60 of Ind AS 113 states that if "the transaction price differs from fair value, the entity shall recognise the resulting gain or loss in profit or loss unless that Ind AS specifies otherwise." Further, paragraph B5.1.1 of Ind AS 109, reproduced above states that "if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset." From the above, the Committee is of the view that the difference in the fair value and transaction price should be recognized as gain or loss in the statement of profit and loss unless it qualifies for recognition as some other element. In this context, the Committee notes the definitions of 'Income' and 'Expense' as per the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards as follows:

> "70. The elements of income and expenses are defined as follows:
>
> (a) Income is increases 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) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."

The Committee notes from the above that income or expense is any increase or decrease in economic benefits during the accounting period, other than those relating to contributions from or distributions to equity participants, respectively. Thus, the transactions with equity participants cannot be recognized as income or expense; rather these should be recognized as equity. In the extant case, the interest-free debt is provided by the parent company in its capacity as equity participant and accordingly, the Committee is of the view that at the time of initial recognition and measurement of interest free subordinated loan provided by the holding company to the subsidiary, the difference between the transaction price and fair value should be recognized as equity contribution from the holding company rather than as an income or expense (profit or loss) and should be appropriately disclosed under 'other equity' in the financial statements considering the requirements of Schedule III to the Companies Act, 2013.

18. The Committee further notes the following paragraphs of Ind AS 101, First-time Adoption of Indian Accounting Standards, which states as follows:

> "6 An entity shall prepare and present an *opening Ind AS Balance Sheet* at the *date of transition to Ind ASs*. This is the starting point for its accounting in accordance with Ind ASs subject to the requirements of paragraphs D13AA and D22."
>
> | | |
> |---|---|
> | **"Date of transition to Ind ASs** | The beginning of the earliest period for which an entity presents full comparative information under Ind ASs in **first Ind AS financial statements."** (Appendix A to Ind AS 101) |
>
> **"7 An entity shall use the same accounting policies in its opening Ind AS Balance Sheet and throughout all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, except as specified in paragraphs 13–19 and Appendices B–D."**
>
> "9 The transitional provisions in other Ind ASs apply to changes in accounting policies made by an entity that already uses Ind ASs; they do not apply to a *first-time adopter*'s transition to Ind ASs, except as specified in Appendices B–D."
>
> "12 This Ind AS establishes two categories of exceptions to the principle that an entity's opening Ind AS Balance Sheet shall comply with each Ind AS:
>
> (a) paragraphs 14–17 and Appendix B prohibit retrospective application of some aspects of other Ind ASs.
>
> (b) Appendices C–D grant exemptions from some requirements of other Ind ASs."

> "18 An entity may elect to use one or more of the exemptions contained in Appendices C-D. An entity shall not apply these exemptions by analogy to other items."

From the above, the Committee notes that on the date of transition, viz., 1.4.2015, the company shall prepare an opening Ind AS balance sheet and use the accounting policies which shall comply with each Ind AS effective at the end of its first Ind AS reporting period, except as specified in paragraphs 13–19 and Appendices B–D. Accordingly, the Standard requires retrospective application of accounting policies unless there is specific exemption/exceptions in the Standard from such retrospective application. In this regard the Committee notes that the prescriptions in paragraph B8C and D20 of Ind AS 101 would also be relevant in case it is impracticable for the company to apply effective interest rate with retrospective effect. Considering the fact that company has chosen to classify the financial liability as subsequently measured at amortised cost and the loan transactions of recent period the Committee assumes that the company has decided not to avail any exemption/relaxation under Ind AS 101.

D. Opinion:

19. On the basis of above, the Committee is of the opinion that the company should follow the following accounting treatment:

(a) As stated in paragraph 19 above the difference between the fair value and transaction price of interest free subordinated debt at the date of initial recognition shall be taken to other equity.

(b) Interest expense from the date of initial recognition of liability till Ind AS transition date that would have been recognised using effective interest rate method shall be debited to retained earnings as of 01/04/15.

Query No. 3

Subject: Amortisation of goodwill in respect of subsidiaries and jointly controlled entities recognised as an asset in consolidated financial statements. [1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as the 'company'), which is a wholly owned subsidiary of a listed government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India.

2. The company operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. Globally, Exploration and Production (E&P) business is carried out by way of joint arrangements or investments in form of subsidiaries/associates. The company was following Indian Generally Accepted Accounting Principles (IGAAPs) (presumably, by IGAAPs, querist meant Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006) until 31st March, 2016. However, in accordance with the requirement of Ministry of Corporate Affairs (MCA) notification dated 16th February, 2015, the company has adopted Indian Accounting Standards (Ind ASs) with effect from 1st April, 2016 (Transition Date: 1st April, 2015).

3. Usually the legal regimes applicable in most of the countries provide that the ownership of mineral resources (hydrocarbons) is with respective governments. Accordingly, the host governments grant the rights to explore, develop and produce hydrocarbons in certain specified geographical areas within their territories (hereinafter referred to as 'mineral rights') to companies on some equitable consideration under various regimes. The activities of the company thus include securing such mineral rights and then to explore, develop and produce hydrocarbons as under:

(a) direct acquisition of mineral rights in properties, exploration (including prospecting), development and production of oil and gas solely or in joint operations with some other parties;

(b) indirectly through acquisition of shares in a jointly controlled entity owning such mineral rights;

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[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

(c) indirectly through acquisition of shares in a subsidiary owning such mineral rights.

4. Mineral rights are granted by the host governments in accordance with the applicable legal and fiscal regime in the host country which are incorporated into the binding contractual arrangements entered into with the host governments. Mineral rights can be granted through direct license or through production sharing agreement (PSA), under which the host government having ownership rights over the hydrocarbons, grants the rights to a company or consortium (usually called contractor) subject to certain obligations/ payments by the contractor including sharing of hydrocarbons, with the government or its nominated agency as per principles contained in PSA.

5. The overseas oil and gas operations are generally conducted in joint arrangements with other partners. Main reason for holding mineral rights through jointly controlled entities/subsidiaries is because of host country's regulations and / or various business considerations (strategic/risk management/financing etc.). When the project is already in existence through a corporate structure and the company joins the project later on, the investment in jointly controlled entities /subsidiaries is a legacy issue.

6. The company has been preparing its consolidated financial statements for the group comprising of standalone financial statements of the company, its subsidiaries and jointly controlled entities in accordance with the applicable Accounting Standards (AS).

Accounting Treatment accorded by the company under IGAAP

7. The querist has stated that under IGAAPs, the company accounted for the investments in subsidiaries and jointly controlled entities in its standalone financial statements in accordance with the requirement of Accounting Standard (AS) 13, 'Accounting for Investments'. In consolidated financial statements of the company, the company was consolidating financial statements of its subsidiaries on a line by line basis following the consolidation procedures mentioned in paragraph 13 of Accounting Standard (AS) 21, 'Consolidated Financial Statements'. Similarly, in its consolidated financial statements, the company was reporting its interest in jointly controlled entities using proportionate consolidation as per the requirements of paragraphs 29 to 39 of Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures'.

8. Further, the company recognised goodwill in respect of subsidiaries and jointly controlled entities in accordance with the requirements of paragraph 13(b) of AS 21 and paragraph 36 of AS 27 respectively in its consolidated financial statements, as according to the querist, there was no specific guidance in the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) as well as the Guidance Note on Accounting for Oil & Gas Producing Activities (Revised 2013) regarding the amortisation of such goodwill under IGAAPs.

9. The company considered that such goodwill mainly arises due to corporate structure and the line by line consolidation of subsidiaries' / proportionate consolidation of jointly controlled entities' financial statements prepared on historical costs convention which do not take into consideration the valuation of underlying oil and gas reserves for which excess amount (i.e. goodwill calculated as per the relevant AS requirements) has been paid by the company at the time of acquisition.

10. The company further considered that in oil and gas E&P companies, the goodwill generated on acquisition of mineral rights either through jointly controlled entities or subsidiaries, inherently derives its value from the underlying mineral rights and, accordingly, value of such goodwill depletes as the underlying mineral resources are extracted.

11. According to the querist, in case of acquisition directly or through joint operations, the goodwill, so calculated, would have been accounted for as 'acquisition costs' as defined in the Guidance Note on Accounting for Oil and Gas Producing Activities and accordingly would have been amortised over the life of the reserves using Unit of Production (UOP) method considering related proved oil and gas reserves.

12. Therefore, taking a prudent approach and considering the above substance, the company framed the accounting policy under IGAAPs for amortisation of the goodwill in respect of its subsidiaries/jointly controlled assets over the life of the underlying mineral rights using UOP method as under:

> "**Goodwill Amortisation**: The company amortises goodwill (on consolidation) based on 'Unit of Production Method' considering the related Proved Reserves."

13. This allowed the company to utilise the value of goodwill over the life of mineral rights and completely charging off the goodwill over the life of the reserves.

Change under Indian Accounting Standards (Ind ASs) regime

14. The querist has stated that Indian Accounting Standards (Ind ASs), as notified by the Ministry of Corporate Affairs (MCA), are mandatorily applicable for periods beginning on or after 1st April, 2016, with comparatives for the period ending 31st March, 2016. Also, the ICAI has issued revised 'Guidance Note on Accounting for Oil and Gas Producing Activities (Ind AS)' to align the oil and gas accounting under Ind AS regime.

15. The querist has further stated that the company had availed transition exemption under Ind AS 101, 'First-time Adoption of Indian Accounting Standards' and has not applied the principles of Ind AS 103, 'Business Combinations' retrospectively and, therefore, did not fair value the acquisition of shares in joint ventures (jointly controlled entities under IGAAPs) / subsidiaries which happened before the transition date of 1st April, 2015. The carrying amount of goodwill at the date of transition to Ind AS in accordance with previous GAAPs (IGAAPs) has been taken as carrying value of the goodwill in the opening Ind AS balance sheet in accordance with the para C4 (g) and (h) contained in Appendix C to Ind AS 101.

16. According to the querist, prospectively from the transition date, i.e., 1st April, 2015, acquisition of interest/ share in subsidiary will be accounted for in accordance with Ind AS 103 and acquisition of interest /share in joint venture /associate will be accounted for in accordance with Ind AS 28, 'Investments in Associates and Joint Ventures'.

17. The company understands that paragraph 32(a) of Ind AS 28 specifically prohibits amortisation of goodwill relating to an associate or a joint venture. It is noticed that there is no such specific prohibition laid down by Ind AS 103. It is also noticed that paragraph 10 (b) of Ind AS 36, Impairment of Assets requires testing of goodwill acquired in a business combination for impairment, annually.

18. Accordingly, as per the querist, by simple reading of the applicable Ind ASs, it appears that Ind ASs envisage testing of goodwill annually for impairment rather than its amortisation. This seems to align with the concept of fair valuation of acquired assets and liabilities and goodwill/capital reserve being a residual amount. This however may not be the case where goodwill

is carried at historical value in the manner as stated above. Accordingly, considering the substance over form of the goodwill to be in the nature of 'acquisition costs' (as discussed in paragraphs 8 to 13 above), the company intends to continue amortisation of the goodwill recognised under IGAAPs in respect of its subsidiaries/ joint ventures (jointly controlled entities under IGAAPs) over the life of the underlying mineral rights using Unit of Production method, under Ind ASs also post transition date in accordance with the same accounting policy as under:

> "Goodwill amortisation: The company amortises goodwill (on consolidation) based on 'Unit of Production Method' considering the related proved reserves."

B. Query

19. In view of the above facts, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the appropriate accounting treatment under Ind ASs for amortisation of the goodwill by the company, viz., whether:

(i) the accounting treatment as suggested in paragraph 18 in respect of amortisation of goodwill by the company is appropriate; or

(ii) there is any other appropriate accounting treatment for amortisation of goodwill.

C. Points considered by the Committee

20. The Committee notes that the basic issue raised in the query relates to amortisation of carrying amount of goodwill under Ind ASs after the date of transition. Accordingly, 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, initial recognition of goodwill arising on consolidation under Accounting Standards notified under Companies (Accounting Standards) Rules, 2006 and its valuation, correctness of determination of goodwill, etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter, is in the context of Indian Accounting Standards (Ind ASs) and not in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and the same is with regard to accounting treatment in Consolidated Financial Statements of the Company and not separate Financial Statement. The Committee also wishes to point out that although the querist has used the terms, 'jointly controlled entity',

'joint operations' and 'jointly controlled assets' interchangeably in respect of joint ventures for foreign based oil and gas operations, it is presumed that these joint ventures are 'jointly controlled entities' in accordance with the requirements of AS 27. The Committee also presumes from the Facts of the Case that the acquisitions of mineral rights/business in the extant case is within the purview of the requirements of Ind AS 103, 'Business Combinations'.

21. The Committee notes from the facts of the case that the company has availed transition exemption under Ind AS 101, First-time Adoption on Indian Accounting Standards and has not applied Ind AS 103, Business Combinations principles retrospectively. The Committee further notes that the following paragraphs of Appendix C, 'Exemptions for business combinations' to Ind AS 101, First-time Adoption of Indian Accounting Standards would be relevant in this regard:

> "C4 If a first-time adopter does not apply Ind AS 103 retrospectively to a past business combination, this has the following consequences for that business combination:
>
> …
>
> (c) The first-time adopter shall exclude from its opening Ind AS Balance Sheet any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under Ind ASs. The first-time adopter shall account for the resulting change as follows:
>
> (i) the first-time adopter may have classified a past business combination as an acquisition and recognised as an intangible asset an item that does not qualify for recognition as an asset in accordance with Ind AS 38, *Intangible Assets*. It shall reclassify that item (and, if any, the related deferred tax and non-controlling interests) as part of goodwill (unless it deducted goodwill directly from equity in accordance with previous GAAP, see (g)(i) and (i) below) or capital reserve to the extent not exceeding the balance available in that reserve.
>
> …

(g) The carrying amount of goodwill or capital reserve in the opening Ind AS Balance Sheet shall be its carrying amount in accordance with previous GAAP at the date of transition to Ind ASs, after the following two adjustments:

(i) If required by (c)(i) above, the first-time adopter shall increase the carrying amount of goodwill or decrease the carrying amount of capital reserve when it reclassifies an item that it recognised as an intangible asset in accordance with previous GAAP. Similarly, if (f) above requires the first-time adopter to recognise an intangible asset that was subsumed in recognised goodwill or capital reserve in accordance with previous GAAP, the first-time adopter shall decrease the carrying amount of goodwill or increase the carrying amount of capital reserve accordingly (and, if applicable, adjust deferred tax and non-controlling interests).

(ii) Regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter shall apply Ind AS 36 in testing the goodwill for impairment at the date of transition to Ind ASs and in recognising any resulting impairment loss in retained earnings (or, if so required by Ind AS 36, in revaluation surplus). The impairment test shall be based on conditions at the date of transition to Ind ASs.

(h) *No other adjustments shall be made to the carrying amount of goodwill* / capital reserve at the date of transition to Ind ASs. For example, the first-time adopter shall not restate the carrying amount of goodwill / capital reserve:

(i)

(ii) to adjust previous amortisation of goodwill;

…"

(Emphasis supplied by the Committee)

22. The Committee notes from above that Ind AS 101 specifically provides that if a first-time adopter does not apply Ind AS 103 retrospectively to a past business combination then the carrying amount of goodwill in the opening Ind AS balance sheet shall be its carrying amount in accordance with previous GAAP at the date of transition to Ind ASs and no adjustments apart from as required by paragraph C4(c)(i) of Ind AS 101 shall be made to such carrying amount. Further, the company shall apply Ind AS 36 in testing the goodwill for impairment at the date of transition to Ind ASs, regardless of whether there is any indication that the goodwill may be impaired (refer paragraph C4(g)(ii) reproduced above). In this context, the Committee notes paragraph 10 (b) of Ind AS 36, 'Impairment of Assets', which provides as follows:

"10 Irrespective of whether there is any indication of impairment, an entity shall also:

(a) …

(b) test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80–99."

The Committee further notes from paragraph 3 and B86 of Ind AS 110, 'Consolidated Financial Statements' that Ind AS 110 does not deal with the goodwill arising on a business combination; rather refers to Ind AS 103, 'Business Combinations'. Similarly, the Committee notes that paragraph 3(f) of Ind AS 38, 'Intangible Assets' also states that it does not apply to goodwill acquired in business combination and refers to Ind AS 103.

23. The Committee further notes the following paragraph of Ind AS 103, 'Business Combinations':

"B63 Examples of other Ind ASs that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination include:

(a) Ind AS 38 prescribes the accounting for identifiable intangible assets acquired in a business combination. The acquirer measures goodwill at the amount recognised at the acquisition date less any accumulated impairment losses. Ind AS 36, *Impairment of Assets,* prescribes the accounting for impairment losses.

…"

From the above, the Committee notes that Ind AS 103 specifically requires the carrying amount of goodwill or goodwill acquired under business combination to be tested for impairment. However, the Committee notes that it does not contain any specific requirement for amortisation of goodwill arising on acquisition. Similarly, the Committee notes the following requirements of Ind AS 28, 'Investments in Associates and Joint Ventures':

"32 An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:

(a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. **Amortisation of that goodwill is not permitted**.

(b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is recognised directly in equity as capital reserve in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made for impairment losses such as for goodwill or property, plant and equipment." (Emphasis supplied by the Committee.)

From the above, the Committee note that according to Ind AS 28 Goodwill is not separately accounted rather included as part of carrying amount of Investment. Further, the Standard specifically clarifies that amortisation of goodwill relating to a joint venture is not permitted.

24. In the context of joint ventures, the Committee also notes the following requirements of Ind AS 101, 'First-time Adoption of Indian Accounting Standards':

"D1 An entity may elect to use one or more of the following exemptions:

(a) ...;

...

(r) joint arrangements (paragraphs D31-D31AL);

(s) ..."

"Joint ventures - transition from proportionate consolidation to the equity method

D31AA When changing from proportionate consolidation to the equity method, an entity shall recognise its investment in the joint venture at transition date to Ind ASs. That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any goodwill arising from acquisition. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the relative carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged.

D31AB The balance of the investment in joint venture at the date of transition to Ind ASs, determined in accordance with paragraph D31AA above is regarded as the deemed cost of the investment at initial recognition.

D31AC A first-time adopter shall test investment in joint venture for impairment in accordance with Ind AS 36 at the date of transition to Ind ASs, regardless of whether there is any

> indication that the investment may be impaired. Any resulting impairment shall be recognised as an adjustment to retained earnings at the date of transition to Ind ASs. …"

From the above, the Committee notes that where an entity elects to use the exemption provided under paragraphs D31AA to D31AC of Ind AS 101, as reproduced above also, the Standard requires to test the investment in joint venture which comprises of goodwill for impairment only and does not specify for amortisation.

Accordingly, on a holistic reading of the above paragraphs, the Committee is of the view that the carrying amount of goodwill (arising on consolidation of subsidiary or jointly controlled entity under the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006) on the date of transition cannot be amortised under Ind ASs.

D. Opinion

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

(i) and (ii) No, the accounting treatment as suggested in paragraph 18 in respect of amortisation of goodwill by the company is not appropriate. The carrying amount of goodwill (arising on consolidation of subsidiary or jointly controlled entity under the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006) on the date of transition cannot be amortised under Ind ASs and the carrying amount of goodwill or goodwill acquired under business combination will have to be tested for impairment periodically.

Query No. 4

Subject: Classification of investments in units of debt mutual funds under Ind AS 109.[1]

A. Facts of the Case

1. X Ltd. is a company incorporated in India and its shares are listed on Bombay Stock Exchange and National Stock Exchange. It is engaged in software services and has made investments in financial assets which are essentially in the form of investments in Fixed Maturity Plans (FMPs), Liquid Mutual Funds, Equity Mutual Funds, Tax Free Bonds, and Preference Shares.

2. The classification and accounting treatment of the financial assets is dealt with in Indian Accounting Standard (Ind AS) 109, 'Financial Instruments'. A financial asset can fall into one of the following three categories (see Section 4.1 of Ind AS 109) based on the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset:

- Measured at amortised cost
- Measured at fair value through other comprehensive income
- Measured at fair value through profit or loss

An entity's business model for managing financial assets could be holding the financial assets in order to collect the contractual cash flows or selling the financial assets or both (see paragraph B4.1.2A of Ind AS 109).

Measured at amortised Cost:

Paragraph 4.1.2 of Ind AS 109 is reproduced below:

> **"4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:**
>
> **(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and**

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[1] Opinion finalised by the Committee on 4.1.2018.

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions."

Although the objective may be to hold financial assets to collect contractual cash flows, the entity need not hold all of those instruments until maturity. The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the asset's credit risk (see paragraphs B4.1.3 and B4.1.3A of Ind AS 109).

Measured at fair value through other comprehensive income:

Paragraph 4.1.2A of Ind AS 109 is reproduced below:

"4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions."

Measured at fair value through profit or loss:

Paragraph 4.1.4 of Ind AS 109 is reproduced below:

"4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election

> **at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5-5.7.6).”**

As per paragraph 5.7.5 of Ind AS 109, the equity instrument should not be held for trading, if election is made to present fair value changes in other comprehensive income.

3. The scope of Ind AS 32, ‘Financial Instruments: Presentation’ includes financial instruments issued by an entity that meet the definition of an equity instrument. The following extracts from paragraph 11 of Ind AS 32 are relevant in this regard:

> **“A *financial asset* is any asset that is:**
>
> **(a) cash;**
>
> **(b) an equity instrument of another entity;**
>
> **(c) a contractual right**
>
> > **(i) to receive cash or another financial asset from another entity; or**
> >
> > **(ii) …**
>
> **(d) …”**
>
> **“An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.”**

Examples of equity instruments include instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. (See paragraph AG13 and paragraphs 16C and 16D of Ind AS 109).

4. X Ltd. has a portfolio of investments in debt mutual funds through FMP/Liquid/ short-term/ultra short-term schemes. Essentially, the debt funds carry relatively low to moderate risks. FMPs are close-ended mutual funds, which are redeemable only on maturity. FMPs seek to generate income by investing in a portfolio of fixed income securities maturing on or before the maturity of the scheme and the cash flow which the Asset Management

Company (hereinafter referred to as 'the AMC') gets is largely for principal and interest. The AMC invests in relatively safe debt instruments and generally one can infer the indicative return. The offer document to the scheme typically provides the maturity period, the investment objective, investment strategy, the asset allocation pattern, investment associated risks and strategies to manage the risks. (Sample offer document for a close-ended debt fund has been furnished by the querist for the perusal of the Committee).

5. As per the querist, on analysis of the sample offer document, the FMPs may meet the 'Hold to Collect contractual cash flows' test, since, the investments are largely held to maturity for collecting contractual cash flows rather than to realise benefits through fair value changes/sale. Though the payments made by the fund to the holder (in this case X Ltd.) represent principal and interest and even though there is no pre-agreed contractual cash flow, the redemption value is dependent on the performance of the underlying securities and any default in principal or interest could affect the fair value. The investments in liquid/ultra short-term/ short-term plans also have the same characteristics except that these are open-ended schemes. X Ltd. does not hold these investments to maturity but exits depending on the cash flow requirement and books the resultant profit or loss. Given that the investment in the debt funds carry similar low to moderate risks, X Ltd. would like to examine considering them as a single portfolio for the purpose of classification and application of Ind AS 109. If one were to consider the investment in debt funds as a single portfolio, cash flow would be generated both through holding securities until their maturity and trading. Further, the payments received by the AMC are primarily for the principal and interest, which finally get distributed to the unitholders (X Ltd. in this case). It is pertinent to note that the cash flow for the unitholders is primarily through the contractual cash flows received by the AMC consisting of principal and interest.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to whether the investments in debt funds (FMPs and liquid/short-term) can be treated as a single portfolio for the purpose of characterisation and application of Ind AS 109 and whether in such a case the unrealised gains or losses on account of fair valuation can be routed through other comprehensive income.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to classification and treatment of investments in *units* of certain debt mutual funds (hereinafter referred to as 'investments in debt funds') under Indian Accounting Standard (Ind AS) 109, 'Financial Instruments', notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended till date (hereinafter referred to as 'the Rules'). Further, the Committee presumes that the querist's intention in Query in paragraph 6 above is to evaluate possibility of treating its investments in debt funds as a single portfolio for the purpose of classifying such investments as subsequently measured at fair value through other comprehensive income. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. The Committee notes that investments in units of mutual funds meet the definition of financial assets given in paragraph 11 of Ind AS 32, 'Financial Instruments: Presentation', notified under the Rules, (reproduced by the querist in paragraph 3 above). At the outset, the Committee wishes to point out that Asset Management Company (hereinafter referred to as 'the AMC') and the mutual funds managed by the AMC are distinct entities. Hereinafter, any reference to AMC should be understood in the context of relevant funds managed by the AMC. The Committee presumes that X Ltd. has not designated any investment in the debt funds in a hedging relationship. Further, the Committee presumes that X Ltd. has not designated any investment as measured at fair value through profit or loss to eliminate or significantly reduce a measurement or recognition inconsistency, as permitted in paragraph 4.1.5 of Ind AS 109. From the sample offer document furnished by the querist, the Committee notes that investments in the close-ended debt fund (which is a Fixed Maturity Plan ('FMP')) can be redeemed only at the time of maturity or sold before that date through the relevant stock exchange on which the units of the Scheme are listed. 'Switch-out' (which, in substance, represents redemption and reinvestment of the redemption proceeds in another scheme) is possible only based on 'Net Asset Value' ('NAV') on the date of maturity. The Committee also notes that while the sample offer document for the close-ended debt fund states that the mutual fund or AMC and its empanelled brokers are prohibited from giving any indicative portfolio and indicative yield in any communication, as per the querist, *generally* one can infer the indicative return. However, the AMC shall, on its website, disclose portfolio of all Schemes on a monthly basis as on the last day of month, on or

before tenth day of the succeeding month. Further, in the case of the close-ended debt fund, there are two options *viz.* cumulative option and dividend option. In the case of dividend option, half-yearly dividend frequency will be available, subject to the availability of distributable surplus, while the Trustee at its sole discretion may also declare interim dividend. For open-ended debt funds, no sample document has been furnished by the querist. However, it is obvious that in the case of open-ended debt funds, redemption is possible as and when opted for by the unitholder and dividend frequency (in case of dividend option) will be as specified in the scheme. Incidentally, as per the querist, the 'FMPs' may meet the 'Hold to Collect contractual cash flows' test, since, the investments are largely held to maturity for collecting contractual cash flows rather than to realise benefits through fair value changes/sale (see paragraph 5 above). Here, it appears that the term 'FMPs' should read as 'investments in FMPs'.

8. The Committee notes that the classifications under Ind AS 109 determine their subsequent measurement. In this regard, paragraph 4.1.1 of Ind AS 109 is reproduced below:

> **"4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:**
>
> **(a) the entity's business model for managing the financial assets and**
>
> **(b) the contractual cash flow characteristics of the financial asset."**

From the above, the Committee notes that there are two tests to be performed for classification of financial assets based on their subsequent measurement (i.e., measurement after initial recognition) *viz.* 'Business model test' and 'Contractual cash flow characteristics test'. The conditions for subsequent measurement of financial assets at amortised cost, fair value through other comprehensive income and fair value through profit or loss based on the assessment of the above two tests are prescribed in paragraphs of 4.1.2, 4.1.2A and 4.1.4 of Ind AS 109 respectively, reproduced by the querist in paragraph 2 above, while paragraph 4.1.3 of Ind AS 109 deals with meaning of 'principal' and 'interest' for the purposes of paragraphs

4.1.2 and 4.1.2A of Ind AS 109. Hereinafter, reference to these measurement bases should be understood in the context of subsequent measurement.

9. The Committee first examines whether the investments in debt funds meet the business model test prescribed in paragraph 4.1.2 or 4.1.2A of Ind AS 109. In this regard, the Committee notes the principles elaborated in paragraphs B4.1.1-B4.1.6 of Ind AS 109. The key aspects that emerge from the analysis of prescriptions in these paragraphs are summarised below:

(a) An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Further, since an entity may have more than one business model for managing its financial instruments, the classification need not be determined at the reporting entity level. The business model is as determined by the entity's key management personnel (as defined in Ind AS 24 *Related Party Disclosures*).

(b) In some circumstances, it may be appropriate to separate a portfolio of financial assets into subportfolios in order to reflect the level at which an entity manages those financial assets. For example, an entity may hold similar or identical financial assets and it may classify those assets into subportfolios, some of which may be portfolios with an objective to hold to collect contractual cash flows (see paragraph 4.1.2 of Ind AS 109) and others may be classified into portfolios whose business model objective is achieved both by holding those assets to collect contractual cash flows as well as by selling them (see paragraph 4.1.2A of Ind AS 109).

(c) An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model.

(d) Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Therefore, some amount of sales before contractual maturity is permitted even in case of business model whose objective is to hold financial assets to collect contractual cash flows only. However, the frequency, value and timing of sales and the reasons for such sales before maturity are critical factors which require analysis and use of judgement by the entity's management.

The Committee observes from the above analysis that the classification of financial assets into different portfolios for business model test is based on the objective of the business model i.e., whether to hold the financial assets to collect contractual cash flows or to hold the financial assets to collect contractual cash flows as well as to sell the financial assets or to hold financial assets for other purposes, for example, to realise cash flows through the sale of the financial assets. It is not in accordance with the principles of Ind AS 109 to create single portfolio or a particular subportfolio comprising financial assets which are managed under different business models. As stated by the querist, investments in FMPs are largely held to maturity to collect contractual cash flows rather than to realise benefits through fair value changes/sale. These investments would meet the criteria for inclusion in a portfolio whose business model objective is achieved by collecting contractual cash flows only. Thus, these investments meet the business model test prescribed in paragraph 4.1.2(a) of Ind AS 109. The investments in liquid/ultra short-term/ short-term plans are not held to maturity but the entity exits depending on the cash flow requirement and books the resultant profit or loss. The Committee notes that paragraph B4.1.4A of Ind AS 109 specifically cites the example of objective of the business model to manage everyday liquidity needs or to match the duration of the financial assets to the duration of the liabilities that those assets are funding and states that to achieve such an objective, the entity will both collect contractual cash flows and sell financial assets. Hence, the investments in liquid/ultra short-term/ short-term plans would meet the criteria for inclusion in a portfolio whose business model objective is achieved by both collecting contractual cash flows and selling financial assets. Thus, these investments meet the business model test prescribed in paragraph 4.1.2A(a) of Ind AS 109. In reaching this conclusion, the Committee presumes that such investments do not constitute a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis, since, as specifically stated in paragraph B4.1.6 of Ind AS 109, such a portfolio is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets and consequently, such a portfolio must be measured at fair value through profit or loss.

Based on the above, the Committee concludes that the objective of business model of investments in FMPs is different from the objective of business model of investments in liquid/ultra short-term/ short-term plans. Consequently, all these investments cannot be grouped into a single portfolio and classified as subsequently measured at fair value through other comprehensive income.

10. In the extant case, though it is not necessary to evaluate compliance with cash flow characteristics test, the Committee considered it appropriate to elaborate this as it has relevance for classification these two portfolio separately. Thus, Committee now examines application of cash flow characteristics test to investments in close-ended debt funds (FMP). For this purpose, the Committee is of the view that the company has to 'look through' the instruments in which the close-ended debt funds have invested. From the sample offer document furnished by the querist, the Committee notes that the investment objective of the scheme is to seek to generate income by investing in a portfolio of fixed income securities/debt instruments maturing on or before the maturity of the scheme and that the investments will be in debt instruments including government securities and money market instruments. The allocation may vary during the tenure of the scheme depending on some instances like coupon inflow, calling of or buy-back of the instrument by the issuer and anticipation of any adverse credit event. In case of downgrade of a particular instrument, the Fund manager will endeavour to rebalance the portfolio on a best effort basis. There will be no exposure to derivatives. While the contractual cash flows from such instruments are expected to include payments of principal and interest on principal outstanding, it has to be examined as to whether such cash flows consist of *solely* payments of principal and interest on principal outstanding (hereinafter referred to as 'SPPI'), having regard to the provisions of paragraph 4.1.3 and paragraphs B4.1.7-B4.1.26 of Ind AS 109. Some of the key requirements in this regard are outlined below:

(a) Contractual cash flows that are SPPI are consistent with a basic lending arrangement. Hence, elements of interest can include consideration for time value of money, credit risk, other basic lending risks, for example, liquidity risk, costs associated with holding the financial asset for a particular period of time and profit margin that is consistent with a basic lending arrangement.

(b) Principal is the fair value of the financial asset at initial recognition. This may change subsequently if there are repayments of principal.

(c) An entity should assess whether contractual cash flows are SPPI for the currency in which the financial asset is denominated.

(d) Financial assets with leverage features do not meet the SPPI test since leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristic of interest.

(e) Contractual terms that change the timing or amount of contractual cash flows should be analysed to determine whether they meet the SPPI test. For making this determination, the entity should assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows and nature of contingent event that would change the timing or amount of contractual cash flows. For example, in case of prepayment features, the SPPI test is met, if the prepayment amount substantially represents unpaid amount of principal and interest on principal outstanding, which may include reasonable additional compensation for the early termination of the contract.

If the contractual cash flows of the instruments in which the close-ended debt funds invest meet the 'SPPI' test, then, the cash flow characteristics test prescribed in paragraph 4.1.2(b) of Ind AS 109 is met for *investments* in close-ended debt funds. This is because the cash flows from investments in close-ended debt funds originate from the cash flows of the debt instruments held by such funds. In this situation, since business model test prescribed in paragraph 4.1.2(a) of Ind AS 109 is also met (see paragraph 9 above), investments in close-ended debt funds should be measured at amortised cost in accordance paragraph 4.1.2 of Ind AS 109. If the cash flow characteristics test prescribed in paragraph 4.1.2(b) of Ind AS 109 is not met for the investments in close-ended debt funds in the manner explained above, then, even though the business model test prescribed in paragraph

4.1.2(a) of Ind AS 109 is met, such investments should be measured at fair value through profit or loss in accordance with paragraph 4.1.4 of Ind AS 109. While making the analysis of cash flow characteristics test, the fact that the units may be traded on a recognised stock exchange (if the scheme provides for the facility) should be disregarded. This is because in the case of close-ended debt funds, redemption and switch-out can occur only on maturity of the scheme. Hence, contractual cash flows of the instruments held by such funds and, consequently investments in such funds, are not affected by the quoted prices for the units in the relevant fund on the recognised stock exchange.

In respect of investments in open-ended debt funds (liquid/ultra short-term/ short-term plans), the cash flow characteristics test mentioned in paragraph 4.1.2A(b) is not met. The reason is that its redemption value is based on NAV which is in turn based on future value of the underlying investments which is not consistent with the basic lending arrangement. Secondly, fund managers normally have discretion to buy and sell the underlying instruments to generate better yield/return for unit holders. Therefore, the NAV/redemption value is likely to include gain or loss on sale of underlying instruments which is not consistent with the basic lending arrangements. Consequently, the contractual cash flow characteristics test prescribed in paragraph 4.1.2A(b) of Ind AS 109 is not met for investments in open-ended debt funds, even though the business model test prescribed in paragraph 4.1.2A(a) of Ind AS 109 is met for such investments (see paragraph 9 above). Hence, the Committee is of the view that such investments should be measured at fair value through profit or loss in accordance paragraph 4.1.4 of Ind AS 109.

11. The Committee wishes to point out that investments in units of mutual funds are not investments in equity instruments as defined in Ind AS 32, simply because they may represent residual interest in the funds. This is because irrespective of classification of units by the mutual fund, there is contractual obligation on the part of the Fund to deliver cash on redemption of the units or to deliver units of another scheme on 'switch-out', which involves an obligation to deliver cash on behalf of the unitholder to the management of the other scheme. The units are, therefore, financial liabilities, having regard to the definition of the term 'Financial liability' given in paragraph 11 of Ind AS 32, which reads as below:

"A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) …

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

…"

The Committee is of the view that the exception requiring *classification* of certain financial instruments meeting the definition of a financial liability as equity by the *issuer* in accordance with paragraphs 16A-16D of Ind AS 32 cannot be applied by the *holder* of such instruments while applying Ind AS 109. This is because Ind AS 109 does not provide for an exception similar to the exception contained in Ind AS 32. In reaching this conclusion, the Committee relies on the views of the IFRS Interpretations Committee published in 'IFRIC Update', September 2017, duly supported by paragraph BC5.21 of International Financial Reporting Standard 9, 'Financial Instruments'.

Consequently, the election to recognise fair value changes of particular investments in equity instruments permitted in paragraph 4.1.4 of Ind AS 109 read with paragraph 5.7.5 of Ind AS 109 is not available for investments in debt funds.

D. Opinion

12. On the basis of the above, the Committee is of the following opinion that all investments in (units of) debt funds (FMPs and liquid/short-term) cannot be treated as a single portfolio for the purposes of assessment of business model test and consequent classification as fair value through other comprehensive income under Ind AS 109. They should be measured as explained in paragraph 10 above.

Query No. 5

Subject: Treatment of investments in units of equity mutual funds under Ind AS 109.[1]

A. Facts of the Case

1. X Ltd. is a company incorporated in India and its shares are listed on Bombay Stock Exchange and National Stock Exchange. It is engaged in software services and has made investments in financial assets which are essentially in the form of investments in Fixed Maturity Plans, Liquid Mutual Funds, Equity Mutual Funds, Tax Free Bonds, and Preference Shares.

2. The classification and accounting treatment of the financial assets is dealt with in Indian Accounting Standard (Ind AS) 109, 'Financial Instruments'. A financial asset can fall into one of the following three categories (see Section 4.1 of Ind AS 109) based on the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset:

- Measured at amortised cost
- Measured at fair value through other comprehensive income
- Measured at fair value through profit or loss

An entity's business model for managing financial assets could be holding the financial assets in order to collect the contractual cash flows or selling the financial assets or both (see paragraph B4.1.2A of Ind AS 109).

Measured at amortised Cost:

Paragraph 4.1.2 of Ind AS 109 is reproduced below:

> **"4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:**
>
> **(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and**
>
> **(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely**

[1] Opinion finalised by the Committee on 4.1.2018.

payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.”

Although the objective may be to hold financial assets to collect contractual cash flows, the entity need not hold all of those instruments until maturity. The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the asset’s credit risk (see paragraphs B4.1.3 and B4.1.3A of Ind AS 109).

Measured at fair value through other comprehensive income:

Paragraph 4.1.2A of Ind AS 109 is reproduced below:

“4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.”

Measured at fair value through profit or loss:

Paragraph 4.1.4 of Ind AS 109 is reproduced below:

“4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value

> **through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5-5.7.6).”**

As per paragraph 5.7.5 of Ind AS 109, the equity instrument should not be held for trading, if election is made to present fair value changes in other comprehensive income.

3. The scope of Ind AS 32, ‘Financial Instruments: Presentation’ includes financial instruments issued by an entity that meet the definition of an equity instrument. The following extracts from paragraph 11 of Ind AS 32 are relevant in this regard:

> **“A *financial asset* is any asset that is:**
>
> **(a) cash;**
>
> **(b) an equity instrument of another entity;**
>
> **(c) a contractual right**
>
> **(i) to receive cash or another financial asset from another entity; or**
>
> **(ii) …**
>
> **(d) …”**
>
> **“An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.”**

Examples of equity instruments include instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. (See paragraph AG13 and paragraphs 16C and 16D of Ind AS 109).

4. Equity mutual funds are open-ended equity schemes which aim to generate capital appreciation, generally long-term, to unitholders through investment in equity and equity related securities. The Scheme Information Document discloses the investment objective, risk factors and other information about the scheme. (Sample Consolidated Scheme Information Document for various open-ended equity funds has been furnished by the querist for the perusal of the Committee). The Asset Management Company (hereinafter referred to as ‘the AMC’) invests in equity and equity related

securities on behalf of mutual fund. A unitholder of the mutual fund participates in the investment through subscription of units, whose underlying value is derived from such investments in equities. In a broader economic sense, investment in equity mutual fund is similar to direct investment in equity. The investor indirectly carries similar risks as they would carry when investing directly in equity. However, if one were to limit by the accounting definition used in Ind AS 32, residual interest in the assets of the entities invested by the mutual fund would be with the mutual fund and not with the unitholder. This is, however, a pass through and the residual benefits or otherwise indirectly flow to the investor in the units (X Ltd. in this case) eventually. It is important to note that X Ltd. generally holds the investments in equity mutual funds for capital appreciation rather than benefit out of trading.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee as to whether the investments in equity mutual funds can be treated as investments in equity instruments for the purpose of application of Ind AS 109 and whether in such case the fair value changes of such investments can be routed through other comprehensive income.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to treatment of investments in *units* of certain equity mutual funds (hereinafter referred to as ‘investments in equity funds’) as investments in equity instruments with possible recognition of fair value changes in other comprehensive income in accordance with Indian Accounting Standard (Ind AS) 109, ‘Financial Instruments’, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended till date (hereinafter referred to as ‘the Rules’). The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. The Committee notes that investments in units of mutual funds meet the definition of financial assets given in paragraph 11 of Ind AS 32, ‘Financial Instruments: Presentation’, notified under the Rules, (reproduced by the querist in paragraph 3 above). At the outset, the Committee wishes to point out that Asset Management Company (hereinafter referred to as ‘the AMC’) and the mutual funds managed by the AMC are distinct entities. Hereinafter, any reference to AMC should be understood in the context of

relevant funds managed by the AMC. The Committee presumes that X Ltd. has not designated any investment in the equity funds in a hedging relationship. Further, the Committee presumes that X Ltd. has not designated any investment as measured at fair value through profit or loss to eliminate or significantly reduce a measurement or recognition inconsistency, as permitted in paragraph 4.1.5 of Ind AS 109. From the sample Consolidated Scheme Information Document for various open-ended equity funds furnished by the querist, the Committee notes that a portion of investments of a particular Scheme can be in debt instruments also. (The Committee presumes that X Ltd. invests in open-ended equity funds only and, hence, hereinafter, unless otherwise stated, any reference to equity funds is made in the context of open-ended equity funds only). The options under the Schemes could be growth option and dividend option with dividend payout and dividend reinvestment sub-options. Distribution of dividend and the frequency of distribution will depend, inter-alia, on the availability of distributable surplus and will be entirely at the discretion of the Trustee. Redemption and switch-out are possible. 'Lock-in' period is applicable only for Tax Plan under 'Equity Linked Saving Scheme Guidelines'. Generally, redemption is at 'Net Asset Value' of the units, subject to 'exit load', if applicable.

7. The Committee notes paragraphs 4.1.4, 5.7.5 and 5.7.6 of Ind AS 109, reproduced below:

"4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5-5.7.6)."

"5.7.5 At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither *held for trading* nor contingent consideration

recognised by an acquirer in a business combination to which Ind AS 103 applies. (See paragraph B5.7.3 for guidance on foreign exchange gains or losses.)

5.7.6 If an entity makes the election in paragraph 5.7.5, it shall recognise in profit or loss dividends from that investment in accordance with paragraph 5.7.1A."

Further, the Committee notes the definition of equity instrument given in Ind AS 32, and reproduced by the querist in paragraph 3 above. In addition, the Committee notes that as an *exception*, paragraph 11 of Ind AS 32 requires certain financial instruments meeting the *definition* of a financial liability to be *classified* as equity instrument by the *issuer* in accordance with paragraphs 16A-16D of that Standard. (Paragraphs 16A-16B of Ind AS 32 deal with certain 'puttable instruments' while paragraphs 16C-16D of Ind AS 32 deal with certain instruments imposing a contractual obligation on the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation). Subject to meeting the prescribed conditions, it is possible that units of equity mutual funds may meet the conditions prescribed by paragraphs 16A-16D of Ind AS 32 and the mutual fund issuing such financial instruments should, subject to applicable regulatory requirements, classify such units as its equity instruments. The term 'equity instruments' in paragraph 4.1.4 of Ind AS 109, reproduced above, is italicised, which means that it is a defined term. Appendix A of Ind AS 109 makes cross-reference to paragraph 11 of Ind AS 32 for the definition of that term.

8. The Committee notes that the exceptions given in paragraphs 16A-16D of Ind AS 32 do not change the fundamental definition of equity instrument given in that Standard. Paragraph 18(b) of Ind AS 32, which specifically cites the example of open-ended mutual funds, and paragraph 19 of Ind AS 32 might give an impression as if financial instruments classified as equity instruments in accordance with paragraphs 16A-16D of Ind AS 32 also meet the definition of equity instrument. However, this is not conveyed by paragraph 11 of Ind AS 32, which, inter alia, reads, "**As an exception, an instrument *that meets the definition of a financial liability* is classified as an equity instrument, if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D"**. [Emphasis, supplied by the Committee]. Appendix A to Ind AS 109 ('Defined terms') makes cross-reference to Ind AS 32 for the *definition* of equity instrument and states, inter alia, that the term 'equity instrument' is used in

Ind AS 109 with the meaning specified in Ind AS 32. Accordingly, only investments that meet the definition of equity instrument of the issuer, as given in Ind AS 32 can be considered as investment in equity instruments for the purposes of paragraphs 4.1.4 and 5.7.5 of Ind AS 109. As per paragraph 16 of Ind AS 32, the basic feature of an equity instrument is absence of contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer. This is in line with the definition of financial liability given in paragraph 11 of Ind AS 32, which reads as below:

> **"A *financial liability* is any liability that is:**
>
> **(a) a contractual obligation:**
>
> > **(i) to deliver cash or another financial asset to another entity; or**
> >
> > **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or**
>
> **(b) …**
>
> **As an exception…"**

The Committee is of the view that the exception requiring *classification* of certain financial instruments meeting the definition of a financial liability as equity by the *issuer* in accordance with paragraphs 16A-16D of Ind AS 32 cannot be applied by the *holder* of such instruments while applying Ind AS 109. This is because Ind AS 109 does not provide for an exception similar to the exception contained in Ind AS 32. In reaching this conclusion, the Committee relies on the views of the IFRS Interpretations Committee published in 'IFRIC Update', September 2017, duly supported by paragraph BC5.21 of International Financial Reporting Standard 9, 'Financial Instruments'. Hence, it is not necessary to examine whether in the extant case, the investments in equity funds answer the description of the financial instruments mentioned in paragraphs 16A-16B of Ind AS 32 (or paragraphs 16C-16D in case of close-ended equity funds, if any). In the extant case, X Ltd. invests in the units of the equity funds and not in the equity (shares) issued by the AMC. The equity funds issue only units and not equity shares. There is contractual obligation on the part of the equity fund to deliver cash on redemption of the units or to deliver units of another scheme (which are financial assets) on 'switch-out'. Even if the units of the equity fund may represent a right to the residual interest in the assets of the fund available to the holders of the units (the querist's discussion in paragraph 4 above on residual interest in the assets of the entities in which the equity fund has invested is not relevant) because of the link between redemption and 'Net Asset Value' of the units, the ability of the unitholders to put back the units to the Fund (subject to 'lock-in' period, if applicable in some cases (see paragraph 6 above)) for cash or units of another scheme (which are financial assets) in case of switch-out means that the units of the open-ended equity fund meet the *definition* of a financial liability from the perspective of the issuer, given in paragraph 11 of Ind AS 32 (reproduced above), irrespective of their *classification* by the issuer. In the case of open-ended funds, mere fact that contractual obligation on the part of the issuer to deliver cash (or issue units of another scheme in the case of switch-out) depends on the exercise of the redemption/ switch-out option by the unitholders does not mean that the issuer has an unconditional right to avoid such an obligation. This is equally applicable for units of close-ended equity funds, since, redemption or switch-out is certain to occur on the maturity date of such funds. The classification of such units in the financial statements of the funds is irrelevant. In the case of dividend option, the existence of discretion on the part of Trustee to declare dividend does not alter the position. This is because if dividend is not declared, it will be inbuilt in 'Net Asset Value' of the units, which is payable on redemption (either directly or in substance in the case of 'switch-out'). Hence, the Committee is of the view that irrespective of classification of units in the financial statements of the funds, investments in equity funds cannot be treated as investments in equity instruments by the holder of mutual fund units for the purposes of Ind AS 109 and, consequently, the election to recognise fair value changes of particular investments in equity instruments permitted in paragraph 4.1.4 of Ind AS 109 read with paragraph 5.7.5 of Ind AS 109 is not available for investments in equity funds, even if the fund itself invests entirely in equity and equity-related securities. Incidentally, the Committee wishes to point out that in the case of equity fund schemes, a portion of the investments made by the fund can be in debt instruments also (see paragraph 6 above). The treatment of such investments is discussed in paragraph 9 below.

9. The Committee notes that in the extant case investments in equity funds are held generally for capital appreciation rather than for trading purposes. However, it is obvious that irrespective of the way such investments are managed, the contractual cash flows from such investments

do not consist of solely payments of principal and interest on the principal amount outstanding. The contractual cash flows from such investments depend on the cash flows to the fund from its investments which are mainly in equity and equity related securities. Hence, such investments cannot be measured at amortised cost in accordance with paragraph 4.1.2 of Ind AS 109 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A of Ind AS 109. Further, any embedded derivative in such investments, even if not closely related to the host contract, cannot be separated because paragraph 4.3.2 of Ind AS 109, in effect, prohibits separation of embedded derivatives from assets within the scope of that Standard and requires application of paragraphs 4.1.4-4.1.5 of that Standard to the entire host contract. Consequently, entire investments in equity mutual funds should be measured at fair value through profit or loss (without separation of any embedded derivatives) in accordance with paragraph 4.1.4 of Ind AS 109, despite the fact X Ltd. generally holds such investments for capital appreciation rather than for trading purposes.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that investments in (units of) equity mutual funds cannot be treated as investments in equity instruments for the purposes of application of exception permitted in paragraph 5.7.5 read with paragraph 4.1.4 of Ind AS 109 for particular equity investments. Consequently, the question of routing the fair value changes of such investments through other comprehensive income does not arise at all.

Query No. 6

***Subject: Treatment of disputed amount (Principal and Interest) in respect of cases pending before various regulatory authorities.*[1]**

A. Facts of the Case

1. The company (hereinafter referred to as the 'company') is a central public sector undertaking under the Ministry of Petroleum & Natural Gas. The

[1] Opinion finalised by the Committee on 4.1.2018.

company is engaged in engineering consultancy services and execution of turnkey contracts in the field of petroleum refineries, pipelines, oil & gas processing, petrochemicals, offshore structures and platforms, ports and terminals, metallurgy, fertilizers, power, highways and bridges, airports and intelligent buildings and urban development. The company being a listed company and having net worth of more than Rs.500 crore, has prepared and presented its financial statements for the year ended 31st March 2017 as per Ind AS.

2. The querist has stated that in the note - 40 forming part of financial statements of the company for the year ended 31 march 2017, the company had disclosed the information with respect to contingent liability as on 31 March 2017 (relevant extracts have been separately supplied by the querist for the perusal of the Committee).

3. The querist has stated that the disclosure with respect to contingent liability includes:

(a) Income Tax (IT) department is in appeal against tax demand of Rs. 373.83 Lakhs with Income Tax Appellate Tribunal, against the Commissioner of Income Tax (Appeals) orders in the company's favour for various assessment years detailed below:

Assessment Year	Amount (Rs. in Lakhs) 31 March 2017	Amount (Rs. in Lakhs) 31 March 2016	Amount (Rs. in Lakhs) 1 April 2015
2002-03	204.22	204.22	204.22
2004-05	76.07	76.07	76.07
2010-11	-	32.26	32.26
2011-12	50.82	50.82	-
2012-13	42.72	-	-
Total	**373.83**	**363.37**	**312.55**

(b) The company has filed a writ petition before Hon'ble Andhra Pradesh High Court against the VAT assessment order of commercial tax officer dated 27 August 2016 levying tax of Rs. 6,999.17 Lakhs for the period July 2011 to March 2014.

(c) The company has filed an appeal against the order of Additional Commissioner (Appeal), Mathura before Sales Tax Tribunal, Agra, which has been subsequently transferred to Sales Tax Tribunal, Noida, for an amount of Rs. 18.71 Lakhs (previous year 31 March 2016 and 1 April 2015 : Rs. 18.71 Lakhs) on account of entry tax for the year 1999-2000 against which the company has deposited an amount of Rs. 5.01 Lakhs (previous year 31 March 2016 and 1 April 2015 : Rs. 5.01 lakhs).

4. The querist has informed that during the course of audit of accounts of the company for the year ended 31 March 2017, Office of the Director General of Commercial Audit and Ex-officio Member Audit Board-II, New Delhi has raised observations with respect to contingent liabilities disclosed as per 3(a, b & c) above.

5. The observations raised by the Comptroller and Auditor General office (CAG) on 3(a, b & c) are as under:

(a) This includes an amount of Rs. 373.83 Lakhs payable to IT department for different financial years 2001-02 to 2011-12 pertaining to the disallowance as commission paid to foreign agents, short grant of advance tax, short grant of Tax Deducted at Source (TDS) and excess levy of interest. The company has not included the interest payable of Rs. 548.49 Lakhs on this disputed amount up to March 2017.

(b & c) Similarly, the above head includes 7012.87 Lakhs payable to Sales Tax (ST) Department pertaining to entry tax (Rs. 13.70 Lakhs) for the financial year 1999-2000 relating to job work and VAT payable to Andhra Pradesh ST department for the period July 11 to March 2014. The company has not included the interest payable of Rs. 4859.02 Lakhs on this disputed amount up to March 2017.

Hence, this has resulted in understatement of contingent liabilities by Rs. 5407.51 Lakhs and by the same extent in the disclosure of the dues of IT department and sales tax department which was disputed and shown in Annexure A, point VII(b) of Independent Auditors' Report.

6. The querist has also informed that management replies with respect to above observations of CAG are as under:

(a) It is submitted that in these cases, the Commissioner of Income Tax (CIT Appeals) has given order in the favour of the company and against the order of CIT Appeals, IT department has referred these cases before the Income Tax Appellate Tribunal (ITAT).

(The copies of assessment order, order of commissioner (appeals) and notices for referral of cases to ITAT by IT department for assessment years 2002-03, 2004-05, 2011-12 & 2012-13 have been separately supplied by the querist).

Although, the case has been decided in favour of the company, since IT department has moved to ITAT, the company has disclosed an amount of Rs. 373.83 Lakhs as contingent liability.

Since the cases have already been decided in favour of the company by the CIT appeals, based on facts and circumstances of the case, the incurrence of any interest liability on the above account is very remote and as such is not considered as contingent liability. However, since, the case is pending in ITAT, the amount of Rs. 373.83 Lakhs has been disclosed as contingent liability.

(b) With respect to contingent liability on account of VAT assessment order of Commercial Tax Officer, Kakinada for an amount of Rs. 6999.17 Lakhs, it is submitted that based on orders passed by VAT authorities, the company has disclosed the order amount as contingent liability. (The copy of assessment order of commercial tax officer is separately supplied by the querist). However, the company has filed a writ petition before Hon'ble High Court of Andhra Pradesh against the assessment orders. Since the judgment is yet to be delivered by the Hon'ble High Court of Andhra Pradesh, the contingent liability, if any, on account of interest etc. is not ascertainable and as such the assessment order demand amount has been disclosed as contingent liability.

It is further submitted that transit sales have been allowed in all other states except Andhra Pradesh and Karnataka, where the company has executed these types of projects and, as such, it is expected that there is remote possibility of fructifying the demand.

Regarding the inclusion of interest as contingent liability, it is submitted that the same shall be reviewed including an opinion of experts shall be taken based on facts and circumstances of the case in the year 2017-18.

(c) In respect of entry tax demand order of Rs. 13.70 Lakhs by Additional Commissioner (Appeal) Mathura, the company has filed an appeal before Sales Tax Tribunal. (The Copies of order of Dy. Commissioner Commercial Tax, Mathura and Additional Commissioner (Appeal), Grade-2 have been separately supplied by the querist).

In this regard, it is submitted that in earlier years, there were two cases involved, wherein the company was in appeal with the tribunal against the orders of the Commissioner (Appeals), Mathura.

In one of the cases, the ST department was disallowing the transit sales made by the Company to the project owner. The said cases for the years 1999-2000 and 2000-2001 have been decided by the commercial tax tribunal in the favour of company (relevant extract have been separately supplied by the querist). Since, as per the decided case of sales tax, the sales tax liability is on account of project owner and, as such, liability for entry tax as per the provision of law shall be borne by the project owner. The company, based on the demand order, has disclosed amount of Rs. 13.70 Lakhs as a contingent liability, although based on decided case for sales tax, no liability shall fall on the company.

In view of above, it is submitted that there has been no understatement of contingent liabilities by Rs. 5407.51 Lakhs and as such, audit is requested to drop its observations.

7. According to the querist, in terms of Ind AS 37, a contingent liability is a possible obligation that arises from the past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of entity.

On the basis of above, the company, on the basis of orders, etc. passed by the respective statutory authorities, has made disclosure in the financial statements of the company. The levy of interest, if any and quantum thereof shall fructify only on the basis of decision made by the tribunal/court, etc. as these are not a part of orders passed by statutory authorities. As of date, the company has in its possession only the order passed by the statutory authorities and the same has been disclosed as contingent liability in the financial statements of the company.

8. The company has further assured the office of Director General of Commercial Audit and Ex-officio Member Audit Board-II, New Delhi that independent expert opinion shall be taken from the Expert Advisory Committee of the Institute of Chartered Accountants of India.

B. Query

9. Considering the facts as stated above, the company has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India in respect of the following:

(a) (i) Whether the amount of Rs. 373.83 Lakhs disclosed as contingent liabilities is correct, although CIT (Appeals) has given the orders in favour of the company but IT department has referred these cases to Income Tax Appellate Tribunal (ITAT).

(ii) If the above disclosure is correct, then :

(1) Whether interest liability on the above amount of Rs.373.83 Lakhs is required to be computed and disclosed as contingent liability as on balance sheet date, although, as such, there is no demand for it; or

(2) Since, there is no demand for interest on the company, whether the fact that above amount of Rs.373.83 Lakhs does not include interest, if any, is required to be disclosed; or

(3) None of above (1) or (2) is required to be disclosed.

(b) (i) Whether disclosure of VAT assessment order of Commercial Tax Officer, Kakinada levying tax of Rs. 6999.17 Lakhs on the company as contingent liability is correct, although the company has filed writ petition against the order before Hon'ble Court of Andhra Pradesh.

(ii) If the above disclosure is correct, then:

(1) Whether the interest liability on above amount of Rs.6999.17 Lakhs is required to be computed and

disclosed as contingent liability as on balance sheet date, although as such, there is no demand for it; or

(2) Since there is no demand for interest on the company, whether the fact that above amount of Rs.6999.17 Lakhs does not include interest, if any, is required to be disclosed; or

(3) None of above (1) or (2) is required to be disclosed.

(c) (i) Whether disclosure of entry tax demand order of Rs.13.70 Lakhs by the Additional Commissioner (Appeals), Mathura as contingent liability is correct, considering that as per decided cases of sales tax by the commercial tax tribunal, the sales tax liability in respect of transit sales made by the company shall be on account of project owner and, as such, liability for entry tax as per provision of law shall also be borne by the project owner.

(ii) If the above disclosure is correct, then:

(1) Whether the interest liability on above account is required to be computed and disclosed as Contingent Liability as on balance sheet date, although as such, there is no demand for it; or

(2) Since there is no demand for interest on the Company, whether the fact that above amount of Rs.13.70 Lakhs does not include interest, if any, is required to be disclosed; or

(3) None of above (1) or (2) is required to be disclosed.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to whether the disclosure of demand raised in respect of cases pending before various tax authorities as contingent liability is correct. Further, whether interest liability that may arise in respect of said cases is also required to be computed and disclosed as contingent liability. The Committee

has, therefore, considered only these issues and has not examined any other issue that may be contained in the Facts of the Case such as calculation of demand and interest thereon in respect of cases pending before various regulatory authorities, adjustments on transition to Ind ASs, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view and not from any legal perspective. The Committee also wishes to point out that the opinion expressed hereinafter, is in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Accounting Standards) Rules, 2015 and not in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006.

11. The Committee notes the following terms as defined in paragraph 10 of Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets':

> **"A *provision* is a liability of uncertain timing or amount.**
>
> **A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.**
>
> **An *obligating event* is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.**
>
> **A *legal obligation* is an obligation that derives from:**
>
> **(a) a contract (through its explicit or implicit terms);**
>
> **(b) legislation; or**
>
> **(c) other operation of law.**
>
> **A c*onstructive obligation* is an obligation that derives from an entity's actions where:**
>
> **(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and**
>
> **(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.**

A *contingent liability* is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; 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) the amount of the obligation cannot be measured with sufficient reliability."

12. The Committee further notes the following paragraphs of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets':

"14 A *provision* shall be recognised when:

(a) an entity has a present obligation (legal or constructive) 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 shall be recognised.

15 In rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

16 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 entity determines whether a present obligation exists at the end of the reporting period 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 reporting period. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the end of the reporting period, the entity recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the end of the reporting period, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86)."

"23. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, ie the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86)."

"27 An entity shall not recognise a contingent liability.

28 A contingent liability is disclosed, as required by paragraph 86, unless the possibility of an outflow of resources embodying economic benefits is remote."

"86 Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 36–52;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.”

13. The Committee notes from the above that an element of judgement is required to determine whether the demand raised in respect of cases pending before ITAT, Honourable High Court of Andhra Pradesh and Sales Tax Tribunal should be provided for in the accounts or treated as contingent liability and disclosed by way of a note to the accounts. It is for the management of the enterprise to decide and for the auditor to assess, considering the circumstances of each case, whether the demand raised warrants recognition of provision or disclosure of contingent liability. The Committee is of the view that while making such judgement, all facts and circumstances available on the balance sheet date, including for example, legal opinion of an expert on the possibility and extent of outcome (success or failure) of the company’s cases in the court of law, experience of the company or other enterprises in similar cases, decisions of appropriate authorities, etc. should be considered. The Committee is further of the view that mere expert opinion should not be considered in isolation; other factors prevailing on the balance sheet date, as suggested above should also be considered while making the judgement. Further, the Committee is also of the view that in determining whether the demand raised should be provided for in the accounts or treated as contingent liability and disclosed by way of notes to the accounts at the balance sheet date or not, events occurring after the balance sheet date but, before the date of finalization of accounts, should also be taken into consideration.

14. Further, the Committee is of view, the interest liability that may arise on demands raised in respect of cases pending before ITAT, Honourable High Court of Andhra Pradesh and Sales Tax Tribunal, will depend on the decision taken by respective authorities i.e. whether interest needs to be paid in addition to the principal amount or not in case the outcome does not result in favour of the company (which itself is uncertain). The Committee also wishes to clarify that the fact that no demand has been raised by the authorities does not necessarily indicate that demand cannot be raised. Accordingly, whether interest liability that may arise in respect of cases

pending before various authorities requires to be disclosed as contingent liability or not, requires an element of judgement and should be decided by the management of the company on the basis of all facts and circumstances available on the balance sheet date such as the past decisions taken by the taxation and judicial authorities in similar cases etc.

D. Opinion

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

(a) The company should, based on all the available evidence, assess whether there is a present or possible obligation towards the demand raised in respect of cases pending before ITAT, Honourable high Court of Andhra Pradesh and Sales Tax Tribunal. If it is considered probable that a present obligation exists at the balance sheet date and the said obligation will be settled, of which a reliable estimate can be made, the company should recognise a provision for the demand raised. 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 , unless the possibility of an outflow of resources embodying economic benefits is remote.

(b) Further, the Committee is of the opinion that based on all facts and circumstances available on the balance sheet date such as the past decisions taken by the taxation and judicial authorities in similar cases etc., it should be decided by the management of the company as to whether the interest liability that may arise in respect of cases pending before various authorities is required to be computed and disclosed as a contingent liability or not.

Query No. 7

Subject: Classification of grant related to assets in the statement of cash flows.[1]

A. Facts of the Case

1. A company was incorporated on 16th August 1984 for procuring, transmission, processing and marketing of natural gas. The company has an authorised share capital of Rs. 2,000 crore, out of which Rs.1,691.30 crore is paid-up share capital. The Government of India ('GoI') holds 54% equity of the company at present. The securities of the company are listed on National Stock Exchange, Bombay Stock Exchange and London Stock Exchange. At present, the company owns over 11,000 Kms of pipeline and currently transmits about 206 MMSCM per day of natural gas. The company operates six LPG manufacturing plants in different parts of the country with an installed capacity of 1.04 Million MT of LPG per annum. The company has an integrated petrochemical plant at Pata, Uttar Pradesh for manufacturing polymers. The company has world's longest pipeline from Jamnagar to Loni for transmission of LPG. The company has integrated its business activities and operates the City Gas Distribution ('CGD'), Exploration of Natural Gas, Wind Power & Solar Power Plant and Telecom Businesses. The company has formed subsidiaries/associates/joint venture companies for CGD, Petrochemicals, LNG, Gas Trading, Power Generation and Shale Gas.

2. The company has prepared its accounts as per Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016. In compliance with the Companies (Indian Accounting Standards) Rules, 2015, the company has prepared its financial statements for F.Y. 2016-17 with comparative figures for F.Y. 2015-16. The company has adjusted the impact of transition from Indian Generally Accepted Accounting Principles to Ind ASs in the opening reserve as on 1st April 2015 and in the statement of profit and loss for F.Y. 2015-16. Further, the holding company, subsidiaries, joint ventures, or associate companies of the company also need to make transition to Ind ASs w.e.f. 1st April 2016.

3. The GoI has entrusted with the company the task to execute the 2,600 km. long Jagdishpur Haldia & Bokaro-Dhamra Gas Pipeline Project connecting the Eastern states of the country to the National Gas Grid. Five states, viz., Uttar Pradesh, Bihar, Jharkhand, Odisha and West Bengal will

[1] Opinion finalised by the Committee on 4.1.2018.

benefit from gaining access to natural gas on affordable and equitable basis. The project work is under progress as per phase-wise schedule. The Cabinet Committee on Economic Affairs (CCEA), GoI has approved a capital grant of Rs.5,176 crore being 40% of estimated capital cost of Rs.12,940 crore *vide* Notification no. L-14014/44/2006-GP-I (Pt. II) dated 7th October 2016. The first instalment of Rs.450 crore was disbursed by the GoI to the company during F.Y. 2016-17. (Copy of circular separately supplied by the querist)

4. As per the querist, in accordance with the provisions of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance', the company has accounted for the amount of capital grant under the head "Other non-current liabilities". Further, the company has classified the amount of capital grant under "Cash flows from financing activities" in the Cash Flow Statement during F.Y. 2016-17 in line with the provisions of Ind AS 7, 'Statement of Cash Flows'.

5. The Comptroller & Auditor General of India (C&AG) has conducted supplementary audit on the accounts of the company for F.Y. 2016-17 under section 143(6) of the Companies Act, 2013. While conducting the supplementary audit of accounts, the C&AG accepted the accounting treatment made by the company. However, the C&AG has made observation on classification of capital grant by the company as *Financing Activity* in the Cash Flow Statement and opined that it should be classified as an *Investing Activity* in the Cash Flow Statement.

6. The company and its statutory auditors are of the opinion that the capital grant is one of the sources of financing the project expenditure besides loan and internal generation/equity. The company is of the view that had the company not received the capital grant, the alternate source for such financing would be either from equity or borrowings. Thus, in substance, capital grant is in the nature of a financing activity and, therefore, is correctly shown as Financing Activity.

7. However, the C&AG has not accepted views of the company/joint statutory auditors and, instead, is of the view that, since the capital grant was received specifically for investment and acquisition of long-term asset, the company should recognise the government grant as deferred income in accordance with paragraph 24 of Ind AS 20. Accordingly, the amount should be proportionately taken to income over the period of useful life of pipeline project. Unlike financing activities, viz., loan and equity on which

interest/dividend is payable, the amount received as government grant will be utilised for investing activities only and, therefore, will not change the equity/borrowing of the company and should be reflected as an "Investing activity" in the Cash Flow Statement.

8. The provisional comment of the C&AG and the reply submitted by the company are as follows:

Provisional Comment	Reply
III. Standalone Cash Flow Statement for the financial year ended 31st March 2017 **<u>Cash Flow from financing activities</u>**	
The above includes Rs. 450 crore towards the capital grant received from Govt. of India for execution of Jagdishpur-Haldia-Bokaro-Dhamra Pipeline Project (JHBDPL).	It is submitted that the company has received Rs. 450 crore during the year towards capital grant approved by Cabinet Committee on Economic Affairs (CCEA), Government of India for execution of Jagdishpur Haldia Bokaro Dhamra Pipeline Project (JHBDPL).
In this regard, Para 6 of Ind AS 7 states that **"***Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents" while "Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity"*.	The long-term asset will be constructed by utilising the Government grant given for a specific purpose. The grant received, being specific, is source of funds for the creation of the said asset. If the company would not have received any grant from GoI, the alternate source for such financing would be either from equity or borrowings. Thus, in substance, capital grant is in the nature of financing activity as per the provision of Ind AS 7.
However, audit observed that capital	It is also submitted that as per

grant received from GoI was for investment purpose and to meet out the capital expenditure (acquisition of long-term assets) of above said pipeline project. Thus, the same should have been classified as investing activity whereas the company has classified this grant under financing activities in Cash flow Statement.	Indian GAAP (AS-3), the amount of grant was disclosed under Capital Reserve, which forms part of Reserves and Surplus. Further as per the provisions of Ind AS 7 also, the amount of Grant become part of Non-Current Liabilities. Thus, the nature of grant is financial activities.
Management / Joint Statutory Auditors replied that if the company would not have received any grant from GoI, the alternate source for such financing would be either from equity or borrowings. Thus, in substance, capital grant is in the nature of financing activity.	It is further submitted that the expenditures that result in a recognised asset in the balance sheet are eligible for classification as investing activities, whereas the financing activities are related to forecast claims on future cash flows by providers of capital to the entity.
Management's/Joint Statutory Auditors' replies are not acceptable as govt. grant has been received specifically for investment and acquisition of long-term asset and the company has to recognise the Government Grant as deferred income in accordance with Para 24 of Ind AS 20 which would be proportionately taken to income over the period of useful life of pipeline project. Unlike, financing activities, *viz.* loan and equity on which interest/dividend is payable, the amount received as Govt. grant will be utilised for investing activities only and therefore will not change the	Since the grant received by the company was source of fund for creation of assets, the company has correctly classified the capital grant as financing activities. Further, the user is able to understand the cash receipts from grant from the disclosure in Cash Flow Statement. Hence, Provisional Comment may please not be pursued further.

equity/ borrowing of the company. Thus, statement of cash flows is also deficient to that extent.	

9. It is also pertinent to mention that Ind AS 7 does not provide any guidance on treatment of capital grant received from GoI as described hereinabove in the Cash Flow Statement as such. In view of the difference of opinion with the C&AG, it was decided to take the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the said matter.

B. Query

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

(i) Whether the classification of Rs. 450 crore received as capital grant from Government of India under 'Financing activities' in the Statement of Cash Flows for FY 2016-17 for the reasons mentioned in paragraph 6 above is correct as per Ind AS 7.

(ii) In case the answer to (i) above is not in the affirmative, what should be the appropriate classification of capital grant of such nature and purpose from Government of India in the Statement of Cash Flows.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to classification of the receipt of Rs.450 crore by way of grant related to assets (hereinafter referred to as 'the grant') from the Government of India (hereinafter referred to as 'the government') in the statement of cash flows for the financial year 2016-17 in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as 'the Rules'). The Committee notes from the facts of the case that C&AG has agreed that the amount received is in the nature of government grant and not shareholder's contribution. The Committee has, therefore, considered only the issue raised and has not examined any other issue that may be contained in the Facts of the Case, such as amount to be recognised in the balance sheet and statement of profit and loss, classification, recognition, measurement and accounting treatment of grant received by the company. Further, the Committee presumes that the

pipeline will be owned and controlled by the company and that the company is not acting only as an implementing/executing agency of the government and consequently, the pipeline or components thereof, as the case may be, will be recognised as asset(s) in the company's financial statements.

12. The Committee notes that the terms 'Investing activities' and 'Financing activities' are defined in paragraph 6 of Indian Accounting Standard (Ind AS) 7, Statement of Cash Flows, notified under the Rules, as below:

> ***"Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents."**
>
> ***"Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity."**

13. The Committee first examines whether receipt of the grant should be classified as cash flow from financing activity in the cash flow statement. For classification as financing activity, the receipt of the grant should result in change in the size and composition of contributed equity and borrowings. Although there can be equity contribution otherwise than by way of subscription to equity shares, in the extant case, the receipt of the grant does not represent equity contribution from the government neither it is borrowing from the government.

14. As per paragraph 6 of Ind AS 7 reproduced in paragraph 12 above, only acquisition and disposal of long-term assets and other investments not included in cash and cash equivalents should be classified as investing activities. Hence, at first sight, it may appear that receipt of the grant does not meet the definition of investing activity, since the resulting cash inflow does not arise from disposal of any asset. However, in substance, to the extent of the grant, cost of the pipeline project is borne by the government. In effect, the cash outflow on the long-term asset, i.e., pipeline, is reduced by the amount of the grant. This factual position is not changed by the accounting and presentation requirements of Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance', notified under the Rules. Accordingly, the Committee is of the view that the receipt of the grant is an investing activity. This view is strengthened by paragraph 28 of Ind AS 20 which states as follows:

"28. [2]The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are disclosed as separate items in the statement of cash flows."

D. Opinion

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

(i) The classification of Rs.450 crore received as grant related to assets from Government of India as part of cash flows from 'Financing activities' in the statement of cash flows for the financial year 2016-17 is not correct.

(ii) The same should be classified as part of cash flows from 'Investing activities' in the statement of cash flows for the financial year 2016-17 as discussed in paragraphs 13 and 14 above.

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[2] This paragraph has been subsequently revised vide Notification No. G.S.R. 903(E) dated 20th September, 2018.

PART II:
Opinions on Accounting Standards

Query No. 8

***Subject: Accounting treatment of revaluation of 'Regeneration expenses' - Inventories.*[1]**

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is engaged in improving the productivity of forest areas transferred to it by the forest department of the state by raising plantations and carrying out silvicultural activities. The company is predominantly engaged in the selling of forest produce (termed as Crop-I and Crop-II) that has been obtained from the silvicultural exploitation operation in the forest areas. The difference between the two crops is stated below:

(a) **Crop-I:** Forest areas are transferred by the Forest Department, Government of Madhya Pradesh (GoMP) to the company. At the time of transfer of these forest areas, all the forest produce that was initially present in these forest lands is silvicultured by the company as per the approved guidelines, under scientific methods of forestry and approved working plans from the Government of India (GOI). After silvicultural operations of these transferred forests, the forest produce that is reaped, i.e., teakwood etc. is sold by the company on behalf of Forest Department, Government of Madhya Pradesh. After deducting the direct and indirect expenses from the revenue received by selling these forest produces, the net revenue is given to Forest Department, GoMP as 'Lease Rent'. On the total sale of this forest produce, i.e., Crop I, the company receives 2% commission from the GoMP. Hence, basically, Crop I is the revenue generated from the standing crop that is sold by the company on behalf of the Forest Department, GoMP from the areas transferred to the company.

(b) **Crop-II:** The company raises plantations on these exploited forest areas. These plantations will mature for harvesting only after around 60 years of plantation in case of teak. Meanwhile, scientific silvicultural operations, namely, nursery preparation, spacing, pruning, thinning etc. are periodically performed on these growing plantations, which yield substantial forest

[1] Opinion finalised by the Committee on 17.3.2017.

produce and such thinning operations generate substantial revenue. Thinning operations are performed in the 11th, 16th, 21st, 26th, 31st, 36th, 41st and 46th year of plantation in case of Teak and every 4th year in case of Bamboo. These forest produces are being sold by the company and the revenue generated is mentioned as the revenue generated from Crop II in the final accounts of the company. The entire amount received by the company by the sale of such silviculture operation periodically is called as Crop II. Crop II is basically the crop generated by the company after clear felling in the areas transferred to the company year after year against its own plantation done in the previous years. Amount generated from the sale of Crop II fully pertains to company's revenue and nothing is paid to GoMP against the revenue so generated.

The 'net income' arising out of sale of Crop-II (i.e., sale of forest produce grown by the company) is exempt from income tax being *'Agricultural Income'*. The company is carrying out above operations through its 11 divisions situated in various districts of the State of Madhya Pradesh.

2. The raised plantations are planted and nurtured by the company. All the expenses, i.e., both direct and indirect (preparation of nurseries, plantation, weeding, fire protection and other indirect expenses) are incurred by the company. All the expenses are shown in the balance sheet under 'Current Assets- Inventories-Regenerations expenses' as per the original input cost of Crop II. At the time of final felling of these plantations, i.e., Crop II, all the expenses, i.e., direct and indirect expenses shall be proportionately deducted from the net revenue realised in those areas of clear felling which shall be finally termed as the revenue on sale of Crop II and shall be shown in the balance sheet as sale of Crop II.

3. The querist has stated that as per the accounting policy consistently adopted by the company, the expenses incurred on plantation/regeneration in areas transferred to the company are being depicted under the head 'Regeneration expenses- current assets- inventories' in the balance sheet of the company and are duly disclosed in the 'Notes to the accounts' every year. Though, the method of computation of 'regeneration expenses' and depiction thereof in the accounts is being consistently followed by the company since last several years, yet such depiction does not reflect the 'present value' of these assets. Thus, the above assets of the company are

shown in the audited accounts at a substantially suppressed value as compared to its present value. Consequently, the actual 'net worth' of the company is not appearing in the audited accounts. Present book value of standing crop 'regeneration expenses' as on 31/03/2014 as per the audited accounts of the company is Rs. 113.38 crore, whereas the present market value of these assets (inventories) is several times their book value, i.e., about Rs. 3,500 crore. The paid up equity capital of the company is Rs. 39.32 crore and, along with reserves of Rs. 183.13 crores, its net worth as on 31/03/2014 is Rs. 222.44 crore, whereas, the plantations raised by the company alone are valued at more than Rs. 3,500 crore.

4. The querist has further stated that about 7000 hectare area of one of the divisions, Rampur-Bhatodi Project Division, Betul has recently been transferred to Satpura Tiger Reserve, Govt. of Madhya Pradesh. The valuation for this transferred area came to Rs. 1,293.00 crore on the basis of current net market value (market value of standing crop – expenses on exploitation). The company sells its produce in open auctions; hence the valuation of forest produce done on this basis reflects its true market worth. The company has raised around 2,75,000 hectare plantations since its inception. Thus, one can imagine the true market worth of the total plantations raised by the company. The querist has also separately informed that there is no established practice in the company for the valuation of crop of teak and bamboo plantations at net realisable value. Although for fixation of selling price of its forest produce, there is a well established practice for determining the upset price twice a year (in April and October) which is based on the average sale price obtained during the previous 12 months. Further, there is no homogeneous market available in case of forest produce and there is no substitute for teak log, poles, bamboo, fuel etc. because these are natural products and are specific/ specified by nature. According to the querist, there is also no established practice in India or any Accounting Standard issued by the ICAI for valuation of standing crops.

5. The querist has also stated that in its 40 years of existence, the company has pioneered in raising of successful plantations and wishes to utilise its expertise by expansion and diversification of its activities, for which the company would require massive low-cost funds. The company wishes to raise these funds via instruments, like Capital Gain Bonds or Infrastructure Bonds. Since the plantation projects undertaken by the company are typically of long gestation periods, bank finance would not be a very feasible option. If

the company can show its true net worth by revaluing its 'regeneration expenses' to its present worth, it can leverage it to obtain such funds. The company thus intends to revalue its 'regeneration expenses' by depicting the same as its 'real asset value' and increase its net worth by the like amount.

B. Query

6. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee regarding the validity of:

(a) Accounting treatment of the proposed revaluation of 'Regeneration Expenses' with reference to Crop-II;

(b) Disclosure requirement in respect of proposed revaluation having regard to the Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) and provisions of the Companies Act, 2013.

C. Points considered by the Committee

7. The Committee, while answering, 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, such as, accounting treatment in respect of Crop I, accounting for various expenses booked as regeneration expenses under inventory, calculation of net worth of the company, etc.

8. The Committee notes that in the extant case, all the expenses, direct or indirect (such as preparation of nurseries, plantation, weeding, fire protection and other expenses), incurred by the company for raising standing crops in respect of Crop II are being accounted for as 'regeneration expenses' under inventories. Now, the company is proposing to revalue these regeneration expenses/inventory of the standing crops, at its present worth/real asset value based on their market value. In this regard, the Committee notes the following paragraphs of Accounting Standard (AS) 2, 'Valuation of Inventories', notified under Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules').

"***1. This Standard should be applied in accounting for inventories other than:***

...

(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.***"

"2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard."

The Committee notes from the above that AS 2 is not applicable to producers' inventories of *agricultural and forest products* to the extent that they are measured at net realisable value in accordance with well established practices in those industries. The Committee is of the view that the scope exclusion paragraph 1 (d) of AS 2 deals with the agricultural products which are the harvested produces and not standing crops and therefore, the plantations in the extant case do not fall in the scope exclusion paragraph 1 (d) of AS 2, notified under the Rules. Accordingly, the 'regeneration expenses' with reference to Crop II should be valued at the lower of historical cost and net realisable value as per paragraph 5 of AS 2, as reproduced below:

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

The Committee further notes the following paragraph from 'Chapter V-Valuation of Assets' of the Monograph on Accounting for Agricultural Operations, issued by the Research Committee of the ICAI:

"General Principles:

…

3) *Standing Crops:* The standing crops in a farm are similar to the work-in-progress in manufacturing industries and the general accounting principles of valuation of work-in-progress would be applied for standing crops. Thus, the standing crops would be valued at the lower of cost and net realizable value. The latter would be ascertained after making allowance for the expenses yet to be incurred to make the crop marketable and the marketing expenses. It may be mentioned that innumerable

natural risks are associated with the agricultural operations and it would be prudent to carefully assess and provide for these risks while valuing the standing crops."

On the basis of the above, the Committee is of the view that the inventories of standing crops in the extant case should be valued at the lower of cost and net realisable value and accordingly, the proposed revaluation of the regeneration expenses is not correct.

D. Opinion

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

(i) The proposed revaluation of 'regeneration expenses' with reference to Crop II is not correct as discussed in paragraph 8 above.

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

Query No. 9

Subject: Recognition and valuation of Carbon Emission Reductions (CERs).[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') undertakes integrated waste management (IWM) and started its operations in the year 2007. It extracts value from all waste streams including biodegradables, combustibles and inerts (debris, glass, plastic etc.). As a result, compost, refuse derived fuel (RDF) / combustibles and carbon emission reductions (CERs) are produced on processing of municipal solid waste (MSW) input. The company has as on date, seventeen operating composting facilities across the country with waste handling capacity of 2,750 tonnes per day (TPD) of MSW.

2. CERs are generated at various facilities of the company during production of compost and the company has sold these CERs. During the

[1] Opinion finalised by the Committee on 17.3.2017.

past six years, the company has successfully earned revenue of about Rs. 170 mn by selling 4,67,534 number of CERs as against compost revenue of Rs. 288 mn.

3. The process involved in generation of CERs is briefly explained by the querist as below:

(i) Compost can be manufactured by an anaerobic or aerobic process. Aerobic composting means ‘with oxygen’, and anaerobic composting means ‘without oxygen’. Aerobic composting makes MSW project eligible for CERs as per the United Nation Framework Convention on Climate Change (UNFCCC) Guidelines. Aerobic process is evaluated at the time of registration by UNFCCC for determining the eligibility of CERs benefits during operations. One tonne of methane mitigation by processing waste in aerobic condition makes company eligible for one CER.

(ii) In contrast, if the waste is dumped into pits and composting takes place over a period of time in largely anaerobic conditions which leads to emission of Green House Gases (GHG - Methane) in the environment, these facilities are not eligible for CERs benefits.

(iii) CERs are generated due to the mitigation of methane generation in the decomposition of waste in an aerobic manner. The methane generation follows a First Order Decay (FOD) model, which is reflected in the calculation of CERs on year to year basis. The FOD is a compounding model, where it is considered that the previous year’s waste does not decompose completely in a single year. The various components of MSW decay values are defined by the Inter-Governmental Panel on Climate Change (IPCC). Thus, the previous year’s waste would continue to contribute fractionally towards CER generation in the subsequent years.

(iv) Aerobic process requires higher capital expenditure and involves additional operational costs (manpower, vehicle running, power and fuel, depreciation, interest etc.) at every stage of the process.

4. The process flow of the production of compost, RDF and CERs is enumerated below:

5. Brief explanations on key segments of the process are as follows:

(i) Pre-Sorting- MSW received in plant is a mixture of bio-degradables, combustibles and inerts. In the pre-sorting process, the materials like plastic, wood and inerts of particulars size are separated to ensure that maximum bio-degradable material is only transferred to the pad for windrow formation. This process helps in maximising the compost output and reducing GHG emission during aerobic composting at the pad. The segregated material other than inert is used as RDF/ combustibles. To carry out this process, operational cost towards manpower, equipments, power and fuel etc. is incurred for loading, segregating and transferring material to the next stage.

(ii) Windrow formation and Turning- Sorted bio-degradable waste is brought to the pad and windrows are formed for aerobic composting. The material is kept on the pad for atleast 4 weeks and is turned around at regular intervals to ensure proper oxidation, temperature control and aerobic decomposition. This involved operational costs towards manpower, handling equipments, monitoring devices, power & fuel etc.

(iii) Monsoon Shed: Once the material is decomposed, it is kept under shed or any other covered area to further reduce the moisture content. The material is required to be turned around at regular intervals for speeding up the drying process. This process generally takes 5–8 weeks depending on the location of the processing facility. At this stage also, operational costs are incurred towards manpower, handling equipments, power & fuel etc.

(iv) Core-segregation, refinement, storing and packing: Once the moisture is reduced upto a particular level, then it is required to screen the material and bring the material upto the size of 4 mm or below in order to ensure that the material is appropriate to be used as an agricultural input in farms. Part quantity of material with size of 4 mm and above is used as RDF/ combustible and part quantity is sent to reject site. Compost and RDF/combustible produced are kept under covered shed to ensure that the emission of GHG is minimised in the environment.

6. (a) The process stated above very clearly highlights the following points:

(i) There is requirement of various types of plant and machinery, equipments, vehicles, civil structure, monitoring devices etc. to produce compost through aerobic process.

(ii) There are various operational costs incurred towards manpower, power & fuel, repair & maintenance, vehicle hiring, etc. at every stage to produce compost through aerobic process alongwith CERs and RDF/ combustible simultaneously.

(b) Pursuant to the company following the aerobic process, it generates CERs throughout the year at each of its compost production facilities. They are accounted for on a calendar year basis.

(c) The verification of CERs generated is independently done by a Designated Operating Entity (DOE) accredited to the UNFCCC which finalises the number of CERs generated by the project, based on detailed verification of the compliance process followed by that project.

(d) The verification and certification reports are uploaded by DOE on the UNFCCC website capturing the number of CERs generated by the project during a specific period. The Executive Board of UNFCCC considers the report and issues the CERs to the entity. The CER's verified by DOE are rejected only on account of fraud, malfeasance or incompetence of the designated operational entities.

7. Recognition of CERs in the financial statements of the company as per the Guidance Note on Accounting for Self-generated Certified Emission Reductions, issued by the Institute of Chartered Accountants of India (ICAI):

(i) The ICAI has issued a Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs) (hereinafter referred to as the Guidance Note), which lays down the guidance on the matters of applying accounting principles related to recognition, measurement and disclosure of CERs generated by an entity through the Clean Development Mechanism (CDM).

(ii) *Recognition of CERs as an 'asset':*

(a) As per the Guidance Note, a *CER is to be recognised as an 'asset'* in the financial statements of an entity as it meets the criterion for recognition as an '*asset'*. For a CER to be considered as asset, it should be a resource controlled by the generating entity arising as a result of past events, and from which future economic benefits are expected to flow to the generating entity.

(b) At paragraph 17 of the Guidance Note, it has been stated that CERs come into existence when these are credited by UNFCCC in a manner to be unconditionally available to the generating entity. Therefore, CERs should not be recognised before that stage.

(c) The second criterion for recognition of CERs as an asset is the measurement of the cost incurred for their generation. The Guidance Note lists out at paragraph 24, various costs incurred to set up a CDM project activity, operate a CDM project and generate CERs.

(iii) *Valuation of CER Inventory as per Accounting Standard (AS) 2, 'Valuation of Inventories':*

(a) As per paragraphs 21 and 22 of the Guidance Note, though CERs are intangible assets but they have to be considered as inventory of the generating entity as they are generated and held for sale in the ordinary course of business and should be measured at cost or net realisable value, whichever is lower.

(b) Further, paragraph 23 mentions that in accordance with AS 2, ***"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".***

(c) Paragraph 24 of the Guidance Note lists out the various costs incurred to set up CDM project activity as follows :

(i) research costs arising from exploring alternative ways to reduce emissions;

(ii) costs incurred in developing the selected alternative as a process/device to reduce emissions;

(iii) costs incurred to prepare the Project Design Documents;

(iv) fees paid to DOEs for validation and verification and to the National Authority for approval;

(v) fees of registering with UNFCCC;

(vi) costs incurred for monitoring the reductions of emissions;

(vii) costs incurred for certification of CERs; and

(viii) operating costs incurred to run the CDM project.

(d) However at paragraph 25, the Guidance Note mentions that the costs incurred by the generating entity for certification of CERs are the costs of inventories of CERs. It mentions that costs incurred on research and development, costs incurred for preparation of PDD and registration of CDM project with UNFCCC cannot be considered for inventory valuation and only costs incurred for certification should be considered. *However, according to the querist, it is completely silent on the operating costs incurred on generation of CERs as listed at paragraph 24.*

(Emphasis supplied by the querist.)

8. *Views of the company:*

The MSW operations of the company are based on mitigating methane generation through the aerobic composting which generates CERs as an intrinsic and integral part of compost producing process enumerated above. The company requires opinion of the Expert Advisory Committee on the following issues:

(1) Point of recognition of CERs as an 'asset'

(a) As per paragraph 17 of the Guidance Note, "CERs come into existence when these are credited by UNFCCC in a manner to be unconditionally available to the generating entity. Therefore, CERs should not be recognised before that stage". But the querist wishes to apprise the Committee that CERs can be recognised as assets once the Designated Operating Entity (DOE) has verified the number of CERs generated in a period and has uploaded the report at UNFCCC site for the issuance and need not wait till the approval of issuance by the Executive Board. In this context, the paragraphs from the Guidance Note on 'Methodology for Issuance of CERs issued by UNFCCC' have been explained by the querist as below:

(i) The DOE shall, based on its verification report, certify in writing that, during the specified time period, the project activity achieved the verified amount of reductions in anthropogenic emissions by sources of green house gases that would not have occurred in the absence of the

CDM project activity. It shall inform the project participants, parties involved and the Executive Board of its certification decision in writing immediately upon completion of the certification process and make the certification report publicly available.

(ii) The certification report shall constitute a request for issuance to the Executive Board of CERs equal to the verified amount of reductions of anthropogenic emissions by sources of greenhouse gases.

(iii) The issuance shall be considered final 15 days after the date of receipt of the request for issuance, unless a party involved in the project activity or at least three members of the Executive Board request a review of the proposed issuance of CERs. Such a review shall be limited to issues of fraud, malfeasance or incompetence of the designated operational entities and be conducted as follows:

- Upon receipt of a request for such a review, the Executive Board, at its next meeting, shall decide on its course of action. If it decides that the request has merit, it shall perform a review and decide whether the proposed issuance of CERs should be approved;
- The Executive Board shall complete its review within 30 days following its decision to perform the review;
- The Executive Board shall inform the project participants of the outcome of the review, and make public its decision regarding the approval of the proposed issuance of CERs and the reasons for it.

(iv) Upon being instructed by the Executive Board to issue CERs for a CDM project activity, the CDM registry administrator, working under the authority of the Executive Board, shall, promptly, issue the specified quantity of CERs into the pending account of the Executive Board in the CDM registry, …

(v) However, as per the querist's view, the CERs should be recognised as assets in the books post 15 days from the date of report submission by DOE to Executive Board of UNFCCC since there is certainty of the same numbers of CERs to be issued by the Executive Board except in the extreme circumstances of fraud, malfeasance or incompetence of the DOE. Past trends confirming that there is no change in numbers of CERs verified by DOE and issued by UNFCCC Executive Board in respect of the company have been provided by the querist for the perusal of the Committee.

(vi) Further, as per the querist, non-recognition of CERs as inventory in the financial year in which cost is incurred for the generation/production of CERs has the following impact:

- Mismatch in recognition of cost and revenue towards CERs generation
- The entire cost is loaded to the production of compost and RDF which leads to undervaluation of inventory
- Financials of the company do not give true and fair view of the performance of the respective financial year

(2) Compost, CERs and RDF are joint products

(a) It may be mentioned that in respect of MSW facilities, due to the intrinsic and integral nature of activities, CERs and compost / RDF are produced as joint products.

(b) Based on the above, the costs incurred for monitoring the reduction of emissions and the operating costs incurred to run the CER projects are crucial and hence, have to be included in the costs for the purpose of valuation of inventories and not only costs incurred for certification of CERs. The cost of production upto the stage of compost manufacturing should be treated as joint costs to be allocated between the three products, i.e., compost, RDF and CERs.

(c) Joint cost is defined as the cost of common resources used to produce two or more products or services simultaneously. As per paragraph 10 of AS 2, one of the methodologies of bifurcating the joint costs is:

"A production process may result in more than one product being produced simultaneously. … When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. …"

(d) Accordingly, in respect of MSW projects, production of compost, RDF and CERs are intrinsic and integral part of the entire production process which become separately identifiable at the finished stage of compost production. Aerobic composting is an activity which gets completed on production of compost. CER and compost are produced simultaneously and the split-off for these two products are at the point of compost production. Thus, for valuation of inventory of compost, RDF/combustibles and CERs, the company needs to bifurcate joint production cost. This can be done at their respective net sales realisation. However, the CER inventory valuation will be carried out at the lower of cost of production or net realisable value (NRV).

(3) Costs incurred in the process of aerobic composting:

(a) The aerobic composting process efficiency directly impacts production of CERs which includes close control of various parameters like temperature, oxygen, moisture etc. that are controlled through processes like mechanized pre-sorting, deployment of vehicle and manpower for turning of windrows and finished compost, various stages of refinement etc. These combined operational costs incurred towards compost production and CERs generation include the following:

(i) Manpower cost

(ii) Weighing section

(iii) Pre-processing section

(iv) Waste heap pad

(v) Compost refining section

(vi) Vehicle hire charges, diesel and repairs cost

(b) Paragraph 25 of the Guidance Note has apparently not considered any cost other than costs incurred by the generating entity for certification of CERs, for the purpose of valuation of CERs inventories. The Guidance Note appears to be more based on renewable (Solar, Hydro, Wind) energy projects. In these projects, CERs are generated from replacement of energy from fossil fuel generation plants. The operations of these projects do not involve external inputs beyond that of natural resources like sunlight, water and wind. The monitoring of such projects is based on the energy uploaded at the grid inter-connect point and requires verification of only a single parameter. On the other hand, MSW processing projects of the company involves monitoring of large number of parameters in comparison to renewable projects which requires additional capital and operational costs. Differences in various renewable energy processes involved have been provided by the querist for the perusal of the Committee.

B. Query

9. On the basis of the above, the opinion is sought by company on the following issues:

(a) Whether CERs inventory can be recognised in the financials of the company post 15 days of verification report submitted by DOE to UNFCCC Executive Board for issuance of CERs since review by Executive Board post verification by DOE is more of documentation review and issuance is certain except in case of fraud, malfeasance or incompetence of the DOE.

(b) Whether compost, RDF and CERs are joint products.

(c) Whether for the purpose of CER inventory valuation, the costs should include all operating expenses upto the stage of compost production and not be limited to verification and certification expenses.

C. Points considered by the Committee

10. The Committee, while expressing its opinion has examined only the issues raised in paragraph 8 above and has not examined any other issue that may arise from the Facts of the Case, such as, inventory valuation of composts/RDFs, accounting for sale of CERs etc.

11. With regard to the first issue raised by the querist relating to point of recognition of CERs as assets, the Committee notes the following paragraphs of the Guidance Note on Accounting for Self-generated Certified Emission Reductions, issued by the ICAI as follows:

> "13. From the above-mentioned definition of 'asset' it follows that for a CER to be considered as an asset of the generating entity, it should be a resource controlled by the generating entity arising as a result of past events, and from which future economic benefits are expected to flow to the generating entity.
>
> 14. In order to generate CERs, an entity undertakes a CDM project activity and thereby reduces carbon emissions. It is mentioned in paragraph 9 above that various stages are involved in a CDM project activity to generate CERs. After a successful registration, as the CDM project is operated, carbon emission reductions are generated and these continue to be generated over the course of the project. However, at this stage, i.e., when the emission reductions are taking place, CERs do not arise. It may be argued that as soon as emission reductions take place these should be considered as assets since certification thereof subsequently in the form of CERs is a procedural aspect. In this regard, it is noted that issuance of CERs is subject to the verification process, i.e., CERs are applied for and on the expiry of 15 days having received no request for review and after having satisfied all requirements, a communication is received from UNFCCC thereby crediting CERs to the generating entity. It is, thus, possible that emission reductions may not eventually result in to creation of CERs. Accordingly, at this stage when emission reductions are taking place, CERs can, at best, be said to be contingent assets as per Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*, which defines a contingent asset as ***"a possible asset that arises from past events 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". This is because when the generating entity reduces carbon emissions by way of a CDM project, the generating entity becomes eligible to receive CERs from UNFCCC. However, whether CERs will actually arise and be received by the generating entity or not will depend on a future uncertain event, i.e., certification of the same by UNFCCC.

15. It follows from the above that a CER comes into existence and meets the definition of an asset only when the communication of credit of CERs is received by the generating entity. This is because only at this stage the CER becomes a resource controlled by the generating entity and therefore leads to expected future economic benefits in the form of cash and cash equivalents which would arise on the future sale of CERs. As stated above, at other earlier stages of the CDM project activity, there is no resource in existence for the generating entity, and hence the question of 'resource controlled' and 'expected future economic benefits' therefore do not arise. Accordingly, CER is an 'asset', when it comes into existence as stated aforesaid."

"17. From paragraph 15 it follows that CERs come into existence when these are credited by UNFCCC in a manner to be unconditionally available to the generating entity. Therefore, CERs should not be recognised before that stage. Further, from the above it follows that for CERs to be recognised in the financial statements of the generating entity as assets, the two criteria with regard to probable future economic benefits flowing from the CERs and CERs possessing a cost or value that can be measured with reliability should be met as follows:

(a) As regards the probability criterion for recognition of CERs, it may be mentioned that the concept of probability refers to the degree of certainty that future economic benefits associated with CERs will flow to the entity. Therefore, the probability criterion is said to be met when there is a reasonable assurance that future economic benefits will flow from the CERs to the entity. As the market for CERs is relatively new, the future economic benefits may not always be assured. Thus, an entity needs to make an assessment for the probability of future economic benefits. Accordingly, if there is a probable market for the self-generated CERs ensuring flow of economic benefits in the future, CERs should be recognised.

(b) As regards the criterion for measurement of cost or value, there are certain costs which are incurred to generate CERs, and therefore the cost of CERs can be measured reliably. The value at which CERs are to be measured is discussed in later paragraphs.

For reasons stated above, the recognition of CERs as an asset at any earlier or later stage than when they are credited by UNFCCC is not justified in the following cases:

(a) CERs are recognised upon execution of a firm sale contract for the eligible credits.

(b) CERs are recognised on an entitlement basis based on reasonable certainty after making adjustments for expected deductions.”

From the above, the Committee notes that the Guidance Note specifically states that CER becomes a *resource controlled* by the generating entity only when the communication of credit of CERs is received by the entity. Accordingly, before that stage and unless other conditions for recognition as an ‘asset’ as discussed in the Guidance Note are fulfilled, it cannot be recognised as an asset in the financial statements of the generating entity. The Guidance Note also specifically provides that recognition of CERs at an earlier stage than when they are credited by UNFCCC on an entitlement basis based on reasonable certainty is also not justified. Accordingly, the Committee is of the view that CERs inventory cannot be recognised in the financials of the company post 15 days of verification report submitted by DOE to UNFCCC Executive Board for issuance of CERs, as being argued by the querist.

12. With regard to the second and third issue relating to compost, CERs and RDF being considered as joint products and relating to CER inventory valuation, the Committee notes the following paragraphs of the Guidance Note:

“6. To be eligible for CDM benefits, the proposed project must have the feature of additionality, i.e., the CDM project must provide reductions in emissions that are additional to that would occur in the absence of the project. For example, an entity can generate CERs under CDM, if it installs a waste heat boiler that saves energy. This is because reduced fuel use reduces the amount of carbon dioxide emitted. However, if an entity has to undertake the project activity because of law, for example, if the industry is legally mandated to have a waste-heat recovery boiler, such a project is generally not eligible for CDM benefits."

"23. AS 2 prescribes the composition of cost of inventories as follows:

> ***"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."***

24. Various costs are incurred by the generating entity to set up a CDM project activity, operate the CDM project and generate CERs. These may include the following:

- (i) research costs arising from exploring alternative ways to reduce emissions;
- (ii) costs incurred in developing the selected alternative as a process/ device to reduce emissions;
- (iii) costs incurred to prepare the Project Design Documents;
- (iv) fees paid to DOEs for validation and verification and to the National Authority for approval;
- (v) fees of registering with UNFCCC;
- (vi) costs incurred for monitoring the reductions of emissions;
- (vii) costs incurred for certification of CERs; and
- (viii) operating costs incurred to run the CDM project.

25. As already mentioned earlier, CERs do not come into existence and, therefore, do not become the assets of the generating entity till the UNFCCC certifies and credits the same to the generating entity. Accordingly, not all costs incurred by the generating entity give rise to CERs and therefore not all costs can be considered as the costs of bringing the CERs to existence (i.e., their present location and condition). For example, the research and development costs as mentioned above are the pre-implementation costs of the CDM projects which do not result in CERs. Accordingly, these should be

treated as per Accounting Standard (AS) 26, *Intangible Assets* (refer also to paragraph 30 below) when they bring into existence a separate intangible asset such as a patent of a process to reduce carbon emissions. Similarly, the other costs such as those incurred for preparation of PDD and registration of the CDM project with UNFCCC, etc., do not result in CERs coming into existence, and therefore these costs cannot be inventorised. It is only the costs incurred for the certification of CERs by UNFCCC which bring the CERs into existence by way of credit of the same by UNFCCC to the generating entity. Thus, the costs incurred by the generating entity for certification of CERs, are the costs of inventories of CERs."

"35. An entity should disclose the following information relating to certified emission rights in the financial statements:

a) No. of CERs held as inventory and the basis of valuation.

b) No. of CERs under certification.

c) Depreciation and operating and maintenance costs of Emission Reduction equipment expensed during the year."

From the above, the Committee notes that the Guidance Note although considers the CERs as an item of inventory since these are held for sale, it considers them as an ancillary benefit of the CDM project apart from the main product(s) being produced (for example, compost and RDF in the extant case) out of the CDM project and not as a joint product. The Committee also notes that since the Guidance Note requires to recognise the CERs as asset only when communication of credit of CERs is received by the entity, the question of recognition of CERs as joint product before that stage does not arise. Further, with regard to inventory valuation, although the Guidance Note lists out the costs incurred for monitoring the reductions of emissions in paragraph 24, it does not consider such costs to be the cost of inventories of CERs; rather it specifically states that only the costs incurred by the generating entity for certification of CERs, are the costs of inventories of CERs. Accordingly, the Committee is of the view that CERs in the extant case should not be considered as a joint product and the cost of the inventories of CERs should not include operating expenses upto the stage of compost production, as being argued by the querist. Incidentally, with regard to querist's contention regarding mismatch in recognition of cost and revenue towards CERs generation, the Committee wishes to point out that the same would be addressed by the disclosure required under paragraph 35 (b) of the Guidance Note.

D. Opinion

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

(a) CERs inventory cannot be recognised in the financials of the company post 15 days of verification report submitted by DOE to UNFCCC Executive Board for issuance of CERs, as discussed in paragraph 11 above.

(b) Compost, RDF and CERs are not joint products, as per requirements of the Guidance Note, as discussed in paragraph 12 above.

(c) For the purpose of CER inventory valuation, the costs should not include all operation expenses upto the stage of compost production and should be limited to the cost incurred by the generating entity for certification of CERs, as discussed in paragraph 12 above.

Query No. 10

Subject: Accounting for development fee under Delhi School Education Act and Rules, 1973.[1]

A. Facts of the Case

1. The querist has stated that schools in Delhi, both aided as well as unaided are governed by the Delhi School Education Act, 1973 and Rules framed thereunder (DSE A&R). Various notifications have been issued by the Government of Delhi or the Department of Education (DoE) from time to time, under the said Act and Rules. The decisions of the Court of law are

[1] Opinion finalised by the Committee on 17.3.2017.

also binding principles for the schools and authorities regulating schools. The schools are generally set up by a trust or a society registered under the Societies Registration Act. Most of the land allotted to schools in Delhi is by the land owning agencies, like, Delhi Development Authority (DDA) and Land and Development Office to such trust/society and the building is constructed by said trust or society. The schools then get recognition from DoE on fulfilment of certain conditions. Recognised schools are required to file annual returns as prescribed under Rule 180 of the DSE Rules, 1973. Right to Free and Compulsory Education Act (RTE Act) implemented w.e.f. 2010, stipulates reserving at least 25% seats at entry level for economically weaker sections/disadvantage group (EWS/DG) category of students.

2. The issue for consideration here is about accounting treatment for development fee collected by unaided recognised private school in terms of DoE's Order dated 15/12/1999, dated 11/02/2009 and dated 16/04/2016 read together with the Judgement of Apex Court in the case of Modern School (2004).

3. The querist has further stated that DSE A&R, 1973 besides prescribing rules for general management and administration of schools, has also laid down rules for collection of fee and its accounting. The scheme of management of schools as prescribed under Rule 59 lays down procedure for collection and spending of receipts. Some of the relevant sections and rules of DSE A&R, 1973 governing fee, receipt and expenditure are as under:

(i) Section 17(3) deals with collection of fee and the restrictions thereof for an unaided recognised school.

(ii) Section 18 lays down the manner in which the receipts should be accounted for.

(iii) Section 18(4)(b) read with Rule 176 specify that any collection for specific purpose will have to be spent for specific purpose only.

(iv) The Directorate of Education (DoE) has the power to regulate fee of unaided recognised school under section 17(3).

(v) Rules 172 to 179 regulate as to how school's funds should be maintained.

The Guidance Note on Accounting by Schools, issued by the Institute of Chartered Accountants of India is also relevant.

4. The DSE Act & Rules were enacted and notified in 1973 and clarifications/directions have been issued by various Notifications/Circulars/ Orders of DoE. Supreme Court and Delhi High Court have also from time to time given directions on the basis of and in relation to DSE A&R, 1973 and notifications issued thereunder. One of the important judgement is that of Supreme Court in the matter of Modern School vs. Union of India (2004). DoE's Order dated 15/12/1999 is also important in context of said judgement. Copies of relevant sections and rules referred to above and Supreme Court judgement and notifications have been provided by the querist for the perusal of the Committee.

5. The matter needing Expert Advisory Committee's opinion has been detailed by the querist as below:

(1) Rule 175 refers to manner in which the accounts of an unaided recognised school are to be maintained. It prescribes that accounts should exhibit all income accruing by way of fee, fines, income from building, rent, interest, *development fee*, collections for specific purposes, endowments, gifts, donations etc.

(2) The fee fixation by schools has been a matter of dispute between parents of students and schools since 1996. The matter was escalated to legal battles and was thus taken up to Delhi High Court (HC) and Supreme Court on various occasions.

(3) (a) In view of representations from parents and on the recommendation of Delhi HC, DoE appointed a committee (known as Duggal Committee) chaired by a Retd. High Court Judge, viz., Justice Smt. Santosh Duggal. Based on recommendations of the said committee, DoE issued a Notification dated 15/12/1999 laying down policy regulations etc., for schools to adhere to. Paragraph 7 of the said Notification lays down the nature of development fee and its ceiling at 10% of tuition fee (subsequently enhanced to 15%). Also, it laid out the manner in which the tuition fee should be fixed. Development fee has been defined in the Act & Rules for an aided school only (Rule 151) whereas this was allowed as a legitimate

charge/levy by recognised unaided schools vide Notification dated 15/12/1999 and duly upheld by Supreme Court in the case of Modern School (2004). The levy is permitted with certain caveats. As the Act & Rules were introduced in 1973 and there being no significant amendment subsequent to that, one may have to rely on the notifications issued by DoE from time to time.

(b) The Notification dated 15/12/1999 states that development fee shall be treated as capital receipt and used for purchase, up-gradation and replacement of furniture, fixtures and equipment. In effect, it became an earmarked collection for specific purpose only.

(c) Further, the condition imposed for collection of development fee is to have a depreciation reserve fund equal to depreciation charged on assets. Development fee and depreciation reserve have been termed as 'Funds' to be matched up with equivalent security. Whether depreciation on furniture, fixtures and equipment and/or on all assets is a component of Income & Expenditure Account or of Development Fund Account is not clear as the Order dated 15/12/1999 and Apex Court's order in the case of Modern School (2004) are silent on this part.

(d) Similar directions were repeated in DoE's Notification dated 11/02/2009.

(e) The Supreme Court (Justice SH Kapadia) in its judgement in Modern School (2004) case in paragraph 17 has held that under section 17(3) read with section 18(3) & (4), the Directorate has the authority to regulate fee under section 17(3). Thus in effect, vide paragraph 25 of its judgement, Justice SH Kapadia also held Direction No. 7 of DoE's Notification dated 15/12/1999 to be appropriate. Though there is no legislative amendment to Rule 175, the effect and accounting impact on development fee being permitted for unaided school, is to be assessed as change of accounting pattern.

(4) Section 18(3) of DSE Act, 1973 mandates that every recognised unaided school shall maintain a 'Recognised Unaided School Fund' (RUSF) and it shall be credited with all income accruing to the school by way of fee, fines etc. Similarly, Section 18 (4) (a) and (b) mandate that collections be spent for educational purposes only and all collections for specific purposes shall be utilised for the purpose for which they were received. Reading Rule 175 of DSE Rules, 1973 is of significance as it refers to the accounts with regard to the school fund or RUSF as defined in section 18 of the DSE Act, 1973.

(5) Very recently, as per the querist, DoE vide its Order dated 16/04/16 while requiring schools to furnish annual information under Rule 180, has reiterated their view of considering development fee as a capital receipt to be taken directly to balance sheet as a liability under 'Designated Fund' without its movement through Income and Expenditure Account. Copy of the Circular has been supplied by the querist for the perusal of the Committee.

According to the querist, collection of development fee fund has a pre-condition for its use for specific purpose only and not at the discretion of management of school to change the purpose of its utilisation. For accounting purposes, can development fee collected be credited to Income and Expenditure Account for change of its use for purpose other than the one prescribed but for educational purposes. By using the nomenclature for 'Development Fee Fund' as 'Designated Fund' and not 'Restricted Fund', is DoE not implying that development fee be first credited to revenue account and then designated as a fund? This aspect needs to be taken into consideration by the Expert Advisory Committee as there are no corresponding appropriate heads in income and expenditure account or in appropriation account in the prescribed formats under Rule 180 for accounting for development fee as such.

6. As for the nature of development fee, the querist has advised that the Expert Advisory Committee should refer to paragraph 7 of the Notification dated 15/12/1999, issued by the Department of Education which explains the fee charge and nature thereof. Since this paragraph 7 has already been held

'appropriate' by Apex Court in its judgement in the case of Modern School (2004), the querist is of the view that the Notification is a law as interpreted by Apex Court. The recent Notification dated 16/04/16 issued by the Department of Education with regard to presentation of annual accounts has also been submitted for the perusal of the Committee. In view of the above-referred notifications, the querist is of the view that the development fee is a restricted fund to be used for purchase, upgradation and replacement of furniture, fixture and equipment. Further, as for the periodicity of collection of development fee, the querist has informed that it is generally collected along with normal tuition fee as per time table set by respective school. It is either monthly or quarterly as per option exercised by the parent but with a ceiling of the cap on the amount of development fee, upto 15% of tuition fee. The development fee can be accumulated over years depending upon capital expenditure plans of the school as present law does not prescribe any time limit for spending development fee.

B. Query

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

(i) (a) Does reading of section 18 read with Rules 175 and 176 for accounting purposes mean that all income accruing to the school, including development fee, which is declared by DoE to be treated as capital receipt, should first be credited to RUSF A/c and thereafter appropriated to development fee fund account, especially in view of clash between section 18 read with Rule 175 and the Notification dated 15/12/1999 treating development fee as capital receipt.

(b) Would development fee fund appear as balance sheet item, on liability side, represented by security as asset in the form of bank balance (in fixed deposit) to the extent of unspent amount and in form of written down value of assets to the extent of development fee utilised/spent? (Refer paragraph 99 of the Guidance Note on Accounting by Schools, issued by the ICAI.)

(ii) Would accounting principles permit the charge of depreciation on furniture, fixtures and equipment to development fee fund account or be part of depreciation in income and expenditure account with corresponding credit to Depreciation Reserve Account?

(iii) In either of the case, would the fund in the form of a security have to be maintained to meet the requirement of calling it as Depreciation Reserve *Fund* by charge of such depreciation to revenue account and treated as a cost recoverable against fee? In effect, would school be rightfully able to accumulate funds for capital expenditure from two sources, i.e., development fee collected @15% and depreciation reserve fund funded out of the surplus of respective year? Will this reserve fund be equal to the whole of depreciation charged in revenue accounts or restricted to depreciation of specified assets only?

C. Points considered by the Committee

8. The Committee notes that the basic issues raised in the query relate to accounting for development fee and presentation of development fee fund, charge of depreciation on fixed assets acquired out of development fee and treatment of depreciation reserve fund in the financial statements of a school. Accordingly, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of Case, such as, accounting in the financial statements of the trust/society running the schools, etc. At the outset, the Committee wishes to point out that the Committee has considered the issue purely from accounting perspective, viz., applying the accounting principles in the context of the requirements of the laws and regulations governing a school and has examined the issue without interpreting the requirements of Delhi School Education Act, 1973 and Rules framed thereunder (DSE A & R), various notifications issued from time to time by the Department of Education or the Government of Delhi and the Court's judgements, for determination of nature of development fee. While expressing the opinion, the Committee has relied upon the view of the querist that development fee received is of the nature of restricted fund.

9. With regard to the accounting for development fee and charging of depreciation, the Committee notes the following paragraphs from the Guidance Note on Accounting by Schools, issued by the Institute of Chartered Accountants of India:

> "*Restricted Funds* are contributions received by the school, the use of which is restricted by the contributors."
>
> "99. Restricted funds that represent the contributions received whose use is restricted by the contributors, are credited to a separate fund account when the amount is received and reflected separately in the balance sheet. Such funds may be received for meeting revenue expenditure or capital expenditure. Where the fund is meant for meeting revenue expenditure, upon incurrence of such expenditure, the same is charged to the income and expenditure account ('Restricted Funds' column); a corresponding amount is transferred from the concerned restricted fund account to the credit of the income and expenditure account ('Restricted Funds' column). Where the fund is meant for meeting capital expenditure, upon incurrence of the expenditure, the relevant asset account is debited which is depreciated as per the recommendations contained in this Guidance Note. Thereafter, the concerned restricted fund account is treated as deferred income, to the extent of the cost of the asset, and is transferred to the credit of the income and expenditure account in proportion to the depreciation charged every year (both the income so transferred and the depreciation should be shown in the 'Restricted Funds' column). The unamortised balance of deferred income would continue to form part of the restricted fund. Any excess of the balance of the concerned restricted fund account over and above the cost of the asset may have to be refunded to the donor. In case the donor does not require the same to be refunded, it is treated as income and credited to the income and expenditure account pertaining to the relevant year ('General Fund' column). Where the restricted fund is in respect of a non-depreciable asset, the concerned restricted fund account is transferred to the 'General Fund' in the balance sheet when the asset is acquired."

From the above, the Committee notes that in the extant case, the development fee is a capital receipt to be used for purchase, upgradation and replacement of furniture, fixtures and equipments, which are depreciable fixed assets. Therefore, initially the development fee received would be credited to a separate fund account. Upon incurrence of the expenditure on acquisition of the asset, the relevant asset account is debited which is depreciated as per the recommendations in the Guidance Note and the fund so created would be treated as deferred income to the extent of the cost of the asset and an amount equivalent to depreciation amount is transferred to the credit of income and expenditure account in proportion to the depreciation charged every year.

10. With regard to the issue raised by the querist relating to whether income accruing to the school including development fee should be first credited to Recognised Unaided School Fund (RUSF) Account and thereafter appropriated to Development Fee Fund Account considering the requirements of section 18 read with Rule 175 of DSE A & R, the Committee notes the requirements of section 18 and the relevant rules of DSE A&R as follows:

Section 18

"18. (3) In every recognised unaided school, there shall be a fund, to be called the "Recognised Unaided School Fund", and there shall be credited thereto income accruing to the school by way of –

(a) fees,

(b) any charges and payments which may be realised by the school for other specific purposes, and

(c) any other contributions, endowments, gifts and the like.

(4) (a) …

(b) Charges and payments realised and all other contributions, endowments and gifts received by the school shall be utilised only for the specific purpose for which they were realised or received."

Rules

"173 (4) Every Recognised Unaided School Fund shall be kept deposited in a nationalised bank or a scheduled bank or in a post office in the name of the school, and such part of the said Fund as may be specified by the Administrator or any officer authorised by him in this behalf shall be kept in the form of Government securities and as cash in hand respectively:

Provided that in the case of an unaided minority school, the proportion of such Fund which may be kept in the form of Government securities or as cash in hand shall be determined by the managing committee of such school.

175. Accounts of the school how to be maintained – The accounts with regard to the School Fund or the Recognised Unaided School Fund, as the case may be, shall be so maintained as to exhibit, clearly the income accruing to the school by way of fees, fines, income from building rent, interest, *development fees*, collections for specific purposes, endowments, gifts, donations, contributions to Pupils' Fund and other miscellaneous receipts, and also, in the case of aided schools, the aid received from the Administrator. (Emphasis supplied by the Committee.)

176. Collections for specific purposes to be spent for that purpose – Income derived from collections for specific purposes shall be spent only for such purpose."

From the above, the Committee notes that in order to meet the requirements of both section 18 and the Rules, a separate account termed as Recognised Unaided School Fund Account may be maintained, wherein all receipts by the school including development fee should be first credited to such account and then from this account, it may be transferred to the respective account depending upon the nature of the receipt, for example, development fee may be first credited to RUSF Account and then transferred to 'Restricted Fund' and thereafter the accounting treatment as discussed in paragraph 9 above may be followed.

11. With regard to presentation of such fund, the Committee notes 'Part II-Balance Sheet' of Appendix III – Formats of Financial Statements of Schools to the Guidance Note on Accounting by Schools as follows:

"PART II – BALANCE SHEET

FUNDS EMPLOYED

UNRESTRICTED FUNDS

General Fund

…

RESTRICTED FUNDS

Restricted funds are funds subject to certain conditions set out by the contributors and agreed to by the School when accepting the contribution. This head includes:

(i) Endowment funds.

(ii) Funds related to depreciable/non-depreciable assets in respect of which assets are still to be acquired.

(iii) Balances of deferred income, e.g., grants and donations in respect of which specific depreciable assets have been acquired.

(iv) Funds related to specific items of revenue expenditure not yet incurred.

Each restricted fund should be reflected separately either on the face of the balance sheet or in the schedule(s) to the balance sheet.

Notes:

1. ...

2. …

3. Designated/Restricted Funds represented by specifically earmarked bank balances/investments should be disclosed separately in respect of each fund."

From the above, the Committee notes that the funds related to depreciable assets in respect of which the assets are still to be acquired are to be presented under the sub-head, 'Restricted Funds' under the head 'Funds Employed' in the balance Sheet. Moreover, balances of deferred income, i.e., the funds in respect of which specific depreciable assets have been acquired should also be presented in a similar way under 'Restricted Funds' in the balance Sheet. Further, the restricted funds represented by specifically earmarked bank balances/investments should be disclosed separately either on the face of balance sheet or in the schedules to the balance sheet.

12. With regard to creation of depreciation reserve as per the requirements of the DoE Notification, the Committee is of the view that from accounting perspective, the school, if so desires, may create a depreciation reserve equal to the depreciation charged during the year as an appropriation of profits. However, in order to term such depreciation reserve as 'depreciation reserve fund' the same should be represented by specifically

earmarked assets. In this regard, the committee notes the definition of the term, 'fund' as per paragraph 6.15 of the Guidance Note on Terms Used in Financial Statements[2], issued by the ICAI, which is reproduced as below:

> **"6.15 Fund**
>
> An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked assets."

13. Further, with regard to the issue raised by the querist relating to creation of depreciation reserve fund account to the extent of the depreciation charged in the income and expenditure account or restricted to depreciation of specified assets only (viz., those acquired out of the development fee), the Committee notes clauses 7 and 14 of the Notifications of DoE dated 15th December, 1999 and dated 11th February, 2009, respectively, as follows:

> "7. Development fee, not exceeding ten percent of the total annual tuition fee may be charged supplementing the resources for purchase, up gradation and replacement of furniture, fixtures and equipment. Development fee, if required to be charged, shall be treated as capital receipt and shall be collected only if the school is maintaining a Depreciation Reserve Fund, equivalent to the depreciation charged in the revenue accounts and the collection under this head along with the any income generated from the investment made out of this fund, will be kept in a separately maintained Development Fund Account."
>
> "14. Development fee, not exceeding 15% of the total annual tuition fee may be charged for supplementing the resources for purchase, up gradation and replacement of furniture, fixtures and equipment. Development Fee, if required to be charged, shall be treated as capital receipt and shall be collected only if the school is maintaining a Depreciation Reserve Fund, equivalent to the depreciation charged in the revenue accounts and the collection under this head along with and income generated from the investment made out of this fund, will be kept in a separately maintained Development Fund Account."

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[2] Subsequently, on issuance of the 'Glossary of Terms used in Financial Statements' by the Research Committee of the ICAI on July 1, 2019, the Guidance Note on Terms Used in Financial Statements was withdrawn.

From the above, the Committee notes that on a harmonious reading of the above-reproduced requirements, it appears that since the development fee can be collected only if the school is maintaining a depreciation reserve fund and the use of development fund is restricted for some specified assets, the depreciation reserve fund should be maintained equivalent to the depreciation charged in respect of the specified assets only and not the total amount of depreciation charged in the income and expenditure account.

D. Opinion

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

(i) (a) In order to meet the requirements of both section 18 and the Rules, a separate account termed as Recognised Unaided School Fund Account may be maintained, wherein all receipts by the school including development fee should be first credited to such account and then from this account, it may be transferred to the respective account depending upon the nature of the receipt, for example, development fee may be first credited to RUSF Account and then transferred to 'Restricted Fund', as discussed in paragraph 10 above.

(b) Development fee fund to the extent of unspent amount and the fund in respect of which specific depreciable assets have been acquired should be presented and disclosed as per the requirements of the Guidance Note on Accounting by Schools, as discussed in paragraph 11 above.

(ii) Depreciation on furniture, fixtures and equipment should be provided as per the recommendations in the Guidance Note on Accounting by Schools and an amount equivalent to depreciation amount is transferred from the development fund account to the credit of income and expenditure account in proportion to the depreciation charged every year. Depreciation reserve, from accounting perspective, may be created equal to the depreciation charged during the year as an appropriation of profits, as discussed in paragraphs 10 and 12 above.

(iii) In order to term the depreciation reserve as 'depreciation reserve fund', the same should be represented by specifically earmarked assets, as discussed in paragraph 12 above and the same would also be in accordance with the accounting principles. As far as the issue of creation of depreciation reserve fund account to the extent of the depreciation charged in the income and expenditure account or restricted to depreciation of specified assets only (viz., those acquired out of the development fee) is concerned, the depreciation reserve fund should be maintained equivalent to the depreciation charged in respect of the specified assets only and not the total amount of depreciation charged in the income and expenditure account, as discussed in paragraph 13 above.

Query No. 11

Subject: Accounting treatment of temporary income in relation to construction contract.[1]

A. Facts of the Case

1. A Ltd. is a public sector shipyard under the Ministry of Defence and is in the business of construction of warships. Indian Navy, Coast Guard and other customers award contracts to the company on commercial terms. The contracts are awarded on fixed price basis except certain variable components, such as, foreign exchange variation and cost of spares etc. The payment for fixed price part is on the basis of completion of milestones. The payment for variable component is based on actual cost to the shipyard.

2. The querist has informed that the shipyard recognises revenue on percentage completion method as per Accounting Standard (AS) 7, 'Construction Contracts'. The total revenue from a project is the contract price of the project plus extras as mentioned above.

3. The payment terms for fixed price portion of the contract are generally spread over 10-12 milestones starting with initial payment of 10% on signing

[1] Opinion finalised by the Committee on 4.5.2017.

of the contract. As the gestation period of the contracts for shipbuilding is longer, it so happens that during initial period when the funds are made available, at times, become temporary surplus funds, which are deployed in short-term fixed deposits. However, in the later part of execution of the contract, the cost incurred on the project exceeds the stage payments received on the vessel leading to a negative cash flow. Further, the last stage payment of the project is deferred till one year after the delivery of the vessel.

4. Thus, the interest earned initially on the temporary surplus compensates to a certain extent for the period of deficit cash flow, especially at the later part of the execution of the project.

5. The querist has further informed that at present, in the books of account, the total stage payments, i.e., contract price is taken as operating revenue and interest earned from the surplus of stage payments is accounted for under the head 'Other Income'.

6. In view of the facts mentioned, it is felt that interest earned from such surplus of stage payments should also be considered under 'other operating revenue' since the interest is inextricably connected to stage payments and is one of the parameters for contract price.

7. The querist has provided the reasons for inclusion of interest earned on stage payments under 'other operating revenue' for shipyards in brief as follows:

(a) Shipyards are engaged in long gestation contracts with operating cycle ranging from 3 to 4 years. The stage payments for milestone activities are directly linked to physical progress achieved in each project (sample copy for one of the project has been supplied by the querist for the perusal of the Committee). Stage payments are not released in the event of non-completion of specified milestones. Thus, the stage payments received on milestone achievement and interest, if any, earned thereon arises from operations.

(b) If customer had not agreed for stage payments in the existing manner, the company will have to arrange funds to meet working capital requirements and cost of working capital would have been factored in for arriving at contract price. In such a scenario, the profit arising out of revised contract price would be higher to the extent of such interest factor considered for quoting the price. Therefore, the interest earned out of stage payments shall also deserve to be treated as a part of core business activities and considered under 'operating revenue'.

(c) The notional interest income arising out of investments from temporary surpluses of stage payments is considered by the customer as a negotiating point during the price negotiation of the contracts.

B. Query

8. Considering the facts submitted as above, opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) is sought on whether interest earned on deposits made out of temporary surpluses of milestone payments can be considered as 'other operating revenue'.

C. Points considered by the Committee

9. At the outset, the Committee notes that although the issue raised is whether interest earned on deposits made out of temporary surpluses of milestone payments can be considered as 'other operating revenue', the basic issue raised by the querist relates to presentation of such interest earned during contract execution under the head 'other income' or under 'other operating revenue'. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. Further, the opinion being expressed hereinafter is purely from the perspective of presentation in the financial statements and not from any other perspective. The Committee also wishes to point out that since the querist has referred to Accounting Standard (AS) 7, 'Construction Contracts', the opinion has been expressed considering the requirements of Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not the requirements of Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015.

10. The Committee notes that Note 2(A) to General Instructions for the Preparation of Statement of Profit and Loss in Part II – Form of Statement of Profit and Loss of Schedule III to the Companies Act, 2013 requires that in respect of a company other than a finance company, revenue from operations shall disclose separately in the notes revenue from (a) sale of products, (b) sale of services, (c) other operating revenues, and (d) less:

excise duty. The Committee further notes the following requirements of the Guidance Note on Schedule III to the Companies Act, 2013[2], issued by the ICAI:

> "**9.1.6** For non-finance companies, revenue from operations needs to be disclosed separately as revenue from
>
> (a) sale of products,
>
> (b) sale of services and
>
> (c) other operating revenues.
>
> It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".
>
> **9.1.7** The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from the sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held. For instance, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is continuously engaged in leasing of real estate properties, the rent arising from leasing of real estate is likely to be "other operating revenue". On the other hand, consider a consumer products company which owns a 10 storied building. The company currently does not need one floor for its own use and has given the same temporarily on rent. In that case, lease rent is not an "other operating revenue"; rather, it should be treated as "other income".''
>
> **"9.2 Other income:**
>
> The aggregate of 'Other income' is to be disclosed on face of the Statement of Profit and Loss.

[2] Subsequently, this Guidance Note was revised in July, 2019 as 'Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013'.

9.2.1 As per Note 4 to General Instructions for the preparation of Statement of Profit and Loss 'Other Income' shall be classified as:

(a) Interest Income (in case of a company other than a finance company);

(b) Dividend Income;

(c) Net gain/loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

9.2.2 All kinds of interest income for a company other than a finance company should be disclosed under this head such as interest on fixed deposits, interest from customers on amounts overdue, etc."

From the above, the Committee notes that the classification of an item under "other operating revenue" or "other income" is a matter of judgement considering the specific facts and circumstances of each case, for example, considering the nature of activity the company is engaged into, etc. The Committee also notes that the Guidance Note requires all types of interest income in case of a company other than finance company to be disclosed under the head 'other income'. Accordingly, considering the company's business of construction of warships, the Committee is of the view that interest income from temporary investments of milestone payments cannot be classified as 'other operating revenue'; rather the same should be classified as 'other income' only.

D. Opinion

11. On the basis of the above, the Committee is of the view that interest income from temporary investments of milestone payments cannot be classified as 'other operating revenue'; rather the same should be classified as 'other income' only.

Query No. 12

Subject: Charging of pro rata depreciation.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May, 2002 after unbundling of erstwhile State Electricity Board (SEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP Notification No. 226 dated 31st May, 2005.

2. The company is engaged in the business of electricity distribution in the area of Indore and Ujjain Commissionaire of State of Madhya Pradesh and is governed by the provisions of the Electricity Act, 2003. The company is responsible for all activities associated with distribution of power within its territory, including management of assets, operation and maintenance of network and supply, technical and financial planning, business development and management of human resources, legal and regulatory affairs, etc.

3. The querist has stated that as per the accounting policy of the company, depreciation on addition/ retirement of fixed assets is provided on 'pro rata basis' from beginning of quarter in which the asset was put to use.

4. However, while conducting audit of annual accounts of the company for financial year (F.Y.) 2014-15, the government auditor (C&AG auditor) has following observation in this regard:

> "**Depreciation and amortisation expenses**
>
> This is overstated by Rs. 2.96 crore due to adoption of depreciation method for addition to fixed assets during the year on quarterly basis in deviation to AS 6. As per the accounting policy of the company, depreciation on addition to fixed assets is provided on pro rata basis. However, in deviation to its own accounting policy, the company while calculating the depreciation on addition to fixed assets, worked out on quarterly basis, i.e., from the beginning of the quarter in which the asset was put to use, irrespective of the date on which the asset was actually put to use. Thus, the company in deviation to Accounting Standard (AS) 6 'Depreciation Accounting' and also its own accounting policy worked out the depreciation on addition to fixed assets on

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[1] Opinion finalised by the Committee on 4.5.2017.

quarterly basis instead of pro rata basis. This has resulted in overstatement of Depreciation & Amortisation Expenses and understatement of fixed asset by Rs.2.96 crore. Consequently, loss for the year is overstated by similar amount."

5. In response to above, the company has submitted the following reply:

"CAG audit observed that the company while calculating the depreciation on addition to fixed assets, worked out on quarterly basis, i.e., from the beginning of the quarter in which the asset was put to use, irrespective of the date on which the asset was actually put to use. Thus, the company is in deviation of Accounting Standard (AS) 6, 'Depreciation Accounting'.

In this regard, it is stated that depreciation is to be charged on pro rata basis, however, the meaning of pro rata basis is not defined. Hence, kind attention is invited on 'Guidance Note on Accounting for Depreciation in Companies' which provides the following accounting treatment in case of pro rata depreciation:

> "24. Note no. 4 in Schedule XIV to the Companies Act, 1956, prescribes that "where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed". The Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging *pro rata* depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved."

It is clearly mentioned above that the company may calculate pro rata depreciation on 15 days basis, or monthly basis or quarterly basis.

Accordingly, based on the principle of materiality, the company has grouped the addition of assets on quarterly basis for depreciation on assets."

6. The C&AG auditor was also requested to consider the directions given in Madhya Pradesh Electricity Regulatory Commission (MPERC) (Terms and Conditions For Determination of Tariff For Supply and Wheeling of Electricity

And Methods and Principles For Fixation of Charges) Regulations, 2009 {G - 35 of 2009}. The relevant extracts of the same are reproduced as under:

> "30 Depreciation
>
> 30(1)(g) Depreciation shall be chargeable from the first Year of commercial operation. In case of commercial operation of the asset for part of the Year, depreciation shall be charged on *pro rata* basis".

7. Further, an earlier opinion of the Expert Advisory Committee of ICAI on related subject matter was also submitted to C&AG auditors, in which the Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved. However, it was not considered by C&AG auditors.

B. Query

8. In light of the above facts, the querist has requested the Expert Advisory Committee to provide the opinion that whether the treatment given by the company of charging depreciation for addition and disposal of fixed assets during the year pro rata on quarterly basis is correct or not.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to appropriateness of the method of charging the depreciation for addition and disposal of fixed assets during the year pro-rata on quarterly basis. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, determination of the rates of depreciation, etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various legal enactments such as, MPERC Regulations, Electricity Act, 2003, etc. Further, as a reference has been made to AS 6, the Committee has not examined the requirements of Accounting Standards revised vide MCA Notification dated March 30, 2016 and Indian Accounting Standards (Ind ASs).

10. At the outset, the Committee notes that the company is charging depreciation from the beginning of the quarter in which the asset was put to use whereas as per the requirements of Schedule II to the Companies Act,

2013, depreciation should be charged from the date when the asset is available for use by the company rather than from the date when the asset is put to use. However, the Committee notes that MPERC Regulations require depreciation on assets to be charged from the first year of commercial operation and Part B of Schedule II to the Companies Act, 2013 also states that "the useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of this Schedule". Therefore, since whether requirements of MPERC Regulations would be covered under Part B of Schedule II or not, would involve interpretation of MPERC Regulations and since the same is also not the issue raised in the extant case, the Committee has not examined the issue as to whether in the extant case, the company should charge depreciation from the date the asset is put to use/commercial operation or the date when it is available for use by the company. Further, since the company is not differentiating between these two dates, it is presumed from the Facts of the Case that these dates are same in the extant case and accordingly, the Committee has restricted itself to the issue raised of charging the pro rata depreciation on quarterly basis.

11. The Committee further notes that the company is charging depreciation from the beginning of the quarter in which the asset was put to use irrespective of the date on which the asset was actually put to use. In this regard, the Committee notes the requirements of Note 2 of Schedule II of the Companies Act, 2013 which states as follows:

> "Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed."

From the above, the Committee notes that Schedule II requires calculation of depreciation on pro rata basis for any additions/disposals of assets made during the year. The Committee notes that the manner of providing pro rata depreciation has been explained in paragraph 59 of the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the

Companies Act, 2013[2] which states as follows:

> **"Pro-rata Depreciation**
>
> 59. Note no. 2 in Schedule II prescribes that "where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed." The company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved."

From the above, the Committee notes that the Guidance Note allows grouping of assets acquired or disposed of on quarterly basis for providing pro rata depreciation subject to the considerations of materiality of the amounts involved. The Committee is of the view that ideally, as a matter of principle, depreciation should be calculated from the date the asset is available for use (i.e., on daily basis). However, as a matter of administrative convenience, the Guidance Note allows grouping of assets acquired or disposed of on a 15 days/monthly/quarterly basis and calculation of depreciation on such assets accordingly unless the amounts involved are material. In other words, the intention behind such grouping is that to the extent possible, the depreciation so calculated should not be materially different from the actual depreciation, computed from the date the asset is available for use. As far as materiality is concerned, it is a matter of judgement and needs to be considered in the specific facts and circumstances of the company. Accordingly, the Committee is of the view that in the extant case, the company may continue to charge pro rata

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[2]The said Guidance Note was issued in the year 2016, whereas the query relates to the financial year 2014-15. However, since in the extant case, the requirements of Companies Act, 2013 are applicable, in the context of which this Guidance Note has been issued, the same has been referred to. Further, since the erstwhile Guidance Note on Accounting for Depreciation in Companies (which was in force during the financial year 2014-15) was in context of Schedule XIV to the Companies Act, 1956 and contained same requirements in respect of pro-rata depreciation, the same has not been referred to.

depreciation on additions and disposal of assets on quarterly basis provided the amounts involved are not material. However, if the amounts involved for specific assets are material, the company should consider grouping of additions and disposals of such assets on some more suitable basis, for example, on monthly or 15 days period basis, etc.

D. Opinion

12. On the basis of above, the Committee is of the opinion that the company may continue to charge pro rata depreciation on additions and disposal of assets on quarterly basis provided the amounts involved are not material. However, if the amounts involved for specific assets are material, the company should consider grouping of additions and disposals of such assets on some more suitable basis, for example, on monthly or 15 days period basis, etc., as discussed in paragraph 11 above.

Query No. 13

Subject: Recognition of gross receipt as revenue.[1]

A. Facts of the Case

1. In June 1972, Government of India (GOI) constituted the Space Commission (SC) and established the Department of Space (DOS) to formulate and implement space policies and programmes in the country.

2. The Indian Space Research Organisation (ISRO) is the research and development (R&D) organisation of the DOS and is responsible for executing the programmes and schemes of the DOS in accordance with the directives and polices laid down by the SC and the DOS through ISRO centres/ units and the grant-in-aid institutions.

3. A company (hereinafter referred to as 'the çompany') was incorporated on 28th September, 1992 under the Companies Act, 1956 as a private limited company and is a wholly owned Government of India company under the administrative control of DOS.

[1] Opinion finalised by the Committee on 9.6.2017.

4. The company is the commercial arm of ISRO and is mandated to promote and commercially exploit products and services emanating from the Indian space programme by utilising the capabilities, capacities, infrastructure and manpower of ISRO.

5. The company *per se* does not own any space based assets or manufacturing facilities except its corporate office. In the year 2008, the company was awarded 'Mini Ratna' status.

6. The major business areas of the company currently are:

   (i) Provisioning of communication satellite transponders to Indian users;

   (ii) Providing satellite launch services to domestic and international customers;

   (iii) Marketing of direct downlinking of data from Indian Remote Sensing (IRS) satellites to International Ground Stations (IGS) and data products to Indian and international customers;

   (iv) Building and marketing of satellites and satellite sub-systems for international customers and related services;

   (v) Building satellites and establishing associated ground infrastructure for Indian strategic users;

   (vi) Mission support services for foreign satellites.

7. The querist has stated that over the years, DOS/ ISRO has developed and launched the Indian National Satellite (INSAT) and Geosynchronous Satellite (GSAT) series of communication satellites; with transponders operating in C, Extended-C, Ku, UHF and S bands; for broadcasting (TV, DTH, DSNG) and communication applications (VSAT); and established the INSAT system. As and when the INSAT system's transponder capacity was found to be inadequate to meet the user demands, the company is directed to identify suitable transponder capacities from foreign satellite operators to augment the INSAT capacity by leasing. Such leased capacities provided to users are also considered to be part of INSAT's transponder capacity.

8. In the financial year 2014-15, the company earned about INR 1171.23 crores as revenue by providing capacities from the INSAT system. Out of this, the revenue from providing INSAT/GSAT transponders to users is INR 487.07 crores (42%) and revenue from providing foreign satellite capacity to users is INR 684.16 crores (58%).

9. The querist has further stated that the statutory auditor, while auditing annual accounts of the company for the financial year 2014-15, requested the company to obtain the opinion of Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), as to whether the existing practice of "recognising the gross receipt of 'Space Segment Charges (SSC)' in respect of INSAT/ GSAT transponder capacity (other than receipts in respect of foreign satellites capacity) as revenue in the books of the company", is in order.

Technical Background:

10. Every communication satellite that is used for transmission of signals will contain devices called 'transponders'. In a single satellite, there can be 12 to 60 such transponders. These transponders are mainly used for broadcasting (DTH, TV), DSNG and telecommunications (Public Switched Telephone Network and VSAT for closed user groups).

11. The capacity of a satellite is determined by multiplying the number of transponders on it with frequency bandwidth of each such transponder measured in 'Mega Hertz (MHz)'. Each transponder is assigned equal and specific ranges of frequencies, each with a start frequency and end frequency, called as up-linking frequency range and down-linking frequency ranges as explained more elaborately in the following paragraphs. The difference between the start frequency and end frequency (of either up-link or down-link) is called the 'bandwidth' and is the accepted parameter for capacity.

12. As per the requirements of different customers, each of them is allotted a capacity in terms of a particular bandwidth. It is within this range of frequencies that the customer can throw up/transmit their signals into space. This activity is called 'up-linking'. The transponder in the satellite will pick up the signals thrown up/transmitted by the customers and amplify them so that the said signals can be retransmitted back on a greater area called the 'foot print'. The ground station of the customer will have the equipment to identify and receive such signals which are thrown back/retransmitted by the transponders in the specified frequencies. This activity is called 'down-linking'.

13. For providing access to the satellite transponders to users so that this activity of picking up signals, amplifying them and throwing/ retransmitting them back into the space, the company charges the customers a consideration called 'space segment charges (SSC)'.

14. The Union Cabinet approved the norms, guidelines and procedures for implementing the new Satellite Communications (SATCOM) Policy (copy supplied by the querist for the perusal of the Committee), as intimated by DOS Note dated 10-10-2000 (copy supplied by the querist for the perusal of the Committee). As per paragraph 2.3 - Basic Guidelines – “As a baseline making the INSAT capacity available to the commercial sector should be based on sound business lines, i.e., this activity should be on a ‘for profit’ basis and at the same time consistent with the Government policies in the concerned user sectors. As per paragraph 2.6, ‘Commercial and Contractual Factors’, all the commercial activities of INSAT space segment shall be carried out by the Department of Space (DOS) which means the organisation created in DOS for this purpose or the corporate structure meant for operating the INSAT system, if and when such an organisation is created. The querist has supplied a copy of SATCOM Policy and DOS Note for the perusal of the Committee. Since DOS had already incorporated the company during 1992, no separate corporate structure for operating the INSAT system was created and the responsibility of commercialisation of the INSAT capacity was transferred to the company.

15. The activities of billing and revenue collection pertaining to leasing of the INSAT capacity were transferred from Department of Telecommunication (DOT) (XYZ Ltd.) to DOS from July 1, 2003 (copy of the communication from DOT to DOS has been supplied by the querist for the perusal of the Committee). Prior to this date, the revenue collection and recognition were done by XYZ, a corporate entity under DOT based on licence agreement entered into by DOT. (The querist has supplied a sample copy of the invoice raised by XYZ Ltd. for the perusal of the Committee.) As per the understanding of the querist, XYZ Ltd. recognised full amount shown in their invoice as its revenue and the cost of receiving the service from DOS was paid for by XYZ Ltd. to DOS. This cost was treated as expenditure in the books of XYZ Ltd.

16. The existing system of billing and revenue recognition is being followed in the company consistently since 2003 which is similar to the billing and revenue recognition adopted by XYZ Ltd. earlier.

17. DOS on behalf of Hon’ble President of India, since 2003, enters into contracts with the customers for providing ‘Space Segment Capacity (SSC)’ of the INSAT/GSAT systems.

18. The SSC for the INSAT/ GSAT satellites are fixed by the Government of India and included in the agreements. In contrast, SSC in respect of

foreign transponder capacities are negotiated with the satellite operators and fixed by the company and included in the agreements for these capacities. As there are inter-departmental involvement in transponder leasing, like Department of Telecommunication, Department of Space, etc., the agreement is entered into between DOS and the end customer and not directly by the company, though negotiated by the company and the company is responsible for rendering the service of providing space segment.

19. The company, to fulfil its obligations, obtains the service from the INSAT/ GSAT satellites of DOS and provides the same to its end customers. Any tax liability, as per the current provisions of law shall be paid by the company on both as a service provider as well as recipient of service on reverse charge basis, if any.

20. The company is required to carry out various activities to render the service to its customers. Some such activities are provided herewith:

(i) Procure services in the form of space segment from DOS and arrange leasing of the same to its customers.

(ii) Billing of customers on a monthly / quarterly / annually / occasional use etc. basis at the rates, terms and conditions of the individual contracts. (The querist has supplied a copy of an invoice raised for the perusal of the Committee.)

(iii) Realisation of payments against invoices raised on customers.

(iv) Levying, collection and remittance of service tax to appropriate authorities, filing of tax returns and maintenance of related records according to the related tax statutes.

(v) Market INSAT /GSAT space segment capacity both in local and global markets.

21. The company invoices SSC on monthly/ quarterly/ six monthly/ annually as per the agreements' terms as per rates prescribed in the agreements with the customers along with service tax. The company is registered as a service provider as required under the provisions of Chapter-V of the Finance Act, 1994 and has been discharging service tax on the entire amount invoiced by it on INSAT/GSAT SSC and from 16.05.2008 for foreign satellite SSC. (The querist has supplied illustrative copies of the returns filed under the Finance Act, 1944 for the said period for the perusal of the Committee.)

22. *The cost of service rendered by DOS to* the company *is based on agreement (Memorandum of Understanding (MoU)) between DOS and* the company *and a fixed percentage of the contracted value with the end customer is agreed to be the cost of such service.* The copy of Agreement/MoU has been separately provided by the querist for the perusal of the Committee. (Emphasis supplied by the querist.)

23. Apart from the SSC, the company claims penal interest for delay in remittance of SSC by the customers as per the terms of the agreements and the said penal interest is treated as income of the company.

24. The company is currently raising invoices on the customers for SSC and recognizing the entire amount as revenue in its books of account. The cost of SSC, based on DOS Order (85%) is booked against each invoice raised for SSC. Since the invoices are raised based on the price fixed by GOI, the company cannot negotiate the price with the customers or offer any discount on INSAT/GSAT SSC.

25. On receipts from customers, the actual receipts of SSC portion of the INSAT/ GSAT satellites are transferred to DOS and 15% of the SSC is claimed as the company's share from DOS on a quarterly basis as per procedure for sharing of revenue from leasing of INSAT/GSAT satellite transponder capacity. The company retains the penal interest received and accounts it as 'other income'.

26. The querist has also separately informed that the credit risk for the amount receivable from the customers is borne by the company. The company provides for doubtful debts in case of dues for more than three years based on the recommendation of a Debtor Review Committee constituted on direction by the Board and in accordance with the company's accounting policy. The company has also written off bad debts in the past and hence, the credit risk is borne by the company. Further, legal action against customers for recovery of dues, wherever required, is also taken by the company.

B. Query

27. On the basis of the above, the querist has sought the opinion of the Committee as to whether inclusion of the gross revenue from operations for providing the INSAT/GSAT satellite capacity to customers is in order. If not, whether the company's share of revenue in respect of these capacities alone is to be considered as revenue to the company in view of the existing relationship between the company and Department of Space (DOS).

C. Points considered by the Committee

28. The Committee notes that the basic issue raised by the querist relates to whether inclusion of gross revenue from operations for providing the INSAT/GSAT satellite capacity to customers is in order. Therefore, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, timing of recognition of costs and revenue, accounting treatment of receipts/SSC in respect of foreign satellites/transponders capacity or any other income being earned by the company, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting perspective and not from tax (income tax or service tax) or legal perspective. Incidentally, the Committee notes that under the MoU entered into between the Department of Space and the company, the terms, 'revenue sharing/share of profits' or 'fee' in lieu of services rendered by the company to DOS/value of works carried out by the company, have been used interchangeably; however, the same does not affect the opinion expressed hereinafter.

29. As regards the issue raised by the querist with regard to recognition of revenue on gross basis or net basis, the Committee is of the view that the same would depend upon the capacity in which the company is working vis-à-vis DOS, viz., whether the company is acting as an agent of the DOS or not. In this regard, the Committee notes the following from the Memorandum of Understanding between DOS and the company:

(i) Being *commercial arm of ISRO*, the company is the only company charged with the *administration* of contracts of this nature with third party clients for provision of space segment capacity. The company shall interface with the customers and DOS for administering such agreements, raise invoices, collect charges for provision of capacity as per agreements and do all such acts necessary to fulfil its contractual obligations towards such third party in the regular course of business.

(ii) The company will charge a fee, from DOS for all services rendered to DOS as part of the contracts entered into between the company and third parties, for all the functions related to space segment capacity.

(iii) DOS enters into agreement with Indian and Foreign users for provision of the INSAT transponder capacity.

(iv) The revenue sharing arrangement between DOS/ISRO and the company for INSAT/VSAT transponder leasing is 85:15. The revenue sharing arrangement shall be based on estimates of the value of works carried out by ISRO/DOS and value of works carried out by the company.

(v) The entire revenue collected by the company *on behalf of DOS* has to be first transferred to DOS/*Government* of India and then the company may claim their due share on a quarterly basis from DOS/ Government of India. ... The company's share of profit is later remitted by DOS.

(vi) DOS may revise this revenue sharing formula from time to time. The revenue sharing so finalised is binding on the company.

The Committee also notes from the MOU/Agreement signed between the DOS and the customer for provision of space segment capacity in the INSAT/GSAT systems that the company will act as the contract manager/administrator to administer the MOU/Agreement and all the services under the contract are actually provided by the DOS/ISRO using their facilities/assets. Further, all the decisions under the contract, such as, for any addition/reduction in the capacity provided by the DOS, sub-leasing of the transponder capacity, termination of contract, forfeiture of caution deposit, etc. are taken by the DOS. Moreover, the prices/charges to be charged to the customer and any revision in the same is decided by the DOS, as per its pricing policy. DOS is also liable to indemnify and hold customer harmless from any loss, damage, liability, etc. arising from DOS' exercising use, control or operation of the concerned satellite. The Committee also notes that although invoices are raised in the name of the company, the actual contract with the customers is entered into by the DOS. As far as credit risk is concerned, the Committee notes from the MOU between the company and the DOS that the revenue sharing between the DOS and the company shall be *on collection* after accounting for expenditure on the activity, taxes and duties, etc. The Committee further notes from the Exhibit-B, Payment Schedule to the agreement of the DOS with the customer (a private company), as provided by the querist for the perusal of the Committee, *inter alia*, provides that the DOS shall have the right to black out the provisioned capacity if customer defaults on payments as stipulated in this agreement and that upon signing of the contract, customer will require to deposit with the DOS a refundable and interest free 'Caution Deposit' which shall be refunded at the end of agreement upon reconciliation of accounts and remittance of all dues under the agreement. Further, the agreement with the customer also, *inter alia*, provides that DOS has the right to terminate the agreement, including forfeiture of caution deposit, if the customer fails to make two consecutive periodic payments for space segment capacity. These clauses indicate that credit risk is not borne by the company as the revenue sharing will be on collected amount and any non-payment of dues by the customer shall be adjusted against the caution money deposited. Moreover, it appears to the Committee that the company claims to be bearing the credit risk on the ground that the company has provided for and written off bad debts in the past on the debtors/receivables which the company has recognised on the basis of gross revenue in its financial statements, as per the accounting policy followed by it. In this regard, the Committee is of the view that mere accounting treatment accorded by the company does not determine whether the company bears the credit risk or not. Further, the Committee is of the view that bearing of credit risk is not the only relevant indicator to determine the capacity (viz., principal or agent) in which the company may be working; rather other factors, such as, control over the goods/services before these are provided to customers, discretion in establishing prices, etc. in the specific facts and circumstances of the company should also be considered.

30. From the above, the Committee is of the view that the company, while interfacing with the customers for provision of space segment capacity, is only rendering administrative services as contract manager to the DOS, for which it is being paid a fixed fee and is, therefore, acting only as an agent of the DOS. Accordingly, the principle of revenue recognition for agency relationship as enunciated in the following definition of 'revenue' as per Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006 should be applied in the extant case:

> ***"4.1 <u>Revenue</u> 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."

From the above, the Committee is of the view that in the extant case, revenue for the company is the amount of fees received by it as agent of the DOS and not the amount of invoice or gross inflow. Therefore, the accounting treatment followed by the company of inclusion of the gross revenue from operations for providing the INSAT/GSAT satellite capacity to customers is not in order and only the fee received from the DOS on this account should be recognised as revenue of the company, following the principles of AS 9.

D. Opinion

31. On the basis of the above, the Committee is of the view that the existing practice of the company to recognise the gross revenue from operations for providing INSAT/GSAT satellite capacity to consumers is not in order considering the principles of AS 9; rather the company's share of revenue, i.e., the amount of fees received in respect of these capacities alone is to be considered as revenue to the company in view of the existing relationship between the company and Department of Space (DOS), as discussed in paragraphs 29 and 30 above.

Query No. 14

Subject: Accounting for software income.[1]

A. Facts of the Case

1. A company is into information technology (IT) business. The company focuses into two major product verticals, viz., network monitoring tools and cloud computing applications (called as SAAS). Network monitoring tools are downloadable software products that will be used by network administrators and IT managers to manage their internal networks. Cloud computing applications (SAAS) comprise of varied business and office applications which reside in centralised servers that are accessed by customers across

[1] Opinion finalised by the Committee on 9.6.2017.

the globe. The querist has stated that the query is on recognition of revenue for the network monitoring tool product vertical. In this segment, the customer has two types of licensing options:

(i) Perpetual

(ii) Subscription

2. Perpetual model: In this model, the customer will be able to use the product perpetually. For perpetual model, the license fee and maintenance charges are clearly defined in the invoice. The license fee portion is accounted for as revenue immediately and the maintenance part is deferred over the period of maintenance. On an average, the license component works out to 5/6 and the maintenance component is 1/6 of the total.

3. Subscription model: In this model, the customer has the option to choose the usage period. Generally, the period is for 1 year; however the customer has the option of subscribing for multiple years. In this case, the customer is entitled to upgrades to the product, done during the period, free of cost. The invoice amount would be mentioned as a single line item named 'subscription license fee'. (The querist has supplied a copy of the invoice raised under the subscription model for the perusal of the Committee.) Under this model, the price of the product is divided into license fee and maintenance charges. Based on the perpetual model, 5/6th of the amount is treated as license fee and 1/6th as maintenance charges. The maintenance charges are recognised as revenue over the months/years over which the product is subscribed for. (The querist has supplied a copy of the extracts from the significant accounting policies of the company forming part of the Notes to the financial statements for the year ended 31st March, 2015 for the perusal of the Committee.)

4. With respect to license fee, the company wants to get an opinion as to whether the license revenue needs to be deferred over the period of the contract or be recognised upfront.

5. General terms of contract

The customer who is interested in purchasing the product will have to agree to the terms of the contract. On purchase of the product, a license key is sent to the customer. The company has a standard refund policy captured in the contract. Any customer who does not like the product can claim refund for the entire amount within 30 days from date of purchase. 100% of the amount is refunded by the company and no questions are asked.

6. Further, with regard to the nature of licence fee charged to the customers under the subscription model, the querist has clarified that upon payment of the applicable license fees, the company grants licensee a non-exclusive, non-transferable, world-wide license to use the licensed software, including user documentation that licensee has downloaded or received on media provided by the company, including all updates, where applicable, provided that such access and use of the license software is in accordance with the single installation license granted by the company. “Use” means storing, locating, installing, executing or displaying the licensed software. “Single Installation License” means that the license keys provided shall not be used for more than one concurrent ‘Use’. Under the subscription license, the licensed software is licensed only for the period of subscription (‘subscription period’). If licensee does not renew the subscription beyond the subscription period, licensee agrees to stop using the software and remove the software from licensee’s systems. To continue using the licensed software beyond the subscription period, licensee must renew the license at least 10 days before the expiry of the subscription period. As a part of the subscription license, all updates, upgrades, email support for problem reporting and online access to product documentation to the licensed software will be provided to licensee at no additional cost during the subscription period. According to the querist, the broad terms of the contract will be as follows:

(a) The seller’s price to the buyer is substantially fixed or determinable at the date of sale.

(b) The buyer has paid to the seller, or the buyer is obligated to pay to the seller and the obligation is not contingent on resale of the product.

(c) The buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.

(d) The buyer acquiring the product for resale has economic substance apart from that provided by the seller.

(e) The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.

(f) The amount of future returns can be reasonably estimated.

B. Query

7. On the basis of the above, the querist has sought opinion with respect to license fees, as to whether the license revenue needs to be deferred over the period of the contract or be recognised upfront.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to timing of recognition of license fees under the subscription model of network monitoring tools, viz., whether the same needs to be deferred over the period of the contract or be recognised upfront. 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 treatment of maintenance charges, accounting treatment of the fee received under perpetual model, accounting treatment of cloud computing applications, etc. At the outset, the Committee wishes to point out that since the querist has supplied the copy of the invoice and the extracts from the financial statements pertaining to the period before 31st March, 2016, the Committee has not examined the applicability of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

9. In the context of the arrangement of subscription license, the Committee notes the following from the Software License Agreement:

> "Upon payment of the applicable license fees, the company grants Licensee a non-exclusive, non-transferrable, world-wide *License to Use* the Licensed Software, including user documentation that Licensee has downloaded or received on media provided by the company, including all updates …"
>
> Under the Subscription License, the Licensed Software is licensed only for the period of subscription ("Subscription Period"). If Licensee does not renew the subscription beyond the Subscription Period, Licensee agrees to stop using the software and remove the software from Licensee's systems."
>
> "The company provides support that includes email support for problem reporting, product upgrades, updates, and online access to product documentation during the Subscription Period."
>
> "The *company owns all right*, title and interest in and to the Licensed Software.

The Licensed Software is *only licensed and not sold to Licensee* by the Company."

"The company may terminate this Agreement in the event that Licensee is in breach of any of the terms of this Agreement and does not cure such breach… Upon termination, Licensee shall destroy or return to the company all copies of the Licensed Software and certify in writing that all known copies have been destroyed.

…"

"**Technical Support:**

Perpetual License:

Subscription License: The company provides support that includes email support for problem reporting, product upgrades, updates, and online access to product documentation during the /subscription period.

From the above, the Committee notes that under the subscription arrangement in the extant case, the right to use of a particular software has been transferred to the customer for a specified period, which as per the facts of the case, for 1 year. In this context, the Committee notes the following paragraphs of Technical Guide on Revenue Recognition for Software (hereinafter referred to as the 'Technical Guide'), issued by the Research Committee of the Institute of Chartered Accountants of India as follows:

"2.1 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customisation of software. The principles of AS 9, Revenue Recognition, are applicable to all types of software arrangements. …"

"2.8 Generally, revenue is recognised when all the following conditions are met:

(a) Significant risks and rewards of ownership have been transferred to the buyer, which in software industry are generally considered to be transferred when the delivery has occurred,

(b) The seller's price to the buyer is fixed or determinable, and

(c) Collection is reasonably assured."

"2.15 Delivery may be considered to be complete for revenue recognition purposes upon the commencement of the license term even if the license is delivered earlier and payment is also received. …"

"5.1 Many entities offer multiple solutions to their customers' needs. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. …

5.2 A multiple-element software arrangement is any arrangement that provides the customer with the right to software along with any combination of additional software deliverables, services, postcontract customer support (PCS), and non-software deliverables. …

5.3 A vendor should evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. That evaluation must be performed at the inception of the arrangement and as each item in the arrangement is delivered.

5.4 In an arrangement with multiple-deliverables, the delivered item(s) may be considered as a separate unit of accounting if the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis if it is sold separately by the vendor or the customer could resell the delivered item(s) on a standalone basis.
- Reliable fair values of the undelivered item(s) can be determined.
- If the arrangement includes a general right of return relative to the delivered item(s), and delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor."

General Guidelines for revenue recognition for multiple-element arrangements

"5.7 General guidelines for revenue recognition for multiple element arrangements are as follows:

- Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the separate identification criteria specified in paragraph 5.4.
- Revenue recognition criteria should be applied to each separately identifiable component of a single transaction to reflect the transaction's substance. However, in applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element. In software industry reliable determination of fair values for each of the separately identifiable elements is usually essential to reasonably determine the price for such elements, which is one of the conditions for revenue recognition.
- Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values or by application of the residual method."

"5.10 … For revenue to be recorded for the delivered elements, the amount allocated to delivered elements may not be subject to a future adjustment. The portion of the fee that is allocated to an element should generally be recognised as revenue when all of the criteria for revenue recognition have been met with respect to that element. If reliable fair value of each of the element does not exist, all revenue from the arrangement should be deferred until the earlier of when:

(i) Such evidence does exist for each element, or

(ii) All elements have been delivered, or

(iii) The reliable fair values of the undelivered elements can be determined.

…"

"5.32 Upgrade right is the right to receive one or more specified upgrades or enhancements, even if it is offered on a when-and-if available basis. If an upgrade right is offered on a when-and-if available basis then it is considered as Postcontract Customer Support (PCS)."

"6.1 PCS or maintenance as it is usually called, means right to receive services (other than services separately accounted for) or unspecified product upgrades/enhancements (these unspecified arrangements are PCS only if they are offered on 'when-and-if available' basis) or both offered to customers after the software license period begins or other time provided for by PCS arrangement.

6.2 PCS may be a separate element, bundled with other products and services or implicitly included in an arrangement. Regardless of whether PCS is separately stated in a contract, every software arrangement should be evaluated for the potential impact of PCS and, if it proves to be part of an arrangement, it should be considered a separate element in determining revenue recognition."

"GENERAL GUIDELINES FOR REVENUE RECOGNITION OF PCS FOR PERPETUAL LICENSES

6.5 Fees related to PCS, whether sold separately (e.g., renewal period PCS) or as an element of a multiple-element arrangement, should generally be recognised as revenue ratably (i.e., on straight line basis), over the term of the PCS arrangement. If the use of the straight-line basis does not approximate the timing of when the software vendor actually incurs the costs, then revenue could be recognised on pro rata basis based on when the amounts are expected to be charged to expense."

"PCS CONSIDERATIONS FOR TERM LICENSES

6.7 The guidance given above contemplates to PCS arrangements involving perpetual licenses. However, term licenses are becoming common practice in the arrangements. Term licenses involve a license to use the software for a specific period, generally one to five years. Generally, PCS for all or part of the license term will be bundled together with the term license. In this regard, the following aspects may be considered:

(a) Fair value of PCS in a short-term time-based license (ordinarily less than one year) and software revenue recognition.

The duration of the time-based software license is so short that a renewal rate or fee for the PCS services does not generally represent the fair value of the bundled PCS. In arrangements of this kind, the total arrangement fee should be recognised ratably over the PCS period.

…

(b) Fair value of PCS in a multi-year time-based license and software revenue recognition.

…

6.8 It may be noted that it would not be appropriate to use the fair value of PCS sold with perpetual licenses as a “surrogate” for the fair value for PCS in a term license. However, in following type of indicative situations such values may be considered:

(a) The PCS renewal terms in a perpetual license provide the fair value of the PCS services element included (bundled) in the multi-year time-based software arrangement when the term of the multi-year time-based software arrangement is substantially the same as the estimated economic life of the software product and enhancements during that term.

(b) The fees charged for the perpetual (including fees from the assumed renewal of PCS for the estimated economic life of the software) and multi-year time-based licenses are substantially the same.

6.9 In case PCS is the only undelivered element and the fair value cannot be reliably determined, the entire fee under the arrangement is generally recognised ratably over:

- The contractual PCS period (for those arrangements with explicit rights to PCS); or
- The period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

6.10 PCS revenue may be recognised simultaneously with the initial license fee when software is delivered in the following indicative situations provided all of the estimated costs of providing the services, including upgrades and enhancements, must be accrued at the time when the software is delivered.

- The PCS fee is included with the initial licensing fee.
- The PCS included with the initial license is for one year or less.
- The estimated cost of providing PCS during the arrangement is insignificant.
- Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent."

(Emphasis supplied by the Committee.)

From a holistic reading of the above paragraphs, the Committee notes that the extant case is a multiple-element software arrangement as it provides to the customer with the right to use of the software alongwith postcontract customer support (PCS). The Committee further notes that as per the above requirements, in arrangements with multiple-deliverables, if reliable fair value of each of the element does not exist, all revenue from the arrangement should be deferred (refer paragraph 5.10). Further, as per the requirements of paragraph 6.9, reproduced above, in case of short-term term-based licenses, if the only undelivered element is Postcontract Customer Support (PCS) as is the situation in the extant case, and its fair value cannot be determined, the entire fee under the arrangement is recognised ratably over the contractual PCS period in case of arrangements with explicit rights to PCS. However, if the requirements of paragraph 6.10 are fulfilled, PCS revenue and initial license fee may be recognised simultaneously when the software is delivered. Accordingly, the Committee is of the view that recognition of initial license fee in the extant case would depend upon whether or not the fair value of rights to PCS provided under the subscription license can be determined as per the requirements of the Technical Guide and whether the requirements of paragraph 6.10 of the Technical Guide, as reproduced above are fulfilled.

D. Opinion

10. On the basis of above, the Committee is of the opinion that recognition of license fees under the subscription model would depend upon whether or not the fair value of rights to PCS provided under the subscription license can be determined as per the requirements of the Technical Guide and whether the requirements of paragraph 6.10 of the Technical Guide, as reproduced above are fulfilled, as discussed in paragraph 9 above.

Query No. 15

Subject: Provision for debtors transferred to Franchisee.[1]

A. Facts of the Case

1. A company is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May, 2002 after unbundling of erstwhile Madhya Pradesh State Electricity Board (MPSEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP Notification No. 226 dated 31st May, 2005. The company is engaged in the business of electricity distribution in the area of Indore & Ujjain Commissionaire of State of Madhya Pradesh and is governed by the provisions of the Electricity Act, 2003. The company is responsible for all activities associated with distribution of power within its territory, including management of assets, operation and maintenance of network and supply, technical and financial planning, business development and management of human resources, legal and regulatory affairs etc.

2. The company entered into a Distribution Franchisee Agreement (hereinafter referred to as “the DFA”) with the successful bidder with an objective to minimise Aggregate Technical & Commercial Losses, improve distribution and operational efficiency, minimise billing arrears etc., in the area of Ujjain city. (Copy of the DFA has been supplied by the querist for the perusal of the Committee).

3. As per the terms and conditions of the DFA, from the effective date to expiry date i.e., 15 years from the effective date or date of default (in case of

[1] Opinion finalised by the Committee on 23.8.2017.

a default made by Franchisee), whichever is earlier, the sundry debtors as on effective date excluding amounts collected within three months of the last billing cycle will be handed over to Franchisee. Similarly, on expiry date/date of default, all sundry debtors excluding amounts collected within three months of last billing cycle will be handed over by Franchisee to the company. Accordingly, the company transferred the sundry debtors as on effective date excluding amounts collected within three months of the last billing cycle to Franchisee and makes a provision for doubtful debts by debiting profit and loss account on remaining amount of sundry debtors in the books of account of the company, because, now, as per the agreement, right to recover those debtors is transferred to the Franchisee.

4. While conducting audit of Annual Accounts of the company for FY 2014-15, the government auditor (C&AG Auditor) has made the following observations in this regard:-

> *"(i) This includes an amount of Rs. 38.84 crore towards the provision for doubtful debts in respect of sundry debtors of Ujjain City circle as on effective date i.e.31.07.2014 (on the date of handing over of the operation to Franchisee). As per terms and conditions of the Franchisee agreement clause 12.5 (i), from the effective date to the expiry date, the distribution franchisee shall be responsible to collect and retain payment of Consumer bills in the Franchisee Area, and as per clause 12.5(ii), the distribution franchisee shall collect the amounts due from the Consumers on day to day basis and remit to the Distribution Licensee on a weekly basis the amount collected against the Consumer bills for the last Consumer billing cycle immediately preceding the effective date up-to a period of three (3) months from the Effective Date.*
>
> *As per clause 12.5 (iii), on the expiry date, the distribution licensee shall allow the Distribution Franchisee to collect amounts due from the Consumers as per the provisions of Article 32.11.2.*
>
> *As per article 32.11.2, amounts due from the Consumer from the billing cycle ending on any date prior to the expiry shall be permitted to be collected by the distribution franchisee up to a maximum period of three (3) months after the expiry date. Thereafter, any such amount collected from the consumer by the distribution licensee shall be retained by the Distribution Licensee and the Distribution Franchisee shall not be entitled for any claim on such amount.*

To sum up, as per the above terms and conditions of the agreement, the sundry debtors as on the effective date excluding the amounts collected within three months of the last billing cycle will be handed over to the franchisee. Similarly, on the expiry date, all the sundry debtors on the expiry date excluding the amounts collected within three months of the last billing cycle will be handed over to the distribution licensee i.e., the company. As such, there is no loss of sundry debtors, it is only transfer of sundry debtors to the Franchisee for franchise period like any other assets transferred to Franchisee for operation and on expiry of the franchise period, the company will receive all the sundry debtors. ***Hence, booking the loss on account of sundry debtors which were only transferred to the Franchisee for franchise period considering it as doubtful is imprudent and highly objectionable. It should have been shown under other noncurrent assets as Trade receivable as they will be received on expiry of the franchise period. Hence, making the provision for the doubtful debts on sundry debtors who were only transferred for the franchise period has resulted in overstatement of other expenses and understatement of sundry debtors by Rs.38.84 crore. Consequently, loss for the year is also understated by similar amount.”***

5. In response to the above, the company submitted the following reply:-

“Audit observed that no provision is required to be made on the debtors transferred to the Franchisee and, accordingly, there is understatement of sundry debtors. Here, it is stated that sundry debtors is an asset. Hence, kind attention is drawn towards the definition of ‘Asset’ given in the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India, relevant paragraphs of which are reproduced below:-

> “49 (a) An *asset* is a resource **controlled by the enterprise** as a result of past events **from which future economic benefits** are expected to flow to the enterprise.”
>
> “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.”

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

From the above, it may be noted that an item can be recognised as an asset only if it is a 'resource controlled by the enterprise' and future economic benefit will flow to the enterprise. Thus, it is the control over the resource that is important for recognising an expenditure as an asset. An entity that controls a resource can generally deal with it as it pleases. For example, the entity having control of a resource can exchange it for other assets, employ it to produce goods or services, charge a price from others to use it, use it to settle liabilities, or distribute it to owners. Further, an indicator of control would be that the entity can restrict the access of others to the benefits derived from that resource. This view is also supported by the principles enunciated in paragraph 14 of Accounting Standard (AS) 26, 'Intangible Assets', reproduced below:

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

In the present case, the Discom has transferred the debtors to the Franchisee. The collection of those debtors shall be done by the Franchisee and the said collection shall be retained by the Franchisee. No economic benefits shall be received by the Discom. Hence, the debtors transferred to Franchisee does not fulfil the definition of an asset and recognition criteria for an asset. Hence, the Discom made provision on those debtors and recognised expenses as per the requirements of para 96 of the 'Framework' quoted above.

Audit further observed that at the end of Franchise period, the company will receive the outstanding debtors of the Franchisee and, hence, booking the loss on account of sundry debtors which were only transferred to the Franchisee for the franchise period considering it as doubtful is ***imprudent and highly objectionable.***

Here, in this regard, it is submitted that the transfer of debtors from the Discom to the Franchisee and from the Franchisee to Discom are two different transactions and cannot be correlated, because, debtors will be outstanding at the end of the franchise period of 15 years and no one can forecast how much amount shall be transferred. Possibility of outstanding dues in the private operation is very rare and even after 15 years when technology will get change tremendously.

*Audit party termed the action of the Discom making provision as **imprudent.** Here, kind attention is drawn towards the definition of 'prudence' given in AS 1, 'Disclosure of Accounting Policies', reproduced below:*

"17. For this purpose,…

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information."

Discom, while making the provision for debtors transferred to Franchisee, has duly complied with the principle of prudence quoted above in the following manner:-

(i) Discom made provision on debtors transferred to Franchisee.

(ii) Discom has not considered the anticipated benefits which may or may not be received at the end of the franchise period."

6. However, the CAG audit has not considered the company's response and issued the following comments:-

"This includes an amount of Rs.38.84 crore towards provision for doubtful debts made in respect of sundry debtors of Ujjain City circle as on 31.07.2014. The company entered into a Distribution Franchisee Agreement (DFA) on 31.07.2014 with successful bidder with an objective to minimise Aggregate Technical & Commercial Losses, improve distribution and operational efficiency, minimise billing arrears on the date of handing over of the operation to Franchisee. As per terms and conditions of the Franchisee Agreement from the effective

date (31.07.2014) to the expiry date (15 years from the effective date or in case of a default by the Franchisee ,the date of default whichever is earlier), the sundry debtors as on effective date excluding the amounts collected within three months of the last billing cycle will be handed over to the Franchisee. Similarly, on the expiry date/date of default, all the sundry debtors excluding the amounts collected within three months of the last billing cycle will be handed over by the distribution Franchisee to the distribution licensee, since the debtors were only transferred to the Franchisee for the specific period but the ownership and title remained with the company.

Thus, making provision for doubtful debts on sundry debtors which were only transferred as a temporary measure during agreement period has resulted in overstatement of other expenses and understatement of sundry debtors by Rs.38.84 crore. Consequently, loss for the year is also *overstated by similar amount."*

7. The querist has separately clarified the following:

   (i) Debtors transferred to the Franchisee amounting to Rs.38.84 crore exclude both the amount collected within three month from the effective date as well as arrear in litigation. Further, right of collection and retention of the collected amount was granted to the Franchisee.

   (ii) The company has appointed the distribution Franchisee through competitive bid process. In the bidding process, all the conditions were made available to the bidder by way of bid and bidders were asked to submit to their Price Bid, mentioning the input rate for input energy for each year of the contract period, applicable for the energy to be injected by the Distribution Licensee at the input point(s) in the Franchisee Area. In the bidding process, the bidder who has offered the maximum levelised input rate for the input energy to be injected by the Distribution Licensee at the input point(s) in the Franchisee Area has been selected. The bidders were required to quote input rate considering all its obligations and other terms and conditions mentioned in the bid document. All these terms and conditions now form part of the Franchisee agreement.

   In view of above, as per conditions of bidding/agreement, the

Franchisee shall receive payment on the basis of input energy and quoted rates. These rates were quoted by Franchisee considering all the conditions. Transfer of arrears is also one of the conditions of the bidding. No separate consideration is paid by the distribution Franchisee to the company for transfer of such arrear.

(iii) After following a transparent bidding process, by way of agreement, the Franchisee was authorised for collection and retention of such collected amount from debtors (arrear). Except this agreement, no other legal deed/instrument was executed. In substance, beneficial owner of such arrear is the Franchisee. Such transfer of arrear to the Franchisee results in the following:

(a) it transfers from the company to Franchisee, the contractual rights to receive the cash flows from the debtors; and

(b) it transfers from the company to Franchisee substantially all the risk and rewards relating to such debtors.

(iv) Since the contractual right to receive cash flows has been transferred to the Franchisee, the arrear amounting to Rs. 38.84 crore does not fulfil the definition of asset in the books of the company.

(v) The company, by way of legally enforceable agreement, has transferred the arrear to Franchisee and now the company cannot dealt with such arrear as it pleases. Therefore, in the absence of 'control', asset should be charged to the profit and loss account for the period in which the company lost control, even though some indirect and remote economic benefits are expected to flow to the enterprise. In this regard, paragraph 56 of AS 26, 'Intangible Assets', provides as follows:

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

(vi) In the present case, since right of collection from debtors and retention of the same were transferred to Franchisee, as per

'Prudence' concept, loss on such transfer should immediately be recognised, even if any remote or estimated gain is possible.

(vii) While making the provision, the company has not derecognised the transferred debtors. However 100% provision has been made on transferred arrear. Even when the company has made the provision, instead of derecognising the asset, presentation on the face of the balance sheet is not changed because, in the balance sheet, debtors is being presented net of provision on the face of the balance sheet as per provisions of the Companies Act.

B. Query

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

(i) Whether the booking of loss upon transfer of debtors is correct or not as per Generally Accepted Accounting Principles.

(ii) As observed by the C&AG in its comments, the amount of provision for doubtful debts on such sundry debtors is Rs.38.84 crore against the total turnover of Rs. 8,268.45 crore for the company. Whether, in the light of principle of materiality, the treatment given by the company in its books of account is correct or not.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to booking of loss on transfer of debtors of Rs.38.84 crore to the Franchisee by way of provision for doubtful debts. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. The Committee notes from the facts of the case that the arrears under litigation have not been transferred by the company to the franchisee and also no provision has been created on debtors on account of being doubtful of recovery , therefore the Committee presumes that revenue recognition in respect of the transferred debtors of Rs.38.84 crore was appropriate and that *before* the transfer of those debtors, no portion of the same was impaired/doubtful and, hence, there was no need for any provision for doubtful debts *before* the said transfer. The Committee notes that in paragraph 4 above, there is incorrect reference to

understatement of loss for the year which is set right in paragraph 6 above which makes reference to overstatement of loss for the year. This, however, does not affect the opinion of the Committee. Further, in paragraph 7(ii) above, the querist has stated that as per conditions of bidding/agreement, the Franchisee shall *receive* payment on the basis of input energy and quoted rates. The Committee notes that actually Franchisee shall *make* payment to the company on the basis of input energy and quoted rates and, therefore, proceeds on that factual position. The Committee also notes the statement of the querist in paragraph 5 above that the possibility of outstanding dues in private operation is very rare whereas in paragraph 7(v) above it is stated that some indirect and remote economic benefits are *expected* to flow to the enterprise. In this regard, the Committee relies on the statement in paragraph 5 above in preference to the statement in paragraph 7(v) above. Incidentally, the Committee notes the use of the term 'Discom' in paragraph 5 above, which is an acronym of 'Distribution Company'.

10. The Committee notes that for the transfer of debtors of Rs.38.84 crore on the effective date, no separate consideration is received by the company from the Franchisee. Instead, the input rate was quoted by the Franchisee taking into account the transfer of debtors to the Franchisee *and* various obligations undertaken by the Franchisee under the Franchisee agreement. The Committee is of the view that as the Debtors have been transferred in the extant case, the same should be derecognized and the carrying amount of the transferred debtors should be transferred to an appropriate account (alternate asset). Subsequent clearance from this account should be made in an appropriate manner taking into account the nature and quantum of benefits expected to be obtained by the company during the Franchise period under the Franchisee agreement (for e.g., expected increase in *net* revenue during the Franchise period). The Committee does not consider this issue further, since, this is not an issue raised by the querist. Since the transferred debtors should be derecognised under the above treatment with concurrent recognition of another asset for equal amount, the question of making any loss or provision for doubtful debts does not arise at all in the extant case. Further, the Committee is of the view that derecognition of the transferred debtors is appropriate in the extant case, since, irrespective of legal title, the significant risks and rewards of ownership of the said debtors have been substantially transferred to the Franchisee. This is due to the fact of transfer to the Franchisee of the right to collect cash from the transferred debtors and retain the same, though uncollectible debtors, *if any*, out of the transferred debtors at the end of the Franchise period will be retransferred to the

company, which is very rare in view of the querist's statement in paragraph 5 above and having regard to the length of the Franchise period (15 years in the absence of default by the Franchisee). (See also paragraph 11 below).

11. The Committee agrees with the querist that possible return of the uncollectible transferred debtors to the company at the end of Franchise period is a contingent asset. Such possible future return meets the definition of contingent asset given in paragraph 10.5 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') which reads as below:

> ***"10.5 A <u>contingent asset</u> is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise."***

The Committee notes that paragraph 30 of AS 29, notified under the Rules, prohibits recognition of contingent assets.

12. The Committee does not agree with the querist that derecognition and provision for doubtful debts, which is offset against gross carrying amount of debtors, have the same effect on the presentation in the balance sheet. Derecognition means removal of an item from the balance sheet whereas offset does not result in such removal. For example, derecognition of an asset, which is not accompanied by concurrent recognition of another asset for equal amount, results in a gain or loss whereas offset of a liability or a valuation allowance or an allowance for impairment loss against an asset does not result in any gain or loss, though provision for doubtful debts has an impact on profit, which, however, is not correct in the extant case for the reasons stated in paragraph 10 above.

13. With regard to the issue raised by the querist in relation to materiality aspect of the amount involved, the Committee notes that paragraph 4.3 of the Preface to the Statements of Accounting Standards, issued by Institute of Chartered Accountants of India, states, inter alia, that "The Accounting Standards are intended to apply only to items which are material". The Committee further notes that paragraph 17(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', explains 'materiality' as below:

> *"c. Materiality*:
>
> Financial statements should disclose all "material" items, i.e. items

the knowledge of which might influence the decisions of the user of the financial statements."

14. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If information is not material, on the consideration of materiality as mentioned in the paragraph 13 above, its accounting would not have any effect on the decisions of the users of the financial statements. Thus, assessment of materiality is a matter of judgement and needs to be determined under the specific facts and circumstances of the company concerned. In the extant case, on the basis of information available in the facts of the case the amount appears to be not material, however, the Committee is of the view that it needs to be determined under the specific facts and circumstances of the company as to whether the amount involved is material, if not accounted for appropriately, can influence the decisions of the users of the financial statements. For this purpose, apart from the volume of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered. An entity should assess whether information either individually or in combination with other information is material in the context of its financial statements. Moreover, materiality concept should be seen in totality.

D. Opinion

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

(i) The booking of loss upon transfer of debtors is not correct. The correct treatment should be as explained in paragraph 10 above.

(ii) The aforesaid opinion of the Committee would be applicable only if the amounts involved are material and the considerations of materiality should be determined in the specific facts and circumstances of the company. For this purpose, apart from the volume of transactions and quantum of turnover, other factors such as nature of the item, impact on profit/loss etc., should also be considered, as discussed in paragraphs 13 and 14 above.

Query No. 16

Subject: Amortisation of expenses incurred on various business requirements at the time of formation.[1]

A. Facts of the Case

1. A company was incorporated under the Companies Act in July, 2015 as a Government company. The company was registered with Securities and Exchange Board of India (SEBI) as an asset management company and guided by SEBI (Alternate investment Funds) Regulations, 2012. The company is primarily engaged in the business of asset management in the infrastructure sector. As on 31st March, 2016, its authorised share capital was Rs. 100 crore (10,00,000 equity shares of Rs. 1000/- each); and issued, subscribed and paid-up capital was Rs. 16 crore (1,60,000 equity shares of Rs.1000 /- each).

2. During November 2015, the company incurred an expenditure of Rs. 92.92 lakh as preliminary expenses which included the following:

Registrar of Companies (ROC) fee (for authorised share capital of Rs. 100 Crore)	Rs. 76,33,920
Professional fee paid	Rs. 12, 97,459
Preliminary expenses paid to lawyers and accountants	Rs. 3, 61, 073
Total expenditure involved	Rs. 92, 92, 452

3. Thus, the expenditure under the above head consists of mainly Rs. 76.33 lakh towards fee for ROC and other professional fees paid. According to the querist, the ROC fee is variable and would have been much less if the company had proposed for a lesser authorized capital. The amount was classified under 'Preliminary Expenses' and shown under 'Current Assets'.

4. The querist has stated that considering the nature of expenditure, the company decided to amortise the preliminary expenses over five years and show the unamortised expenses of Rs. 74.33 lakh under 'Current Assets'. An amount of Rs. 18.58 lakh was charged off (being one fifth) in the first accounts of the company during the financial year 2015-16. The reasons considered by the company for amortising the expenses are quoted below:

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[1] Opinion finalised by the Committee on 23.8.2017.

"The expenditure of Rs. 92.92 lakh consists mainly of fee paid to Ministry of Corporate Affairs. It is classified under 'other current assets' and not under 'Intangible Assets'. This huge expenditure would not have been incurred, had the company not issued shares with authorised capital of Rs. 100 crore. Hence, the expenditure was solely incurred in connection with issue of shares. It is also noted that under paragraph 8.7.4 in Guidance Note issued in December 2011 on the revised Schedule VI, it was suggested that there is no dispute on the treatment of share issue expenses as 'Other Current Assets' to be amortised over 5 years".

5. While conducting supplementary audit under section 143(6)(b) of the Companies Act, 2013, the government auditors from Comptroller & Auditor General of India (C&AG) opined that the above mentioned expenditure is in the nature of preliminary expenses and should be charged off in the same year of incidence.

The preliminary comments of the Accountant General are quoted below:

"The head includes preliminary expenses of Rs. 74, 33,962 being the expenses incurred prior to incorporation for the purpose of formation of the company. As per Accounting Standard (AS) 26, 'Intangible Assets' (under paragraph 56), 'preliminary expenses incurred in establishing a legal entity such as legal and secretarial cost, expenses to open a new facility or business' needs to be recognised as an expense when it is incurred. Omission to write off the preliminary expenses incurred prior to incorporation for the purpose of formation of the company resulted in overstatement of the head by Rs. 74,33,962."

6. The company contested the audit suggestion on the following grounds:

"The expenditure of Rs. 74.34 Lakhs (unamortized portion) consists mainly of fee paid to Ministry of Corporate Affairs. It is classified under other current assets and not under intangible assets. Hence, guidelines quoted by Government auditors under AS 26 are not applicable for this asset. This huge expenditure would not have been incurred, had the company not issued shares with authorised capital of Rs. 100 Crore. The expenditure was solely incurred in connection with issue of shares.

> As per paragraph 8.7.4 of the Guidance Note on Revised Schedule VI to the Companies Act, 1956[2], issued by the Institute of Chartered Accountants of India (ICAI), "share issue expenses, discount on shares, ancillary costs-discount-premium on borrowing, etc., being special nature items are excluded from the scope of AS 26 Intangible Assets (Para 5). Keeping this in view, certain companies have taken a view that it is an acceptable practice to amortize these expenses over the period of benefit, i.e., normally 3 to 5 years. The Revised Schedule VI does not deal with any accounting treatment and the same continues to be governed by the respective Accounting Standards/practices. Further, the Revised Schedule VI is clear that additional line items can be added on the face or in the notes. Keeping this in view, entity can disclose the unamortized portion of such expenses as "Unamortized expenses", under the head "other current/ non-current assets", depending on whether the amount will be amortized in the next 12 months or thereafter".

Accordingly, the company has amortised one fifth of the preliminary expenses in the first year and shown the balance unamortised amount under 'Other current Assets' in the balance sheet.

7. In response to the above views of the company, the government auditors opined that the fee paid is not in the nature of share issue expenses and can only be termed as preliminary expenses. Their further opinion on the issue was made on the following grounds:

> "However, as per the Guidance Note on Terms Used in Financial Statements[3], issued by the Institute of Chartered Accountants of India (ICAI), share issue expenses means "Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares". Therefore, fee paid for authorised share capital is not covered in the definition of 'share issue expenses'. Further, as the shares can be issued only after

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[2] Consequent to promulgation of new Companies Act, viz., the Companies Act, 2013, this Guidance Note was revised.

[3] Subsequently, on issuance of the 'Glossary of Terms used in Financial Statements' by the Research Committee of the ICAI on July 1, 2019, the Guidance Note on Terms Used in Financial Statements was withdrawn.

incorporation of the company, the Memorandum of Association fees on authorized share capital incurred in connection with the incorporation of the company are not in the nature of share issue expenses but pre-operative costs incurred for establishing the legal entity.

Therefore, the entire amount of preliminary expenses of Rs. 92.92 lakh incurred should have been fully recognised as an expense in the statement of profit and loss". (Emphasis supplied by the querist.)

8. The opinion of the government auditors is not acceptable to the company on the grounds quoted below:

"The preliminary expenditure under question includes mainly fees paid to Ministry of Corporate Affairs. AS 26 applicable to intangible assets is not applicable in the instant case, as the expenditure has been treated as share issue expenses, and hence classified as current assets to be amortised over a period of 5 years as stated under the paragraph 8.7.4 of Guidance Note on Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI), issued in December 2011. It is also noted that there is no dispute on the treatment of share issue expenses as 'Other Current Assets' to be amortised over 5 years, but the moot point is only whether the higher ROC fees for authorized capital (during the initial setting up itself) can be classified as share issue expenses. In this regard the government auditor had quoted the Guidance Note on Terms Used in Financial Statements, issued by the ICAI (1983), Share Issue Expenses means "Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage and also expenses in connection with the issue of prospectus and allotment of shares". Therefore, auditor quoted that the fee paid for Authorized Share Capital is not covered in the definition of 'Share Issue Expense'.

It is clarified that the Guidance Note, which is non-mandatory is only clarifcatory. Further, it uses the term "includes" which indicates that the definition given is not necessarily comprehensive. As regards the contention that it is a necessary expense for incorporation and therefore, part of preliminary expenses, it is clarified that such necessary expenses should be fixed and immutable and not such expenses which vary as per a scale. For instance, the company could have served its objects with a lower capital requiring lower MOA fee as per regulatory requirements, but chose to pay higher fees for higher authorised share capital with a view to capture higher credibility to its operations in the minds of probable investors to the 'Infrastructure Fund' proposed to be set up by the company. Therefore, such expenses display a greater nexus to the 'share issue' rather than mandatory incorporation expenses, in our opinion.

The following submissions are also made. While releasing the above terms in 1983, the ICAI preface contained, inter alia, the following statements:

> "The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. As such it does not purport to provide a comprehensive or rigid dictionary."

Thus the definition was provided as guidance 33 years back and not purported to provide a comprehensive dictionary. Further, the operations of the Ministry of Corporate Affairs have taken complete changes during last decades and the accounting also involves various changes with reference to various new types of fees levied and expenses involved.

It is also submitted that the ICAI, while releasing the above terms, also stated, inter alia, as follows:

> "Over a period of time, many of the terms included in the guidance note may become obsolete; connotation of many others may undergo considerable change".

Hence, it is submitted that the above expenditure cannot be treated as intangible asset.

It is also pointed out that the Guidance Note issued in 1983 was in the context of both preliminary expenses and share issue expenses being amortised over more than one accounting period and therefore the distinction was not overly significant. However in the context of changes brought by AS 26 issued in 2002, the connotations have indeed changed, as reflected in the Guidance Note.

Further, with reference to the second part of the comment, suggesting that the fees paid to the Ministry are of the nature of pre-operative cost, it is submitted that the relevant expenses are related to the value of shares and vary accordingly. It cannot be termed as pre-operative expense. For establishing a legal entity, much lesser expenses would have been sufficient. Taking into consideration various aspects, the company decided to classify the expenditure as other current assets and amortise over a period of five years.”

B. Query

9. Under this background, the company has sought the opinion of the Expert Advisory Committee of the ICAI as to whether under the given circumstances, the company can amortise the expenses, mainly relating to fee paid to the Ministry of Corporate Affairs and incidental legal fee, professional fee etc. paid at the time of formation.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to whether the company can amortise the expenses, mainly relating to fee paid to the Ministry of Corporate Affairs and incidental legal fee, professional fee etc. paid in connection with authorized capital at the time of formation of the company. Accordingly, the Committee has examined only this issue and has not examined any other issue arising from the Facts of the Case, such as, accounting for expenses incurred on allotment and other share issue expenses, etc. Further, the opinion of the Committee expressed, hereinafter, is only from accounting point of view and not from legal viewpoint. The Committee also wishes to point out that since financial year 2015-16 has been referred to by the querist in the extant case, the opinion expressed hereinafter, is in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs).

11. The Committee has first analysed that which expenses can be termed as ‘share issue expenses’. In this respect, the Committee notes paragraph 5 of Accounting Standard (AS) 26, ‘Intangible Assets’, notified under the Companies (Accounting Standards) Rules, 2006 (as reproduced in paragraph 4 above), which states that this Standard does not apply to accounting for share issue expenses. The term ‘share issue expenses’, however, has not been defined in AS 26. The Committee further notes that the term has been defined in the Guidance Note on Terms Used in Financial Statements which provides as under:

> “Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses,

> printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares."

From the above, the Committee notes that although this definition is an inclusive definition but it specifically states that share issue expenses are costs incurred in connection with the issue and allotment of shares.

12. The Committee notes that the querist has argued that the expenditure of Rs. 92.92 lakh mainly includes Rs. 76.33 lakh towards fee for ROC and other professional fees paid and the ROC fees being variable, would have been much less if the company had proposed for a lesser authorized capital. Hence, the expenditure was solely incurred in connection with issue of shares.

The Committee is of the view that registration of authorised share capital is a necessary step to set a limit for the paid up capital of a company at any given point of time and cannot be termed as 'share issue expense'. Issuance of shares is a separate independent process subsequent to the registration of authorised capital and the same can be done at a later stage as well.

13. As regards accounting for the expenses incurred on ROC Fees, Professional fees and preliminary expenses paid to lawyers, the Committee notes the following paragraphs of AS 26:

> *"6.2 An asset is a resource:*
>
> *(a) controlled by an enterprise as a result of past events; and*
>
> *(b) from which future economic benefits are expected to flow to the enterprise."*

> "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) ..."

From the above paragraphs of AS 26, the Committee notes that if expenditure does not result into acquisition of an asset, it should be recognised as an expense as and when incurred. The Committee also notes that the amount spent towards ROC Fees, professional fees and legal expenses paid to lawyers, does not give rise to any resource controlled by the enterprise. In fact, such expenses are in the nature of start-up costs/preliminary expenses, which are only related to incorporation of the company and set a limit for the issued/paid-up capital of the company which does not ensure any flow of funds to the company. Accordingly, it does not meet the definition of an asset (either an intangible or current asset), as reproduced above. Thus, the amount aggregating to Rs. 92.92 lakh incurred towards ROC Fees, professional fees and legal expenses should be recognised as expense in the statement of profit and loss as per the requirements of paragraph 56 of AS 26.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that the expenditure incurred by the company relating to fee paid to the Ministry of Corporate Affairs and incidental legal fee, professional fee etc. paid at the time of formation cannot be considered as share issue expenses and should be treated as expense and charged off in the statement of profit and loss, as discussed in paragraphs 12 and 13 above.

Query No. 17

Subject: Making provision for non-approved cost.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May, 2002 after unbundling of the erstwhile State Electricity Board (SEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP Notification No. 226 dated 31st May, 2005.

2. The company is engaged in the business of electricity distribution in the area of Indore and Ujjain Commissionaire of the State of Madhya Pradesh and is governed by the provisions of the Electricity Act, 2003. The company is responsible for all activities associated with distribution of power within its territory, including management of assets, operation and maintenance of network and supply, technical and financial planning, business development and management of human resources, legal and regulatory affairs etc.

3. The company X is a transmission licensee and as per provisions of the Electricity Act, 2003 and Regulations (Terms & Conditions for Determinations of Tariff) made thereunder, a transmission licensee can charge only such tariff which is approved by the MP Electricity Regulatory Commission (MPERC).

4. Accordingly, company X is regularly raising invoices to the company for the electricity supplied, on monthly basis which contain all approved charges like transmission charges, incentive charges and true up charges etc. Apart from above, company X also included one item 'carrying cost of true up charges', which, as per the querist, is not approved by MPERC in its Tariff order or True-up.

5. Since, the 'carrying cost of true up charges' is not elsewhere approved by MPERC, no provision has been made by the company in its books of account for the same following the directions issued in MPERC Regulations (clause-13). However, the amount of 'carrying cost of true-up charges' is being shown as 'contingent liability' in the books of account of the company.

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[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

6. While conducting audit of annual accounts of the company for the financial year (F.Y.) 2014-15, the government auditor (C&AG auditor) had following observations in this regard:

> "This does not include an amount of Rs.13.58 crore towards the carrying cost levied on true up for the financial year 2011-12 by the company X in transmission bills for the year 2014-15. The monthly bills of company X include transmission charges, incentive charges, true up charges, and carrying cost of true up charges. However, while releasing the payments to the company X, the company has been deducting the carrying cost on true up and no provision was made for the same. As the carrying cost on true up was billed by the company X and there is no evidence that the carrying cost is not payable by the company, a provision for the liability should have been made in the accounts. Non-provision of liability has resulted in understatement of power purchase and transmission charges and understatement of liability by Rs.13.58 crore. Consequently, loss for the year was also understated by Rs.13.58 crore."

7. In response to above, the company submitted the following reply:

> "CAG audit observed that the company did not make any provision of liability towards the *carrying cost amount Rs. 13.58 crore* levied on true up for F.Y. 2011-12 by the company X in transmission charges bills for the year 2014-15.
>
> In this regard, it is stated that the company X is a transmission licensee and as per provisions of the Electricity Act, 2003 and regulations made thereunder, a transmission licensee can charge only tariff approved by the MP Electricity Regulatory Commission. It is submitted that although company X billed Rs. 13.58 crore towards the carrying cost on true up for F.Y. 2011-12, however in the true-up order of F.Y. 2011-12 no amount is approved by the MPERC on account of carrying cost.
>
> Kind attention is drawn towards section 62 of the Electricity Act, 2003:
>
> "62. (1) The Appropriate Commission shall determine the tariff in accordance with provisions of this Act for –
>
> a) supply of electricity by a generating company to a distribution licensee;

b) transmission of electricity;

c) wheeling of electricity;

d) retail sale of electricity.

(2) The Appropriate Commission may require a licensee or a generating company to furnish separate details, as may be specified in respect of generation, transmission and distribution for determination of tariff.

(3) The Appropriate Commission shall not, while determining the tariff under this Act, show undue preference to any consumer of electricity but may differentiate according to the consumer's load factor, power factor, voltage, total consumption of electricity during any specified period or the time at which the supply is required or the geographical position of any area, the nature of supply and the purpose for which the supply is required.

(4) No tariff or part of any tariff may ordinarily be amended more frequently than once in any financial year, except in respect of any changes expressly permitted under the terms of any fuel surcharge formula as may be specified.

(5) The Commission may require a licensee or a generating company to comply with such procedures as may be specified for calculating the expected revenues from the tariff and charges which he or it is permitted to recover.

(6) If any licensee or a generating company recovers a price or charge exceeding the tariff determined under this section, the excess amount shall be recoverable by the person who has paid such price or charge along with interest equivalent to the bank rate without prejudice to any other liability incurred by the licensee.

Further, clause 13 of the Madhya Pradesh Electricity Regulatory Commission (Terms and Conditions for Determination of Transmission Tariff) (Revision-II) Regulations, 2012 provides as under:

"13. Charging of Tariff other than approved

13.1. Any Transmission Licensee found to be charging a Tariff different from the one approved by the Commission from Beneficiaries shall be deemed to have not complied with the directions of the

> Commission and shall be liable to be proceeded against under Section 142 of the Act without prejudice to any other liability becoming due from the licensee under any other provisions of the Act. In case the amount recovered exceeds the amount allowed by the Commission, the excess amount so recovered shall be refunded to the Beneficiaries who have paid such excess charges, along with simple interest for that period equivalent to the State Bank of India's Base Rate as on 1st of April of that year plus 3.50% besides any other penalty that may be imposed by the Commission."

Further kind attention is also drawn towards paragraph 14 of Accounting Standard 29 which provides as under:

> ***"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 recognized."***

Since MPERC has not approved any amount towards the carrying cost, there is no present obligation of the company to pay the same, hence need not required to be account for."

8. The company has also requested C&AG auditor that the company has already shown the amount of 'carrying cost of true up charges' as 'Contingent Liability' in the books of account and after approval of MPERC, the same shall be duly recognized in the books of account of the company. However, the C&AG auditor has not considered the submission of the company.

9. The querist has also separately supplied the following information for the perusal of the Committee:

(a) In India, the electricity sector is regulated by the regulators (i.e. Electricity Regulatory Commission established under Electricity

Act, 2003). The prices of supply of power to consumer as well as conditions of such supply are being decided by the regulator. Regulators allow licensees to charge rates from their consumers based on benchmark costs plus a reasonable mark-up. Components of such costs are interest cost, depreciation, operating and maintenance.

As per the provisions of the Electricity Act, 2003, no licensees are allowed to charge prices other than approved by the Regulatory Commission. In this regulatory framework, there are two stages of the approval by the regulators.

At the first stage, before commencement of each year, every licensee is required to file the tariff petition namely, 'Aggregate Revenue Requirement (ARR)' in accordance with the provisions of the regulation prescribed by the regulator in this regard, comprising projected revenue and cost. Based on this tariff petition regulatory commission approves the cost and determines tariff.

In the second stage, after completion of the financial year, based on the audited accounts licensee is again required to file a petition namely, 'True up petition'. The truing up exercise is meant to fill the gap between the actual expenses at the end of the year and the anticipated expenses at the beginning of the year. Based on this true-up petition and considering the provision of the regulation, Commission approves final cost of that year and allows recovery of any unrecovered cost by way of tariff-setting of subsequent year.

In this regulatory framework, it may happen that costs are allowed to be recovered from consumers in the period later than the period in which the costs are actually incurred. Therefore, regulatory commission based on the prevailing circumstances, if deemed fit, apart from cost incurred, may allow recovering the carrying cost also on account of such deferment of recovery of cost.

The carrying cost is allowed based on the financial principle that whenever the recovery of cost is deferred, the financing of the gap in cash flow arranged by the licensee from lenders and/or promoters and/or accruals, has to be paid for by way of carrying cost. In other words, it can be said that the carrying cost represent the interest component to compensate the time value of money for the period between ARR and True-up exercise.

In the present case, the company X has filed the true-up petition for the respective year. However, MPERC has not approved any amount under the head of carrying cost and therefore, the company has not admitted and accounted for the same.

(b) The company has not paid any carrying cost of true up so far. Further, the company has represented the matter before company X (copy of the representations made have been supplied by the querist for the perusal of the Committee).

The company has followed this accounting policy consistently from the financial year 2013-2014, however, neither statutory auditor nor C&AG auditor has objected this treatment till F.Y. 2014-15 and the company has duly disclosed the carrying cost as contingent liability.

Company X has not taken any coercive action against the company for recovery of carrying cost.

(c) The MPERC has never approved any recovery of such carrying cost for any financial year till date and as per provisions of the Electricity Act, no licensee can charge any tariff other than that approved by MPERC.

(d) As per provisions of the clause 1.30 (Detail to be furnished and fees payable by licensee or generating company for determination of tariff and manner of making application) of MPERC Regulations, 2004 and its amendment, any tariff comes in effect only after expiry of seven days from the publication of public notice of tariff order in two newspapers. Therefore, tariff order of MPREC applies prospectively.

B. Query

10. In the light of the above facts, the querist has requested the Expert Advisory Committee to provide the opinion that whether the company is required to make provision towards the 'carrying cost of true up charges' as billed by company X even if the same is not approved by MPERC as required by Electricity Act, 2003.

C. Points considered by the Committee

11. The Committee notes that the basic issues raised by the querist relate to whether the company is required to make a provision towards the 'carrying cost of true up charges' as billed by company X even if the same is not approved by MPERC, as required by Electricity Act, 2003. 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 in the books of account of company X, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of the terms of the MPERC Regulations or Electricity Act, 2003, etc. The Committee also wishes to point out that since the query pertains to financial year 2014-15, the opinion expressed hereinafter is in the context of Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Accounting Standards) Rules, 2015.

12. With regard to issue raised, the Committee notes the following paragraphs from Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006:

> ***"10.1 A <u>provision</u> is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***10.2 A <u>liability</u> is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***
>
> ***10.3 An <u>obligating event</u> is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.***
>
> ***10.4 A <u>contingent liability</u> is:***
>
> > ***(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or***

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made."

"10.6 <u>Present obligation</u> - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

10.7 <u>Possible obligation</u> - 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)."

"22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68)."

13. The Committee notes from the above that an element of judgement is required to determine whether a liability for carrying cost of true up charges should be provided for in the accounts or treated as a contingent liability and disclosed by way of a note to the accounts. It is for the management of the enterprise to decide and for the auditor to assess, considering the circumstances of each case, whether the said liability warrants recognition of provision or disclosure of contingent liability. The Committee is of the view that while making such judgement, *all* the evidences available as on the balance sheet date, including for example, opinion of an expert on the possibility and extent of outcome of the decision of the appropriate authority, experience of the company or other enterprises in similar cases, decisions of appropriate authorities, etc. should be considered. The Committee is also of the view that since in the extant case, as per the querist, appropriate authority (MPERC) has never approved the recovery towards carrying cost of true up charges till date, this in itself, indicates that there is no sufficient clarity as to whether a present obligation exists which may require recognition of a provision. However, the Committee is of the view that whether or not a present obligation exists for the carrying cost of true up charges and accordingly, whether the company may be required to create a provision or not does not merely depend on whether the regulator has already allowed/approved the recovery of carrying cost or not in the past; rather it depends on whether based on all the evidences available in the facts and circumstances of the company (as discussed above) as on the

balance sheet date, there exists an obligation which can be considered probable (i.e., more likely than not) arising from a past event. Further, for recognising a provision, other conditions as per paragraph 14 of AS 29 should also be fulfilled, viz., it is probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of such obligation.

14. The Committee is further of the view that based on certain facts available with us such as, non approval of carrying cost of true up charges till date, no order has been issued by MPERC in the past approving/allowing the recovery of such carrying cost, no explicit statement in the Act indicating whether such charges would be approved or not in future, no legal action initiated by Company X for non payment of carrying cost of true up charges by the Company, it appears that there is no present obligation or a probable obligation that an outflow of resources embodying economic benefits will be required to settle the obligation towards the carrying cost of true up charges at the balance sheet date. Accordingly, the company should not make a provision; rather in this situation, the company should disclose the same as a contingent liability, with relevant disclosures in this regard as per AS 29, until any further contrary facts emerge which indicates that a present or probable obligation towards carrying cost of true up charges exists at the balance sheet date.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the company should, based on all the available evidences in its own facts and circumstances, assess whether there is a present obligation or a possible obligation towards the carrying cost of true up charges. However, on the basis of certain facts and circumstances presently known and as discussed in paragraph 14 above, the company should disclose the same as a contingent liability, with relevant disclosures in this regard as per AS 29, until the possibility of an outflow of resources embodying economic benefits is remote and unless any further contrary facts emerge which indicates that a present or probable obligation towards carrying cost of true up charges exists at the balance sheet date.

Query No. 18

Subject: Accounting treatment of capital work-in-progress (CWIP) held on behalf of Government of India (GoI) and funds received from the GoI.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') was incorporated on 18th July, 2014 under the Companies Act, 2013 as a public sector undertaking (PSU) fully owned by the Government of India (GoI) under the administrative Ministry of Road Transport & Highways (MoRTH) with authorised capital of Rs.10 crore. It has started functioning in September 2014 with the objective to develop national highways (NH) and other infrastructure at fast pace in the North East and strategic areas of the country sharing international borders. The company has been entrusted the task of developing and improving road connectivity in length of 10,000 km including the international trade corridor in the North Eastern region of India on behalf of the GoI. The company has formulated a vision to become an instrument for creation and management of infrastructure of the highest standard while contributing significantly towards nation building. Being a professional company, its mission is to design and develop infrastructure projects in a time bound, most efficient and transparent manner with maximum benefits to all the stakeholders. The company has adopted a business model that relies on outsourcing of a number of activities including design, construction and supervision of national highways, rather than undertaking all such activities through its own employees. This has thus helped the company in maintaining a lean organisational structure to facilitate faster operational decision-making. Within a short period, the company has set up its corporate office and twelve offices in Assam, Arunanchal Pradesh, Jammu and Kashmir, Manipur, Nagaland, Tripura, Uttarakhand, Mizoram, Meghalaya, Sikkim, A & N Islands and Nepal for monitoring and supervising the NH projects entrusted to it.

2. The querist has stated that infrastructure is an important component in the development of any economy, more so, in case of India because of its demographic profile. Infrastructure projects have large capital requirements and also long gestation periods. A typical highways project has a construction period of two-three years, during which it does not generate any cash flows.

[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

3. The querist has further stated that the Government of India (GoI) through Notification entrusted the company the job of construction and development of the highways and other infrastructure projects. The ownership of land acquired for the same remains vest with the GoI. Presently, the company is executing the national highways and other infrastructure projects on behalf of the Government of India (GoI) out of the funds provided by MoRTH and entitled to receive agency commission as per the defined rate on the expenditure incurred. The national highways stretches entrusted to the company are at different stages of planning and development and are likely to be completed in next couple of years.

4. According to the querist, since the company has been incorporated only in mid 2014, it started its activities of the project effectively from the financial year 2015-16 as per the financial model adopted. The financial model includes that all the funds for the execution of the roads and infrastructure projects are being financed by the Government of India on the basis of yearly budget allocations and released to the company on yearly basis. The company, out of the funds received from the GoI for the project execution, regularly spends the amount and has been generating asset as defined by the MoRTH. Accordingly, upto 31.03.2016, Rs. 2819 crore have been released to the company by the GoI and capital work-in-progress (CWIP) of Rs. 1579 crore has been generated.

5. Therefore, the major activities of the company are to build the roads and infrastructure on behalf of the GoI. Other than that, the company has to incur the establishment expenditure towards payment of salary, rent and other establishment expenses, which are nominal in nature, and are being paid out of the agency commission being received against project executions and some interest income.

6. The querist has stated that considering the above financial model and activities of the company, it may be appreciated that a prudent and accepted accounting policy and disclosure procedures are required for accounting for work-in-progress generated and cumulative fund received from the MoRTH in the books of account. Since the financial impact of these activities are substantial in nature as compared to the other activities of the company, these two financial heads require a proper disclosure in the final accounts and financial statement of the company. So far as the accounting standards of the Institute of Chartered Accountants of India (ICAI) are concerned, there is no such clarity to disclose these items in the financial statements. If these

two heads are not depicted in the financial statement considering that the company is not the owner of the work-in-progress and funds, then it may not be justified in respect to the transparency and true & fair view of balance sheet. The querist has separately provided a copy of specimen contract made entered in with third parties wherein the contract is entered in the name of "The President of India through the Ministry of Road Transport & Highways, Government of India".

B. Query

7. Therefore, the querist has requested the Expert Advisory Committee of the ICAI to advise the company, the report policy to be adopted to disclose the following heads in the books of account:

(i) Work-in-progress generated out of the funds provided by the GOI and corresponding work-in-progress generated on behalf of the GOI.

(ii) Cumulative amount of funds released to the company by the MoRTH for project as per the yearly budgetary allocation.

C. Points considered by the Committee

8. The Committee notes that the basic issues raised by the querist relate to accounting treatment of work-in-progress generated out of the funds provided by the GOI and generated on behalf of the GoI and accounting treatment of the amount of funds released to company by the MoRTH (GoI) for project as per the yearly budgetary allocation in the books of account of the company. Therefore, the Committee has considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, accounting for agency commission received by the company and any expenditure incurred by the company out of such commission, etc. Further, the opinion expressed, hereinafter, is purely from accounting perspective and not from any legal perspective. At the outset, the Committee wishes to point out that since the querist has referred to financial year 2015-16 in the Facts of the Case, the opinion expressed hereinafter is from the perspective of the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not from the perspective of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

9. At the outset, the Committee notes from the Facts of the Case that the Government of India (GoI) through Notification entrusted the company

the job of construction and development of the highways and other infrastructure projects, but the ownership of land acquired for the same remains vested with the GoI only. Further, the company is executing the national highways and other infrastructure projects on behalf of Government of India (GoI) and all the funds for execution of these projects are being financed by the GoI on the basis of yearly budget allocations. Moreover, the company is only entitled to receive agency commission as per the defined rate on the expenditure incurred. Hence, the Committee is of the view that it would not be incorrect to consider the company as an agent of the Government of India for execution of the said project and not a contractor for construction of the project. The Committee also notes paragraph 4 of AS 7, notified under the 'Rules', which states that "for the purposes of this Standard, construction contracts include, contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;", therefore, on the basis of facts available with the Committee such as agency commission being paid, the contract with the third parties are made in name of the Government of India, it is evident that the principles of AS 7 are applicable to the extent of revenue earned by the company for such arrangements viz. agency commission in the extant case.

10. With regard to the issue raised, the Committee notes the term 'asset' as defined in paragraph 49(a) of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India as follows:

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

From the above, the Committee is of the view that so far as the company is concerned, the project assets do not meet the definition of 'asset'. This is because the future economic benefits from the project assets are not expected to flow to the company as it is specifically mentioned by the querist that the company is not the owner of the work-in-progress and the funds received from the GoI. The project assets are not even funded by the company; rather these are funded by the GoI. Accordingly, the project assets or work-in-progress during the project execution should not be recognised by the company in its books of account.

11. As regards the issue raised by the querist relating to the accounting treatment of funds received by the company from the MoRTH (GoI), the

Committee is of the view that these funds are received by the company not for its own activities; rather for execution of the project on behalf of the GoI and therefore, these are of the nature of 'asset held in trust'. Accordingly, the asset and liability in respect thereof should be recognised in the books of account of the company. As and when the expenditure is incurred, the 'asset held in trust' should be credited with corresponding debit to the related liability. Further, considering the nature of company's role in the extant case, the company may, if it so desires, disclose in the notes forming part of accounts, project assets/capital work-in-progress and project liabilities with an appropriate disclosure of their nature.

D. Opinion

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

(i) The work in progress generated out of the fund provided by MoRTH (GOI) and corresponding work in progress generated on behalf of GOI should not be recognised in the books of account of the company, as discussed in paragraph 10 above. However, considering the nature of company's role in the extant case, the company may, if it so desires, disclose in the notes forming part of accounts, project assets/capital work-in-progress with an appropriate disclosure of their nature.

(ii) As regards the cumulative amount of funds released to the company by MoRTH (GoI) for project as per the yearly budgetary allocation, the Committee is of the view that these funds are received by the company not for its own activities; rather for execution of the project on behalf of the GoI and therefore, these are of the nature of 'asset held in trust'. Accordingly, the asset and liability in respect thereof should be recognised in the books of account of the company. As and when the expenditure is incurred, the 'asset held in trust' should be credited with corresponding debit to the related liability, as discussed in paragraph 11 above.

Query No. 19

Subject: Accounting treatment of amount invested in LIC's leave encashment plan for meeting the company's leave encashment liability.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company'), as per terms and conditions of employment, has a long term compensated absence scheme under which employees are entitled to certain quantum of paid annual leave (AL) and paid half pay leave (HPL), every year, while in service. They can also encash the AL (subject to certain limits) while in service and can encash AL and HPL on resignation / retirement (subject to certain conditions and limits).

2. As per the querist, the above being a defined benefit scheme, the company in line with the requirements of the Accounting Standard (AS) 15 and Indian Accounting Standard (Ind AS) 19, 'Employee Benefits' with effect from the financial year (F.Y.) 2016-17, has been accounting for the liability based on actuarial valuation. The scheme is an unfunded scheme and the amount of liability is retained in the company's books.

3. As a part of good corporate governance, the company has, during the F.Y. 2015-16, decided to segregate the amount required to meet the above liability from the company's common pool of funds and deposit the amount representing the liability in a separate identifiable and dedicated asset.

4. Accordingly, the company has, during F.Y. 2015-16 deposited the amount of Rs. 241.06 crore (representing an amount of liability on 31st March, 2015) in New Group Leave Encashment Plan of the Life Insurance Corporation of India (LIC). Also, an amount equivalent to incremental liability will be deposited in the above scheme each year. A copy of the scheme has been supplied by the querist for the perusal of the Committee. The querist has separately informed that no separate trust is created to administer/manage the funds maintained in respect of amount invested in LIC's new group leave encashment plan for meeting company's leave encashment liability.

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[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

Accounting treatment of the amount deposited with the LIC and interest earned thereon

5. As informed by the querist, the company has deposited the amount equivalent to the leave encashment liability with the LIC. The amount deposited with the LIC has been grouped under non-current investment in the financial statements and the corresponding liability towards leave encashment is grouped under long-term/short-term provisions (as applicable).

6. The interest earned on the investment has been credited to incremental expense to be booked against leave encashment liability and hence, netted off under employee benefit expenses.

7. The reason for the above classification / accounting treatment is explained below:

Reason for retention of leave encashment liability in the books of account:

As per paragraph 55 of Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005), ***"The amount recognised as a defined benefit liability should be the net total of the following amounts:***

> ***(a)*** ***the present value of the defined benefit obligation at the balance sheet date;***
>
> ***(b)*** ***minus any past service cost not yet recognised;***
>
> ***(c)*** ***minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly."***

Thus, the company should recognise present value of the obligation in respect of leave encashment liability at the balance sheet date and this value can be reduced to the extent of fair value of a plan asset (if any). Accordingly, as per provisions of AS 15 (revised 2005), the company would be able to adjust the leave encashment liability against the investment made to meet the liability, only if the instrument in which the amount is invested qualifies as a plan asset which is defined as follows in AS 15:

> ***"<u>Plan assets</u> comprise:***
>
> ***(a)*** ***assets held by a long-term employee benefit fund; and***
>
> ***(b)*** ***qualifying insurance policies."***

As the company has invested the amount in an insurance policy, the test of whether the investment made by the company qualifies as a plan asset would be whether the policy taken is a qualifying policy. As per AS 15 (Revised), a qualifying insurance policy would be required to meet the following conditions:

- can be used only to pay or fund employee benefits under a defined benefit plan; and
- are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:
  - (i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or
  - (ii) the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.

In the extant case, the policy taken by the company does not satisfy the above conditions due to incorporation of the following clauses in the policy:

- The Grantees and the Corporation reserves the right to terminate the scheme by giving three months notice to either party. In that event, the Life Cover Benefit under this Policy shall terminate forthwith and the benefit available under this policy shall be as per Schedule IV. (Clause 17 of General Conditions)
- The Policy can be surrendered by the Grantees at any time by giving an advance notice of three months. (Point 8 of Schedule IV to the Policy)

Therefore, as the condition for plan asset as specified in AS 15 (revised) is not met by LIC's New Group Leave Encashment Plan, the company has treated the investment as a non-plan asset and accordingly, not reduced the fair value of the investment from the present value of obligation in respect of leave encashment liability as on 31st March, 2016.

Reason for adjustment of interest earned out of investment against incremental leave encashment liability instead of showing it as interest income:

As per paragraph 61 of AS 15 (revised 2005), an enterprise while arriving at the amount to be recognised in the statement of profit and loss can reduce from the current service cost and interest cost, the expected return on any plan assets and on any reimbursement rights.

As per paragraph 103 of AS 15 (revised 2005), in the statement of profit and loss, the expense relating to a defined benefit plan may be presented *net of the amount recognised for a reimbursement* (emphasis supplied by the querist). Since interest earned by the company every year on the investment is credited to Policy account periodically (Refer Schedule II) and the interest so credited is adjusted against the incremental liability each year in order to arrive at the net amount payable to LIC, the interest earned for the year on investment is in nature of reimbursement of the money to the company. In view of this, the interest income earned for the year under the LIC policy is adjusted against the incremental liability (for the year) as determined by the actuary and the net amount is recognised in the statement of profit and loss.

B. Query

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

(i) Whether the company is right in considering the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India towards meeting its leave encashment liability as a Non-Plan investment.

(ii) Whether the company is right in accounting the leave encashment liability in its books and the corresponding amount deposited with LIC under 'Non-current Investment'.

(iii) Whether the company is right in recognising the net amount (i.e., incremental liability for the year as determined by actuary less interest income earned for the year under the LIC Policy) as the leave encashment liability in the statement of profit and loss.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised in the query relate to (i) whether the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India (LIC Policy) towards meeting its leave encashment liability should be considered as a 'qualifying insurance policy/plan asset' and accordingly, whether it should be disclosed as a separate asset or as a deduction from the related leave encashment liability

in the financial statements and (ii) whether the expense recognized in the statement of profit and loss (referred to as 'incremental liability' by the querist) in respect of leave encashment liability for the current year as per the requirements of AS 15 should be recognized net of interest income earned for the year on such LIC Policy. Accordingly, the Committee, while answering the query, has considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, measurement of employee benefit obligations/liability and the investments (LIC Policy) made in relation thereto, accounting for any other employee benefit other than leave encashment liability, nature and type of the employee benefits and benefit plans as per the requirements of AS 15, viz., short term/long-term/other long-term employee benefits and the defined contribution or defined benefit plans etc. The Committee also wishes to point out that although at one place, the querist has made a reference of Ind AS 19, but since throughout the facts of the case, the querist has referred to the requirements of AS 15 (revised) and the financial year being referred to in the extant case is financial year 2015-16, the Committee has expressed its opinion in the context of accounting standards notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and not Ind ASs.

10. At the outset, the Committee wishes to clarify that leave encashment is not a post- employment benefit plan; rather it will be other short-term employee benefits or other long-term employee benefits depending on the terms and condition. The Committee further notes that the company has taken a comprehensive LIC policy in respect of life cover benefit and leave encashment benefit for its employees, some of the significant features of which are as follows:

General Conditions

"10 As soon as a Member or a beneficiary becomes entitled to receive the benefits under the scheme, the Grantees shall send the relevant particulars to the Corporation whereupon the Corporation shall pay to the Grantees appropriate benefits."

"13 Notwithstanding anything herein contained to the contrary, the Corporations' liability to the Grantees under this policy shall be limited to the Life Cover Benefit under this plan effected in respect of the Members subject to the terms and condition applicable to them and Policy Account Value standing to the credit of the Grantees.

14 The Corporation shall issue the Grantees as the policyholder at the end of each financial year a statement of the Policy Account showing various transactions during the financial year."

"17 The Grantees and the Corporation reserves the right to terminate the scheme by giving three months notice to either party. In that event, the Life Cover Benefit under this Policy shall terminate forthwith and the benefit available under this policy shall be as per Schedule IV."

"20. The LIC's New Group Leave Encashment Cash Accumulation Plan is a Non Participating Variable Insurance Plan and will not participate in the profits of the Corporation."

Schedule – I

16.	Policy Account	Policy Account shall mean the account to be maintained by the Corporation in favour of the Grantees to which will be credited the Contribution (as described in Schedule – II). Leave Encashment Benefits shall be paid out of Policy Account.

Schedule II – Contribution and Management of Policy Account

1. **Contributions:** Such amount as is required to secure the Life Cover Benefit and Leave Encashment Benefits in respect of the members of the scheme. The amount payable towards past service Leave Encashment Benefit may be wholly paid on the date of entry and partly on Annual Renewal Date as specified in the scheme rules and amount payable every year as required to secure the Leave Encashment Benefit relating to the current year service as per AS – 15 (Revised).

…

2. **Management of policy Account:** All the Contributions paid by the Grantees will be credited to the maintained Policy Account.

A single Policy Account shall be maintained in respect of all contributions received from Grantees.

Member's Leave Encashment Benefits shall be paid out of the Policy Account of the scheme on the happening of the events as described in the scheme rules.

3. Interest payable on Policy Account:

The following types of interest rates shall be provided on the Policy Account Value:

(a) Minimum Floor Rate (MFR): MFR is a guaranteed interest rate that Policy Account shall earn during the entire policy term. This plan offers a Minimum Floor Rate (MFR) of 0.5% p.a.

(b) Additional Interest Rate (AIR): In addition to MFR, the Corporation shall also declare a non zero-positive Additional Interest Rate (AIR) at the beginning of every financial quarter on the Policy Account and AIR shall remain guaranteed for that financial quarter. This AIR shall remain guaranteed for that quarter.

(c) Residual Addition (RA): Starting from the fifth policy anniversary, in addition to MFR and AIR, the Corporation may also declare a non zero-positive Residual Addition (RA) on Policy Account at the end each policy year.

…

The interest amount earned by way of MFR and AIR will be credited to the Policy Account at the end of each quarter/at the time of exit. The interest amount earned by way of RA, if any, will be credited to the Policy Account at the end of each policy year starting from policy year 5.

Schedule III - Benefits

6. The benefits payable on various events are as follows:

a. Benefits payable on death of Member before Normal Retirement Age:

On death of a Member whilst in service before Normal Retirement Age, the benefit payable will be equal to the sum of following:

(i) Sum assured

(ii) Leave Encashment Benefit as per the scheme rules.

However, for the Leave Encashment Benefit, the Corporation's liability towards the Policyholder shall be limited to the Policy Account Value remaining in the Policy Account.

b. Benefits payable on retirement/Leaving Service:

On retirement of a Member, the Leave Encashment Benefit shall be payable as specified in the scheme rules. However, the Corporation's liability towards the policyholder shall be limited to the Policy Account Value remaining in the Policy Account.

Schedule IV – Discontinuance of Contributions

8. Surrender: The Policy can be surrendered by the Grantees at any time by giving an advance notice of 3 months. The benefit available on surrender shall be higher of Guaranteed Surrender Value and Special Surrender Value. The policy will terminate on surrender. **The Life Cover Benefit effected in this policy carries no Surrender Value.**

Guaranteed Surrender Value:

The Guaranteed Surrender Value shall be equal to the 90% of the total Contributions (net of Mortality charges and Policy Administration Charges already deducted till date) paid less all the benefits paid since the inception of the policy.

Special Surrender Value:

The Special Surrender Value shall be equal to the policy Account Value on the day of surrender less the applicable surrender charges, less Market Value Adjustment, if any, as mentioned in Para 4(iv) of Schedule II

..."

11. With regard to the first issue raised by the company relating to whether the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India towards meeting its leave encashment

liability can be considered as a 'plan asset', the Committee notes from the facts of the case that the company is not treating the investments as a plan asset. The Committee further notes the following paragraphs of Accounting Standard (AS) 15, 'Employee Benefits', notified under the Rules:

> ***"7.14 Plan assets comprise:***
>
> ***(a) assets held by a long-term employee benefit fund; and***
>
> ***(b) qualifying insurance policies.***
>
> ***7.15 Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:***
>
> ***(a) are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and***
>
> ***(b) are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise's own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:***
>
> ***(i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or***
>
> ***(ii) the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid.***
>
> ***7.16 A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:***
>
> ***(a) can be used only to pay or fund employee benefits under a defined benefit plan; and***
>
> ***(b) are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to***

the reporting enterprise, unless either:

(i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid."

12. From the above, the Committee notes that plan assets comprise assets held by a long-term employee benefit fund and qualifying insurance policies. In the extant case, there is a comprehensive LIC policy covering both life cover benefits and leave encashment benefits, but no separate fund exists solely to pay or fund the leave encashment benefits. The Committee notes that as per the definition of plan assets (assets held by a long-term employee benefit fund and qualifying insurance policy), the assets held by the fund/ proceeds of such insurance policy can be only to pay or fund employee benefits and are not available to the reporting enterprise's own creditors and cannot be paid to the reporting enterprise except in certain circumstances as described in the definition. In this context, the Committee notes from the terms of the LIC policy reproduced in paragraph 11 above that whenever an employee (who is a member or a beneficiary as per the policy) becomes entitled to receive the benefits under the scheme, the company (grantees) shall send the relevant particulars to the insurer (Corporation) whereupon it shall pay to the Grantees appropriate benefits. Thus, apparently, the insurer pays to the company, appropriate benefits on its becoming due to the employee on intimation sent by the company and not only to reimburse the company for employee benefits *already paid* by it. Further, the Policy gives a right to the company to terminate insurance policy at any time and in that case, the insurer would pay a specified amount to the company as per the terms of the Policy. The Committee is of the view that the existence of such a right implies that the company can use the proceeds of the Policy for other than to pay or fund employee benefits under the plan i.e. the company has the ability to use such funds for any other purpose than to pay or fund employee benefits under a defined benefit plan. The Committee further notes the requirements of AS 15 in this regard as follows:

"103. When, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to

settle a defined benefit obligation, an enterprise should recognise its right to reimbursement as a separate asset. The enterprise should measure the asset at fair value. In all other respects, an enterprise should treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.”

“105. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. Paragraph 103 deals with such cases: the enterprise recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability recognised under paragraph 55; in all other respects, including for determination of the fair value, the enterprise treats that asset in the same way as plan assets. Paragraph 120(f)(iii) requires the enterprise to disclose a brief description of the link between the reimbursement right and the related obligation.”

“107. The expected return on plan assets is a component of the expense recognised in the statement of profit and loss. The difference between the expected return on plan assets and the actual return on plan assets is an actuarial gain or loss.”

On the basis of the above, the Committee is of the view that although, the LIC policy is not a plan asset, the same should be recognised as a reimbursement right in the financial statements as a separate asset and not as a deduction in determining the defined benefit liability in respect of leave encashment plan as per the requirements of paragraph 55 of AS 15. Further, for classification and presentation of the said insurance policy, the Committee is of the view that the company should also follow the requirements of Schedule III to the Companies Act, 2013 in this regard.

13. With regard to the issue raised by the querist relating to treatment of interest income on the said insurance policy in the extant case, the Committee notes the following requirements of AS 15:

“61. An enterprise should recognise the net total of the following amounts in the statement of profit and loss, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

(a) ***current service cost (see paragraphs 64-91);***

(b) ***interest cost (see paragraph 82);***

(c) ***the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement rights (see paragraph 103);***

(d) ***actuarial gains and losses (see paragraphs 92-93);***

(e) ***past service cost to the extent that paragraph 94 requires an enterprise to recognise it;***

(f) ***the effect of any curtailments or settlements (see paragraphs 110 and 111); and***

(g) ***the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined under paragraph 55 (if negative) exceeds the amount determined under paragraph 59 (b).”***

“92. Actuarial gains and losses should be recognised immediately in the statement of profit and loss as income or expense (see paragraph 61).

93. Actuarial gains and losses may result from increases or decreases in either the present value of a defined benefit obligation or the fair value of any related plan assets. Causes of actuarial gains and losses include, for example:

(a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;

(b) the effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;

(c) the effect of changes in the discount rate; and

(d) differences between the actual return on plan assets and the expected return on plan assets (see paragraphs 107-109).”

"120. An enterprise should disclose the following information about defined benefit plans:

(a) ***the enterprise's accounting policy for recognising actuarial gains and losses.***

…

(c) ***a reconciliation of opening and closing balances of the present value of the defined benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following:***

- ***(i)*** ***current service cost,***
- ***(ii)*** ***interest cost,***
- ***(iii)*** ***contributions by plan participants,***
- ***(iv)*** ***actuarial gains and losses,***
- ***(v)*** ***foreign currency exchange rate changes on plans measured in a currency different from the enterprise's reporting currency,***
- ***(vi)*** ***benefits paid,***
- ***(vii)*** ***past service cost,***
- ***(viii)*** ***amalgamations,***
- ***(ix)*** ***curtailments, and***
- ***(x)*** ***settlements.***

…

(g) ***the total expense recognised in the statement of profit and loss for each of the following, and the line item(s) of the statement of profit and loss in which they are included:***

- ***(i)*** ***current service cost;***
- ***(ii)*** ***interest cost;***
- ***(iii)*** ***expected return on plan assets;***
- ***(iv)*** ***expected return on any reimbursement right recognised as an asset in accordance with paragraph 103;***

(v) actuarial gains and losses;

(vi) past service cost;

(vii) the effect of any curtailment or settlement; and

(viii) the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined in accordance with paragraph 55 (if negative) exceeds the amount determined in accordance with paragraph 59 (b).

…"

From the above, the Committee notes that the Standard requires that unless otherwise required by any other accounting standard, the company should recognize in the statement of profit and loss, expected return and not actual return on the reimbursement rights and the difference between the actual return and expected return on reimbursement rights as actuarial gains and losses. Thus, the return on reimbursement rights is to be recognized as two separate elements in the statement of profit and loss rather than as a single element.

D. Opinion

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

(i) and (ii) Yes, the company is correct in not considering the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India towards meeting its leave encashment liability as a 'plan asset' as per the requirements of AS 15 discussed in paragraph 12 above. The same should be recognised as a reimbursement right in the financial statements as a separate asset and not as a deduction in determining the defined benefit liability in respect of leave encashment plan as per the requirements of paragraph 55 of AS 15. Further, for classification and presentation of the said LIC policy, the company should also follow the requirements of Schedule III to the Companies Act, 2013 in this regard, as discussed in paragraph 12 above.

(iii) While recognising the amount in respect of leave encashment liability, the company should recognize in the statement of profit and loss, expected return and not actual return on the reimbursement rights (LIC Policy) and the difference between the actual return and expected return on reimbursement rights as actuarial gains and losses as per the requirements of AS 15. Thus, the return on reimbursement rights (LIC Policy) is to be recognized as two separate elements in the statement of profit and loss rather than as a single element, as discussed in paragraph 13 above.

Query No. 20

Subject: Consideration of Capital Reserve, Risk Fund & Reserve for calculation of Net Worth of a Company.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company'), is an ISO 9001:2008 certified Government of India (GoI) enterprise working under Ministry of Micro, Small and Medium Enterprises (MSME). The company is engaged in the business of promotion and development of the micro, small and medium sector industries in India, which is done by way of financial assistance, marketing of their produce, procurement of raw materials, training, and a host of other related activities. Also, in exercise of the powers conferred on the Reserve Bank of India (RBI) by section 45 IA of the Reserve Bank of India Act, 1934, the Company has been granted certificate of registration to commence / carry on the business of non-banking financial institution (NBFC) without accepting public deposits.

2. The Querist has stated that all central public sector enterprises (CPSEs) (holding as well as subsidiaries), without exception, are required to sign Memorandum of Understanding (MoU); while the apex/holding companies will sign MoUs with their administrative Ministries/Departments, the subsidiary companies will sign MoUs with their respective apex/holding companies on the same lines as MoU is signed between a CPSE and Government of India. Those CPSEs who do not stick to

[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

Department of Public Enterprises (DPE) schedule for signing of MoU will have their MoU performance rated as "Poor".

3. The Querist has informed that annual targets of the CPSEs are set at the beginning of the year wherein financial targets (static parameters) and non-financial targets are determined. Financial parameters and targets in MoU are fixed using DPE's definitions as appearing in guidelines issued by DPE. The non-financial targets are specific, measurable, attainable, results-oriented, tangible. One of the parameters in the MoU involves the calculation of net worth for PAT/Net Worth and (earning before interest and tax) EBIT/Average capital employed.

4. The Querist has also informed that evaluation of MoU of the CPSE is done at the end of the year on the basis of actual achievements vis-à-vis the MoU targets by DPE. CPSEs (holding as well as subsidiaries) are required to submit performance evaluation reports on the basis of audited data to DPE, after approval of the board of CPSE and through the administrative Ministries/Departments within the stipulated time period.

The abstract of DPE Guidelines for MoU for the year 2015-16 for Central Public Sector Enterprises as provided by the querist:

5. As per DPE Guideline No. M-03/0012/2014-DPE(MoU) dated 07.10.2014,

> *Net Worth: Net worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation. Reserve for the purpose means Reserves and Surplus.*
>
> *Capital Employed*: *Capital employed shall comprise of net worth and long term borrowings but excluding Capital Work-in-Progress (CWIP) and all investments made. However, deferred tax assets (net) shall not be form part of Capital Employed.*

6. *Company's Views*

(i) Since the activities are for promotion and development of the small and medium sector industries in India, the Central and

State Governments provide grants and subsidies to the company:

(a) For purchasing capital assets to be used in training centers for promotion and development of the small and medium sector industries in India or their respective regions.

(b) To meet revenue expenses for promotion and development of the small and medium sector industries in India or their respective regions.

(ii) The querist has mentioned that in accordance to the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'): which are mandatory to be followed by companies to prepare their financial accounts under section 211 (3C) of Companies Act, 1956/ Section 129 of Companies Act, 2013:

Any amount released by the GoI towards purchase of any fixed assets in the corporation is treated as "Grants of the nature of Promoters' contribution" in terms of provisions of AS 12 on 'Accounting for Government Grants'. This has been stated in the accounting policies at s.no. 14 of the annual accounts, wherein it is mentioned that "the grant to the extent of expenditure incurred is recognised as income in the statement of income and expenditure. In case of capital grant the expenditure incurred is reduced from the recognised income by creating capital reserve". This is appropriately depicted in the balance sheet under 'Shareholders funds'.

AS-12 on 'Accounting for Government Grants' of ICAI stipulates two broad approaches to be followed for accounting treatment for government grants i.e. capital approach and the income approach.

Capital approach inter-alia includes grants in the nature of promoter's contribution whereas income approach inter-alia includes grants related to specific fixed assets nature or revenue nature.

It is pertinent to mention that in both the approaches the grant amount should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the assets. Further, such grants should be allocated to income over the periods and in the proportion in which depreciation on these assets is charged. The net effect of charging depreciation and recognition of grant amount is nil in the profit & loss statement.

It automatically follows that no depreciation is chargeable on such assets to the extent of the subsidy or grant.

It was also pointed that even in accordance to section 43 (1) of the Income Tax Act 1961 (which is reproduced here under for ready reference), enjoins a company to reduce the cost of an asset to the extent of grant or subsidy received from any other person or authority for acquiring such asset, either in full or part.

> "*(1) "actual cost" means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority"*

It automatically follows that no depreciation is chargeable on such assets to the extent of the subsidy or grant.

The Central Board of Direct Taxes, under the specific power granted to it under sub-section (2) of section 145 of the Income Tax Act 1961 has notified the income computational & disclosure standards vide notification no. SO 892(E), dated March 31, 2015.

In accordance to paragraphs 5 to 10 of the Income Computation and Disclosure Standard VII relating to the treatment of government grants and subsidies the grants relating to assets shall be deducted from actual cost of the asset or written down value of the block of assets.

Further where the grants not directly relatable to an asset acquired, then such grant shall be deducted on proportionate basis from the actual cost of the assets.

No depreciation is allowable on such assets to the extent of the subsidy or grant.

Therefore, the company, for the purposes of transparency and safeguarding the assets under its custody, has adopted the following procedure:

Record the acquisition of assets in its books under the classification *“Assets acquired out of government grants”,* on the debit side.

At the same time record the contra credit effect by creating a *“Capital Reserve”*.

However it will be evident from the foregoing that they are not surpluses created out of its earnings. Further, at the same time they are not liabilities payable by the company to third parties. Thus, they cannot be included in the non-current or current liabilities in the balance sheet.

Therefore, the company, in order to balance the value of *“Assets acquired out of government grants”* shown on the assets side has included both these reserves in the balance sheet under the grouping of ‘Reserves & Surplus’.

In this manner the company has complied with the requirements of law and at the same time achieved the objective of keeping a track of the assets acquired out of grants in its financial statements.

It has already been stated herein above that the company acquires capital assets fully out of grants granted by the government and other agencies.

It can be said that the company is holding the assets acquired from grants more in the capacity of a trustee for the purpose for which the grant was given.

(iii) The company is in its ordinary course of business/activities grants financial assistance to MSMEs for their purchase of capital assets and raw materials etc.

It needs no elaboration that any person engaged in grating financial assistance has to invariably face certain delinquencies / bad debts. These are also referred to as Non Performing Assets (NPA).

The prudential norms, for those engaged financing activity requires provision to be created, for delinquencies which is a normal feature.

It is gathered that this is similar to the provisioning required under section 45-IB of the Reserve Bank of India Act by non-banking financial companies.

Accordingly the company has created a 'Risk Fund' in its accounts.

The company faced with the same problem as in the case of assets acquired out of grants, has depicted the 'Risk Fund', which is primarily a provisioning for meeting delinquencies, under the heading of *Reserves & Surplus.*

In these circumstances it can be concluded that the *"Risk Fund",* is in fact a provision to meet anticipated liabilities and is not a free Reserve that can be distributed as profits or dividends.

(iv) *Further, the querist has mentioned that the companies are required to create a Deferred Tax Liability / Asset in accordance to Accounting Standard AS 22.*

The deferred tax liability/asset are deemed as contingent liabilities / assets. The contra effect of the deferred tax liability/asset is given to reserves.

In accordance to the Accounting Standard (AS) 22, while it is obligatory to create the deferred tax liability, it is not so for deferred tax asset. This is due to the accounting principle of prudence that while the contingent liabilities are to be recognised, it is not prudent to recognise a contingent asset.

Since the company had a deferred tax asset –the realisation of which was not probable in the near future.

However the Comptroller and Auditor General of India (CAG) insisted on its creation, despite the fact that there is no certainty of its recovery / realization in the near future.

Therefore, the company had perforce created a deferred tax asset of Rs. 47.65 crores in the year ended on 31-3-2015, and hereby increased its profits to that extent by a contingent profit.

The Income tax Act does not recognize this as anything but of contingent nature.

(v) As per Section 123 of Companies Act, 2013,

- No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation.

- No dividend shall be declared or paid by a company from its reserves other than free reserves.

The above referred reserves (Capital Reserves, Risk Fund and on account of Deferred Tax asset) are not to be considered as free or distributable reserves under the Companies Act. The primary reason for it is that they are not reserves created out of actual profits earned.

It is in this context the definition of Net Worth is given in sub-section 57 of section 2 of the Companies Act 2013 is termed, which is reproduced hereunder for ready reference:

> “(57) "net worth" means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance-sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation”

It will be observed from the above definition that it excludes certain types of reserves which by their nature are those reserves, which are not distributable to the shareholders.

Accordingly, the reserves not belonging to the shareholders as distributable are to be excluded.

7. The querist has referred to the views of the Hon’ble Supreme Court in the case of CIT Vs J H Gotla (1985) 156 ITR 323 on to the matter of interpretation of Statutes. Relevant portion beginning from page 339, is reproduced hereunder for ready reference:

> *“In the case of Varghese v. ITO [1981]131 ITR 597, emphasized that a statutory provision must be so construed, if possible, that absurdity and mischief may be avoided.*
>
> *Where the plain literal interpretation of a statutory provision produces a manifestly unjust result which could never have been intended by the Legislature, the court might modify the language used by the Legislature so as to achieve the intention of the Legislature and produce a rational construction. The task of interpretation of a*

statutory provision is an attempt to discover the intention of the Legislature from the language used. It is necessary to remember that language is at best an imperfect instrument for the expression of human intention. It is well to remember the warning administered by judge Learned Hand that one should not make a fortress out of the dictionary but remember that statutes always have some purpose or object to accomplish and sympathetic and imaginative discovery is the surest guide to their meaning."

If the purpose of a particular provision is easily discernible from the whole scheme of the Act, which in this case is to counteract the effect of the transfer of assets so far as computation of income of the assessee is concerned, then bearing that purpose in mind, we should find out the intention from the language used by the Legislature and if strict literal construction leads to an absurd result, i.e., a result not intended to be sub-served by the object of the legislation found in the manner indicated before, then if another construction is possible apart from strict literal construction, then that construction should be preferred to the strict literal construction. Though equity and taxation are often strangers, attempts should be made that these do not remain always so and if a construction results in equity rather than in injustice, then such construction should be preferred to the literal construction. Furthermore, in the instant case, we are dealing with an artificial liability created for counteracting the effect only of attempts by the assessee to reduce tax liability by transfer. It has also been noted how for various purposes the business from which profit is included or loss is set off is treated in various situations as the assessee's income. The scheme of the Act as worked out has been noted before."

Taking a cue from what principle the Hon'ble Supreme court has held in above case, if the reserves which are not distributable or are reserves *(Capital Reserves*) created to give contra effect to assets acquired from grants and subsidies, which should have been made nil in accounts as per the Companies Act and the income tax act or provisions (Risk Fund) loosely grouped as reserves are to be excluded.

Then only one can arrive at the correct or true net worth.

8. Computation of net worth from capital plus free reserves (reserves after excluding reserves that are not available for distribution as dividends) is

as under, on the basis of the audited balance sheet as on 31st March 2016 of the company is as under:

	PARTICULARS		*Rs in lakhs*
a)	Capital	53,298.80	
b)	Reserves & Surplus	22,608.54	
c)	Total Shareholder funds		75,907.34
	Less Non -distributable reserves		
d)	Capital Reserves	1,414.97	
e)	Risk Fund	1,077.04	
f)	Reserve created for Deferred Tax Assets	5,228.48	7,720.49
g)	Net Worth		68,186.85

Now let us consider the ordinary meaning of net worth which, is the value by which, the value of all owned assets exceed the value of liabilities to outsiders or third parties.

Accordingly, the total of the assets after excluding the miscellaneous expenses and losses (to the extent not written off) and the aggregate of liabilities to outsiders will be the net worth.

Further any assets, which are not realisable, or are held as funds held in trust are to be excluded.

9. Computation of net worth by excluding liabilities to outsiders from assets value is as under, on the basis of the audited balance sheet as on 31st March 2016 of the company is as under:

	PARTICULARS		*Rs in lakhs*
a)	Total assets side of Balance sheet		355,319.37
	Less		
b)	Assets created out of Grants, which were required to be made Nil as per the Companies Act and Income Tax Act but kept on assets side by giving contra effect	1,414.97	
c)	Deferred Tax Assets -which are contingent assets -not realisable in near future	5,228.48	

d)	Reduction in value of advances as financial assistance / Risk fund created under Govt. directions to CPSEs as provisioning for delinquencies	1,077.04	
			7,720.49
f)	Sub- total (a less (b+c+d))		347,598.88
	Less Outside liabilities		
g)	Non Current liabilities	11,523.33	
h)	Current liabilities	267,888.70	279,412.03
i)	Net Worth (f less (g+h)		68,186.85

The above computation of net worth by both methods demonstrate this beyond doubt that the non-free/ non-distributable reserves described herein above have to be excluded for the reasons stated, as it will be observed that by both methods the net worth comes to the same amount.

10. It has been separately confirmed by the querist that the query would be answered only in the context of accounting principles and the Committee will lay down only the accounting principles for determination / computation of net worth and not compute the net worth as such.

B. Query

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

(a) Whether capital reserve, risk fund and reserve made on account of recognising deferred tax asset appearing in the balance sheet of the company are to be considered as a part of its net worth or are to be excluded.

(b) Further what will be the company's net worth on the basis of its latest available audited accounts as of 31st March 2016?

C. Points considered by the Committee

12. The Committee notes from the Facts of the Case that the query is with regard to whether capital reserve, risk fund and reserve made on account of recognising deferred tax asset are to be considered as a part of networth. 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 treatment of grant received, reserves created, creation of deferred tax asset etc. The Committee has also not considered the need and rationale for creation of various reserves as mentioned in the query and whether capital reserve, risk fund and reserve made on account of recognising deferred tax asset can be considered and classified as free reserve or distributable reserve under Companies Act, 2013, etc. The Committee would like to highlight that in the facts of the case many aspects have been referred to such as accounting treatment of grants received from the Government, creation of risk fund, creation of provision for doubtful debts, creation of deferred tax liability/asset etc. which may require separate and detailed examination from compliance point of view. However, since the querist is not seeking opinion on these aspects and sufficient facts are also not available with regard to these aspects, the Committee has not examined that whether comments made by the querist are in conformity with the relevant Accounting Standard(s) or applicable guidelines have been complied with or not. The Committee wishes to point out that the opinion expressed hereinafter is purely from the perspective of accounting principles, viz., Indian GAAP and not from legal perspective, such as, interpretation of the terms of DPE Guidelines or various Court judgments, as referred to by the querist or Companies Act, 2013 or Reserve Bank of India Act, Income Tax Act, etc. Further, the Committee can lay down only the accounting principles for determination of networth and not calculate the net worth as such. The Committee also wishes to point out that net worth may be defined by different authorities/regulators for different purposes and, accordingly, the term defined for one purpose may not be relevant for other purpose.

13. At the outset, the Committee notes the definition of the following terms from the 'Guidance Note on Terms Used in Financial Statements[2]', issued by the Institute of Chartered Accountants of India (ICAI):

> **"11.01 Net Assets**
>
> The excess of the *book value of assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds**."
>
> "**11.08 Net Worth**
>
> See **Net Assets**"

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[2] Subsequently, on issuance of the 'Glossary of Terms used in Financial Statements' by the Research Committee of the ICAI on July 1, 2019, the Guidance Note on Terms Used in Financial Statements was withdrawn.

From the above, the Committee notes that the term, 'net worth' has been defined in terms of net assets which is excess of the book value of assets over liabilities. Thus, it does not exclude any kind of reserve – capital reserve or risk fund or reserve made on account of recognising deferred tax asset. Accordingly, the Committee is of the view that purely from accounting perspective, net worth includes all reserves, whether capital or revenue. However, the Committee wishes to point out that whether a particular item (for example, capital reserve) is to be included or not in net worth would depend on the purpose for which such net worth is being computed, for instance, from the Companies Act, 2013 perspective, some specific reserves are excluded from the definition of net worth. Similarly, for some other specific purposes, the net worth may be defined by specifically considering the purpose for which it is to be used.

D. Opinion

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

(i) Without examining the issue from legal perspective, such as, interpretation of the terms of DPE Guidelines, Companies Act, 2013, Reserve Bank of India Act, Income Tax Act, etc., as discussed in paragraph 12 above, the Committee is of the view that purely from accounting perspective, net worth should include reserves, as discussed in paragraph 13 above.

(ii) As mentioned in paragraph 12 above the Committee can lay down only the accounting principles for determination of networth and not calculate the net worth as such, therefore this cannot be answered by the Committee.

Query No. 21

Subject: Appropriate disclosure of Competent Authority Land Acquisition (CALA) bank account in the company's annual financial statements.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') was incorporated on 18th July 2014, under the Companies Act, 2013 as public sector undertaking (PSU) fully owned by the Government of India (GoI) under the administrative control of the Ministry of Road Transport & Highways (MORTH) with authorised capital of Rs. 10 crore. It has started functioning in September 2014 with the objective to develop national highways (NH) and other infrastructure at fast pace in the North East and strategic areas of the country sharing international borders. The company has been entrusted with the task of developing and improving road connectivity in length of 10,000 km including the international trade corridor in the North Eastern region of India on behalf of the GoI. The company has formulated a vision to become an instrument for creation and management of infrastructure of the highest standard while contributing significantly towards nation building. Being a professional company, its mission is to design and develop infrastructure projects in a time bound, most efficient and transparent manner with maximum benefits to all the stakeholders. The company has adopted a business model that relies on outsourcing of a number of activities including design, construction, supervision of national highways, rather than undertaking all such activities through its own employees. This has thus helped the company in maintaining a lean organisational structure to facilitate faster operational decision-making. Within a short period, the company has set up its corporate office and twelve offices in Assam, Arunanchal Pradesh, Jammu and Kashmir, Manipur, Nagaland, Tripura, Uttarakhand, Mizoram, Meghalaya, Sikkim, A & N Islands and Nepal for monitoring and supervising the NH projects entrusted to it.

2. The querist has stated that infrastructure is an important component in the development of any economy specially for the developing country like India. Infrastructure projects have large capital requirements and also long gestation periods. A typical highway project has a construction period of two-three years.

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[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

3. The querist has further stated that the Government of India (GoI) through Notification entrusted the company the job of construction and development (including widening) of the highways and other infrastructure projects. For widening and for other facilities, GoI acquires land under the NH Act, 1956 in its favour through the company. Revenue Authorities of the concerned state are being appointed as Competent Authorities under section 3(a) of NH Act 1956 as independent authority agency for land acquisition work, commencing from issue of notification regarding intent to do so, to award the compensation, its disbursement to the land owners whose land were acquired and to hand over the possession of land acquired for development to the company.

4. The Land Acquisition (LA) compensation amount is being deposited with Competent Authority-Land Acquisition (CALA) in a specific bank account of CALA and GM (Project) of the company jointly for onward disbursement under section 3H of NH Act for land acquired. The CALA account is being operated by Competent Authority for disbursement of land compensations. The responsibility of the payment of LA compensation amount lies with the CALA alone. GM (P), of the company may only render assistance if any, requested by CALA. The querist has separately confirmed that CALA Account is not in the name of the company; rather is a joint bank account in the name of CALA and the GM (P) of the company and that GM (P) is only a joint signatory. Therefore, in substance, all the decisions for operating this account are taken by CALA only. The querist has also informed that funds required for land acquisition are first transferred by MoRTH to the company and then the same are transferred to CALA Bank Account. In order to acquire land through State Government/Competent Authority, the amount as requested by CALA is being deposited in a separate bank account in the name of CALA in order to disburse the amount by CALA. Therefore, it is a routing account for the company for the purpose of acquiring land and to pay land compensation. With regard to the accounting treatment being followed by the company, the querist has informed that the amount transferred to such CALA account for the land acquisition is presently shown by the company as Deposit-Competent Authority Land Acquisition & Other agencies. The amount utilised by CALA towards compensation is being debited to project in progress account (CWIP held on behalf of GoI) on the basis of utilisation certificates issued by CALA.

5. However, there is also an opinion from audit to show this CALA bank account as 'cash and bank balance' of the company in the balance sheet.

6. According to the querist, the opinion of the company on the subject is as follows:

> Presently as per accounting principles, the bank accounts which have been opened exclusively in the name of the company with the approval of Board of Directors have been shown under the head 'cash and bank balances' as per the format prescribed in Companies Act.
>
> The amount released to CALA bank account, is neither in the name of the company nor at the disposal of the company alone. It is being operated by CALA as independent authority.
>
> The amount of land compensation payable to land owners, as determined under section 3G of NH Act, 1956, awarded by CALA is required to be deposited with CALA in such manner as may be laid down by rules made in this behalf by the concerned State Government before taking the possession of the land. Concerned GM (P) of the company renders the necessary assistance, as requested by CALA. Hence the undisbursed amount with CALA has been shown under the head 'Long-term loans and advances' as Deposit with Competent Authority Land Acquisition and other agencies, so that the company can monitor the disbursement progress of CALA bank account from time to time.
>
> Also, as per Guidelines for transfer of compensation to CALA accounts stated in the Compendium of Land Acquisition Circulars, Provisions and Guidelines of National Highways Authority of India (NHAI) (an autonomous body of Ministry of Road Transport and Highways), "*Amount deposited in the joint account for LA is accounted under "CWIP – Land" and joint account shall not be part of books of account of NHAI".*
>
> Considering the above financial model and activities of the company, it may be appreciated that a prudent and accepted accounting policy and disclosure procedures are required for the CALA bank account in the company's books of account. Since the financial impact of land acquisition compensation amount is substantial in nature as compared to the other activities of the company, this financial head requires a proper disclosure in the final accounts and financial statements of the company.

7. The querist has informed separately that the interest received in CALA accounts is returned to the company by CALA authorities after all disbursements from that account are made. Further, after the disbursal has been made by the company into the CALA account, any unutlised portion at the year end remain in the CALA account. However, at the year end, CALA provides the company the utilisation certificate of the amount utilized from CALA account. The company, on the basis of the utilization certificate, books the entry in the accounts. Any unspent amount in CALA account is returned back to the company after full and final settlements are made by CALA alongwith reconciliation statement. The querist has further informed that any interest / unspent amount in CALA account which is refunded back to the company is payable to MoRTH. The querist has also separately supplied a copy of the circular of Ministry of Road Transport & Highways, GoI containing guidelines for payment of agency charges to the company for various activities (DPR preparation, land acquisition, etc.) undertaken on behalf of the Ministry. It has also been informed that the provisions of Ind AS are not applicable to the company as per its latest audited financials.

B. Query

8. In order to disclose appropriately the CALA bank account in the company's annual financial statements, the querist has requested the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) to give its opinion on:

(i) whether the company should disclose the undisbursed amount lying in CALA account under the head 'Long term Loans and Advances' as 'Deposit-Competent Authority Land Acquisition & Other agencies'; or

(ii) whether to disclose the undisbursed amount lying in the CALA bank account under the head 'cash and bank balance' of the company; or

(iii) Any other manner, which Expert Advisory Committee of the ICAI deems fit under the circumstances explained above.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised by the querist relate to disclosure of undisbursed amount/funds lying in the Competent Authority Land Acquisition (CALA) bank account in the company's annual financial

statements. Therefore, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting for the funds received from the GoI/MoRTH utilised for acquisition of land and for other project related activities, accounting for agency charges, etc. Further, the opinion expressed, hereinafter, is purely from accounting perspective and not from any legal perspective. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is from the perspective of the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not from the perspective of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

10. At the outset, the Committee notes from the Facts of the Case that the Government of India (GoI) through Notification entrusted the company the job of construction and development (including widening) of the highways and other infrastructure projects. For widening and for other facilities, GoI acquires land under the NH Act, 1956 in its favour through the company, i.e., the ownership of land acquired remains vested with the GoI only. Revenue Authorities of the concerned state are being appointed as Competent Authorities u/s 3(a) of NH Act 1956 as independent authority agency for land acquisition work, commencing from issue of notification regarding intent to do so, to award the compensation, its disbursement to the land owners whose land were acquired and to hand over the possession of land acquired for development to the company. In this regard, the Committee also notes the provisions of the Circular of the Ministry containing guidelines for payment of agency charges to the company for various activities (DPR preparation, land acquisition, etc.) undertaken on behalf of the Ministry as follows:

> "5. …agency charges of 1% of the amount payable for Land Acquisition would be paid to the company since it is not provided with any budgetary support for meeting administrative/establishment expenses for supervising the work of land acquisition, shifting of utilities and obtaining all mandatory clearances etc."
>
> 6. In order to link the payment of 1% Agency charges to the company to the final outcome and make it performance linked, the company would be permitted to retain 1% as Agency charges, only on the basis of actual disbursement made to CALA against LA compensation and various other executive agencies for forest clearance, utility shifting etc. subject to the following conditions:

(i) The company shall co-ordinate all land acquisition related activities such as preparation of 3(a), 3A, 3D and 3G Notifications in the gazette.

(ii) The company completes preparation of estimates for land acquisition, forest clearance, utility shifting etc.

(iii) Funds are released to the Competent Authorities for Land Acquisition (CALA) after the approval of 3G notification and other executing agencies for forest clearances, utility shifting etc.

(iv) The company liasoning with CALAs for fast tracking the distribution of compensation to the authentic land owners/beneficiaries with forest authorities for tree cutting and timely shifting of other utilities.

(v) The company taking over the possession of land, so acquired by CALA, and ensure its availability to the contractors before the appointment date for timely start of projects.

(vi) Reconciliation of the funds released to CALA vis-à-vis its disbursement to the beneficiaries is done by the company.

(vii) The company co-ordinates and completes all activities involved in obtaining various statutory and mandatory clearances required for smooth execution of the projects.

The above amount to the company shall be payable from the respective total project cost.

From the above, the Committee notes that the role of the company in the activity of land acquisition is that of an agent of the Ministry/GoI for facilitating the activities related to acquisition of land for which the company is only entitled to receive agency commission.

11. With regard to the issue raised, the Committee notes that the first issue to be examined is whether the item (viz., undisbursed amount/funds lying in the CALA bank account) meets the definition of the term 'asset', as defined in paragraph 49(a) of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India as follows:

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

The Committee notes from the Facts of the Case (refer paragraph 4 above) that the funds disbursed by the Ministry towards land acquisition (LA) compensation amount is being deposited with Competent Authority-Land Acquisition (CALA) in a specific joint bank account of CALA and GM (Project) of the company for onward disbursement for land acquired. The company is not a joint account holder and the company does not have any control over the funds lying in the said account. All decisions for operating the account are taken by CALA only in accordance with the rules of individual State Governments. It is only a routing account to the company for the purpose of acquiring land and to pay land compensation. Further, the interest accrued on deposit balance in the joint bank account will be to the Ministry's benefits and any unused funds will have to be transferred to the Ministry after the land acquisition process is over. Further, since the amount of compensation as awarded/determined by CALA is required to be deposited with the CALA in the joint bank account, apparently, the money lying in such account cannot be used for ordinary business of the company and the company has no right to utilise such money except for land acquisition for the Ministry. From this, the Committee notes that the company does not have any right to use the amount lying in the joint bank account and therefore, no control is exercised by the company on such account. Further, since the balance of funds in the joint account with CALA can be used only for the acquisition of land which will be owned and controlled by the Ministry, no future economic benefits from such funds arise to the company. Accordingly, the Committee is of the view that the funds lying in the joint account is not an 'asset' of the company and therefore, and should not be recognised by the company in its books of account either as 'Deposit- with Competent Authority Land Acquisition and other agencies under 'long term loans and advances' or as 'cash and bank balance'. However, considering the role of the company as an agent/facilitator of the Ministry/GoI for acquisition of land and since the company has also to do reconciliation of the funds released to CALA vis-à-vis its disbursement to the beneficiaries, the Committee is of the view that such funds lying in the bank account may be disclosed in the notes to accounts giving details of nature of funds, the purpose and restrictions imposed and its relationship with the Ministry/GoI.

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 undisbursed amount lying in CALA account should not be disclosed under the head 'Long term Loans and Advances' as 'Deposit-Competent Authority Land Acquisition & Other agencies' as discussed in paragraph 11 above.

(ii) The undisbursed amount lying in the CALA bank account should not be disclosed under the head 'cash and bank balance' of the company as discussed in paragraph 11 above.

(iii) The undisbursed amount lying in CALA account may be disclosed in the notes to accounts giving details of nature of funds, the purpose and restrictions imposed and its relationship with the Ministry/ GoI, as discussed in paragraph 11 above.

Query No. 22

Subject: Whether transport subsidy can be treated as capital receipt.[1]

A. Facts of the Case

1. The querist has stated that the partnership firm (hereinafter referred to as 'firm') is engaged in the business of manufacture of cement in the state of Assam. Being located in the North Eastern Region (NER) the firm is enjoying / availing various subsidies and incentives under the North East Industrial Policy 1997, North East Industrial and Investment Promotion Policy (NEIIPP), 2007, Industrial Policy of Assam 2008 and Industrial and Investment Policy of Assam 2014.

2. The firm has been treating the subsidies and incentives in the nature of *Transport Subsidies* as revenue receipts till the Financial Year 2015-16. However, in the Financial Year 16-17, the concern has treated the incentive *(Transport Subsidy)* as capital receipts by transferring the same to Capital Reserve, relying upon the following case / judgement:

- ✓ Shiv Shakti Flour Mills Pvt. Ltd. V/s. C.I.T. (2017) 390 ITR 346 (Gauhati) holding transport subsidy as capital receipt.

[1] Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

3. The querist has also stated that as per AS 12 ***"Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense."***

B. Query

4. (a) The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) that "Whether the firm can treat the said subsidy (transport subsidy) as capital receipt?"

(b) In case it cannot be treated as capital subsidy, then whether the querist needs to qualify / give observations in their report (Form 3CB) or do they refer to the notes on accounts wherein the management discloses the facts and consequences of the change in the accounting policies.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to whether the transport subsidy received by the firm can be treated as a capital receipt? In case it is not a capital receipt then does the querist need to qualify/give observations in their report (Form 3CB) or refer to the notes to accounts wherein the management discloses the facts and consequences of the change in the accounting policies. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise from the facts of the case. The Committee wishes to point out that its opinion is expressed purely from accounting perspective and not from the perspective of interpretation of court orders etc. Further, the Committee also wishes to point out that since AS 12 has been referred to in the facts of the case, the Committee has expressed its views, hereinafter in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs).

6. With regard to the issue raised, the Committee notes the following extracts of "New Industrial Policy and other concession in the North Eastern Region' 1997" as follows:

Transport Subsidy Scheme:

6. Details of the Scheme

(i) A transport subsidy will be given to industrial unit located in the selected areas in respect of raw materials which are bought into and finished goods which are taken out of such areas.

(iv) *In the case of North-Eastern region comprising the States of Assam, Meghalaya, Nagaland, Manipur, Tripura and the Union Territories of Arunachal Pradesh and Mizoram the transport subsidy will be given on the transport costs between Siliguri and the location of the industrial unit in these States/Union Territories. While calculating the transport costs of raw materials the cost of movement by rail from Siliguri to the railway station nearest to the location of the industrial and thereafter the cost of movement by road to the location of the industrial unit will be taken into account. Similarly, while calculating the transport costs of finished goods the costs of movement by road from the location of industrial unit to the nearest railway station and thereafter the cost of movement by rail to Siliguri will be taken into account. In the case of North-Eastern region, for raw materials moving entirely by road or other mode of transport the transport costs will be limited to the amount which the industrial unit might have paid had the raw materials moved from Siliguri by rail upto railway station nearest to the location of the industrial unit and thereafter by road. Similarly in the case of movement of finished goods moving entirely by road or other mode of transport in the North-Eastern region, the transport costs will be limited to the amount which the industrial unit might have paid had the finished good moved from the location of the industrial units to the nearest railway station by road and thereafter by rail to Siliguri.

(vii) + Freight charges for movement by road/sea will be determined on the basis of transport/transhipment rates fixed by the Central Government/State government/Union Territory Administration concerned from time to time or the actual freight paid, whichever is less.

(viii) £ Costs of loading or unloading and other handling charges such as from railway station to the site of industrial unit will not be taken into account for the purpose of determining transport costs.

(ix) £ All New Industrial units located in the selected areas will be eligible for transport subsidy equivalent to 50 per cent or the transport costs of both raw materials as well as finished goods.

(x) £ Existing industrial units in the selected areas are also eligible for transport subsidy in respect of addition transport costs of raw materials and finished goods arising as result of substantial expansion or diversification effect by them after the commencement of the Scheme. Transport Subsidy in such cases will be restricted to 50 per cent of the transport costs of the addition raw materials required and finished goods produced as a result of the substantial expansion or diversification.

(xi) + Transport subsidy will also cover 50 per cent of the transport charges for movement of steel from Guwahati Stockyard of M/s Hindustan Steel Limited to the site of the industrial unit in the North-Eastern region and for movement of industrial raw materials from the State Corporation's depot situated in the hill districts of Uttar Pradesh to the sites of the industrial units located in the hill districts of the State.

(xii) *£ The State government/Union Territory Administration will set up a committee consisting of the Directors of Industries, a representative each of State Industries Department and the State Finance Department etc. on which a representative of the Ministry of Industrial Development will also be nominated. The committee will operate at the State/Union Territory level and scrutinise and settle all claims of transport subsidy arising in the State/Union Territory. The claimants should be asked to provide proof of raw materials, 'imported' into and finished goods 'exported' out of the selected State/Union Territory/areas where the unit is situated from the registered chartered accountants. The committee may also lay down the production of any other documents which in their opinion is necessary to decide the eligibility of claimant for the transport subsidy. However, in the case of small units with a capital investment of Rs 1 lakh or less the requirement of production of certificate from Chartered

Accountants may be waived subject to the condition that such claims are properly verified by the State government authorities before the subsidy is sanctioned/disbursed. After having scrutinised and settled the claims, the amount disbursed to industrial unit should first be adjusted against the outstanding ways and means of advances made to State government/Union Territory Administration for Centrally Sponsored Scheme in accordance with the procedure outlined in the Ministry of Finance letter No. 2(17) PII/58 dated 12.5.1958 and the balance, if any, shall be paid in cash to the State government/Union Territory Administration.

Provided that in case of small units with a capital investment of Rs 1,00,000 and less, the requirement of production of proof of import of raw material and export of finished products from registered Chartered Accountants will be substituted by an appropriate verification by the State Government authorities.

* Amended vide Notification No. F. 6(26)/71-IC dated 28.2.1974.

\+ Renumbered and amended vide Notification No. 6/3/75-RD dated 19.7.1978.

£ Renumbered vide Notification No. 6/3/75-RD dated 19.7.1978.

*£ Amended vide Notification No. F. 6(26)/71-IC dated 28.2.1974.

7. Also, the Committee notes the following extracts of "North East Industrial and Investment Promotion Policy (NEIIPP), 2007" as follows:

(xiv) Transport Subsidy Scheme

The Transport Subsidy Scheme would continue beyond 31.3.2007, on the same terms and conditions. However, an early evaluation of the scheme will be carried out with a view to introducing necessary safeguards to prevent possible leakages and misuse.

8. Further, the Committee notes the following paragraphs of Accounting Standard (AS) 12, 'Accounting for Government Grants' notified under the Companies (Accounting Standards) Rules, 2006 as follows:

"3.2. Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance

which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise."

"Accounting Treatment of Government Grants

5. Capital Approach versus Income Approach

5.1 Two broad approaches may be followed for the accounting treatment of government grants: the 'capital approach', under which a grant is treated as part of shareholders' funds, and the 'income approach', under which a grant is taken to income over one or more periods.

5.2 Those in support of the 'capital approach' argue as follows:

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

(ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

5.3 Arguments in support of the 'income approach' are as follows:

(i) Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

(ii) As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

(iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates."

"8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation."

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

"13. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received."

"15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds."

9. On the holistic reading of the above paragraphs, the Committee is of the view that in the extant case, the government grant (transport subsidy) received from the Government are for meeting specific expenditure of the firm, and not granted with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (as in the case of grants of the nature of promoters' contribution). Accordingly, the transport subsidy received by the firm, should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

10. The Committee further notes the following paragraphs of SA 705, 'Modifications to the Opinion in the Independent Auditor's Report'[2] and SA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report'[3]:

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[2] Standard on Auditing (SA) 705 has although been revised in May 2016, the revised Standard is effective for audits of financial statements for periods beginning on or after April 1, 2018.

[3] Standard on Auditing (SA) 706 has although been revised in May 2016, the revised Standard is effective for audits of financial statements for periods beginning on or after April 1, 2018.

SA 705:

"Qualified Opinion

7. The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive."

SA 706:

"Emphasis of Matter Paragraphs in the Auditor's Report

6. If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements."

11. From the above, the Committee notes that whether the auditor needs to give qualified opinion or emphasis of matter paragraph in the auditor's report is a matter of judgement which needs to be exercised by the auditor considering various factors such as materiality, etc.

D. Opinion

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

(a) The transport subsidy received by the firm should not be treated as a capital receipt. The same should be treated as revenue and should be recognised on a systematic basis in the profit and loss statements over the period necessary to match them with the related costs which they are intended to compensate. The transport subsidy received by the firm should either be shown separately under 'other income' or deducted in reporting the related expenses.

(b) Further, whether the auditor needs to give qualified opinion or emphasis of matter paragraph in the auditor's report is a matter of judgement which needs to be exercised by the auditor considering various factors such as materiality, etc.

Query No. 23

Subject: Clarification regarding recognition of Deferred Tax Liability in respect of Special Reserve created for the purpose of deduction u/s 36(1)(viii) of the Income Tax Act, 1961.[1]

A. Facts of the Case

1. In order to encourage the Banks to undertake long term funding to specified sectors, Section 36(1)(viii) of the Income Tax Act has facilitated tax exemption to the extent of 20% of profit derived from long term finance to infrastructure, industrial, agriculture and housing development sectors - provided equivalent amount is transferred to special reserve.

Section 36(1) (viii) of the Income Tax Act reads as follows:

> "in respect of any special reserve created and maintained by a specified entity, an amount not exceeding twenty per cent of the profits derived from eligible business computed under the head profits and gains of business or profession (before making any deduction under this clause) carried to such reserve account".

2. The Querist has stated that Accounting Standard (AS) 22, 'Accounting for Taxes on Income' (hereinafter referred as AS 22) envisages recognition of deferred tax assets/deferred tax liabilities for the timing differences. As per the said Standard:

[1] Opinion finalised by the Committee on 4.1.2018.

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

***"Permanent differences** are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently."*

3. The Querist has also stated that section 41(4A) of the Income Tax Act reads as follows:

> "Where a deduction has been allowed in respect of any special reserve created and maintained under clause (viii) of sub-section (1) of section 36, any amount subsequently withdrawn from such special reserve shall be deemed to be the profits and gains of business or profession and accordingly be chargeable to income-tax as the income of the previous year in which such amount is withdrawn".

4. The Querist has informed that Reserve Bank of India (RBI), vide its circular dated 20th December 2013 advised all the banks to recognize deferred tax liability (DTL) on special reserve. The extract of the Circular is as follows:

> "The matter regarding creating of DTL on special reserve has been examined and banks are advised that, as a matter of prudence, DTL should be created on special reserve".

Accordingly, the Bank has recognised the deferred tax liability (DTL) on the outstanding balance of special reserve. The RBI Circular on recognition of DTL has been supplied separately by the querist. .

5. According to the querist, the above presumption of treating the creation of special reserve as timing difference holds good when there is a liberty to withdraw the special reserve. The Reserve Bank of India (RBI) vide circular dated 20th September 2006, has instructed the banks that without prior permission of RBI, no reserve can be withdrawn which includes special reserve also. The RBI circular in this regard has been supplied separately by the querist. The relevant extract of the RBI Circular is as follows:

> "In order to ensure that their recourse to drawing down the Statutory Reserve is done prudently and is not in violation of any of the regulatory prescriptions, banks are advised in their own interest to take prior approval from the Reserve Bank before any appropriation is

made from the statutory reserve or any **other reserves**." (Emphasis supplied by the querist.)

6. The querist informed that as the advances made to specified sectors viz Industrial, Infrastructure, Housing and Agriculture purposes are under stress and banks are required to make huge amount of provisions, the bank had requested RBI for utilisation of special reserve by banks but the request has been turned down. The querist has separately provided a copy of the request made by the bank to RBI and the communication received from the RBI in this regard.

According to the querist, since RBI has denied withdrawal of special reserve and Banks are not allowed to withdraw any reserve without prior permission of the Reserve Bank of India, in terms of Accounting Standard (AS) 22, transfer of special reserve and claiming tax benefit have become 'Permanent Difference'.

B. Query

7. The Querist has requested the Expert Advisory Committee to clarify whether transfer of special reserve could be considered as "permanent difference" in terms of the Accounting Standard 22.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether transfer to special reserve created under section 36(1)(viii) of the Income –tax Act, 1961 could be treated as 'permanent difference' for the purpose of accounting treatment under AS 22 and has not considered any other issue that may arise from the facts of the case. The Committee also wishes to point out that since AS 22 has been referred to in the facts of the case, the Committee has expressed its views, hereinafter in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs) Companies (Indian Accounting Standards) Rules 2015.

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

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

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

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

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

11. The Committee notes that in the period in which special reserve is created, the accounting income remains unaffected as the same is created below the line. However, the taxable income for the same year gets reduced by the amount of the special reserve thus, resulting into lesser tax liability. Thus, a difference arises between the accounting income and the taxable income for that period. The Committee also notes that this difference is ***capable of reversal*** in the period in which the special reserve is utilised or withdrawn as in the year of utilisation or withdrawal, the amount of special reserve would be added to taxable income (Section 41(4A) of the Income-tax Act, 1961) thus, resulting into a higher taxable income than the accounting income of that period (emphasis supplied by the Committee). Therefore, the Committee is of the view that the creation of special reserve results into timing differences as per AS 22. Accordingly, a deferred tax liability is required to be created in this regard.

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

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

13. From the above, the Committee notes that the difference between the accounting income and the taxable income for that period should be recognised as timing difference if it is capable of reversal at any time in future. Thus, deferred tax is to be provided for *all* timing differences. Accordingly, the Committee is of the view that in the present case, as long as the utilisation/withdrawal is *capable* of taking place, the creation of special reserve results into timing differences for which deferred tax liability should be provided.

14. With regard to the arguments advanced by the querist in paragraphs 5 and 6 above, the Committee is of the view that RBI's rejection of the querist's request to utilise the special reserve, does not necessary imply that it is permanent policy.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the transfer to special reserve created and maintained under section 36(1)(viii) of the Income-tax Act, 1961 cannot be considered as 'permanent difference' since the same is capable of reversal resulting into the difference between accounting income and taxable income (i.e., timing difference).

ADVISORY SERVICE RULES OF THE EXPERT ADVISORY COMMITTEE

(*Applicable w.e.f. 1st July, 2017*)

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) Where the queries relate to enterprises whose equity or debt securities are **listed** on a recognised stock exchange:

      (a) enterprises having an annual turnover exceeding Rs. 500 crores based on the annual accounts of the year immediately preceding the date of sending of the query

      Rs. 200,000/- plus taxes (as applicable) per query

      (b) enterprises having an annual turnover of Rs.500 crores or less based on the annual accounts of the year immediately preceding the date of sending of the query

      Rs. 100,000/- plus taxes (as applicable) per query

   (ii) Where the queries relate to enterprises whose equity or debt securities are **not listed** on a recognised stock exchange:

(a) enterprises having an annual turnover exceeding Rs. 500 crores based on the annual accounts of the year immediately preceding the date of sending of the query

Rs. 200,000/- plus taxes (as applicable) per query

(b) enterprises having an annual turnover of Rs.500 crores or less but more than Rs. 100 crores based on the annual accounts of the year immediately preceding the date of sending of the query

Rs. 100,000/- plus taxes (as applicable) per query

(c) enterprises having an annual turnover of Rs.100 crores or less based on the annual accounts of the year immediately preceding the date of sending of the query

Rs. 50,000/- plus taxes (as applicable) per query

The fee is payable in advance to cover the incidental expenses. Payments should be made by crossed Demand Draft or cheque payable at Delhi or New Delhi drawn in favour of the Secretary, The Institute of Chartered Accountants of India or may be made online using the link given below:

https://easypay.axisbank.co.in/easyPay/makePayment?mid=MzUxNDY%3D

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 to the best of his knowledge in respect of the following:

   (i) whether 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;

(iii) whether 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 one copy thereof, duly signed should be sent. The Committee reserves the right to call for more copies of the query. A soft copy of the query should also be sent through E-mail at eac@icai.in

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

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

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

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

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

Notes

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