Part-I

COMPENDIUM OF OPINIONS

Volume XL

(Containing Opinions finalised between February 12, 2020 and July, 2020)

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

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(This part of the fortieth volume contains opinions finalised between February 12, 2020 and July 2020. The opinions finalised upto September 1981 are contained in Volume I. The opinions finalised thereafter upto February 11, 2020 are contained in Volumes II to XXXIX.)

Basic draft of this publication was prepared by CA. Parul Gupta

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Foreword

One of the most important aspects of accounting framework is application of accounting principles consistently and accurately. Financial Reporting Standards are intended to provide accounting principles for ensuring sound and high quality financial reporting. Therefore, these Standards continuously undergo various amendments and updations to accommodate the evolving situations and complexities. At times, few aspects of accounting may require guidance to the professionals and stakeholders. To address this situation, the Expert Advisory Committee was constituted by the Council of the Institute.

Since inception, the Expert Advisory Committee is serving the advisory needs of wide variety of interest groups. The Committee earned a respectable stature for providing independent and objective opinions not only to the members in industry and practice but also to 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.

I congratulate the Expert Advisory Committee for bringing out another volume in the series of Compendium of Opinions, which contains opinions finalised by the Committee during the first half of the current Council Year (from February 2020 to July 2020).

I acknowledge the contribution of CA. Babu Abraham Kallivayalil, Chairman, CA. M.P. Vijay Kumar, Vice-Chairman and all the other members of the Committee who have contributed effortlessly in coming out with this Volume, viz., Volume XL - Part (I) of the Compendium of Opinions.

I hope, the latest issues contained in this Volume will prove to be of enormous assistance to members and professionals while dealing with accounting challenges.

New Delhi
February 8, 2021

CA. Atul Kumar Gupta
President

Preface

With a feeling of gratification, we are presenting to the accounting profession, another splendid volume of the Compendium of Opinions, viz., Fortieth Volume (Part-I). Opinions in this Volume were finalised during the first half of the current Council year 2020-21, from February 2020 to July 2020. This is for the first time, the Expert Advisory Committee (EAC) has published the opinions of the current year covering opinions issued in the first half. We have no doubt that this will help to share the latest information and best practice in the field of accounting especially in the Ind AS scenario. We feel extremely delighted to share that, in spite of pandemic conditions due to COVID 19 this year, we have been able to drastically reduce the time taken in finalising the opinions and cleared all queries received till mid of January 2021.

Opinions on many complex and exceptional issues have been compiled in this Part of the Volume and some of the subjects are as follows:

- Recognition of non-convertible cumulative redeemable preference shares as borrowing.
- Presentation and classification of dues recoverable from banks on account of bank guarantee.
- Disclosure and treatment of Feedstock Subsidy.
- Amortisation of stamp duty and registration charges towards execution of mining lease deeds.
- Non-recognition of deferred tax assets on provision for warranty, inventory, doubtful debts etc.
- Consolidation of financial statements of subsidiaries when operational control does not solely vest with parent company.

The opinions or views expressed by the EAC represent the opinions or views of the Expert Advisory Committee and not the official opinion of the Institute of Chartered Accountant of India (ICAI). We would also like to mention that the opinions are facts-specific and are finalised considering the relevant laws and statutes, and the applicable accounting/auditing principles. The date of finalisation of each opinion is mentioned along with the respective opinion. The opinions must 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.

I would also like to point out that the Committee answers all the queries as per the Advisory Service Rules framed by the Council which are available on the website (https://www.icai.org/post/advisory-service-rules-of-the-expert-advisory-committee) of the Institute and also published in this volume of the Compendium of Opinions.

For easy access, all Volumes of Compendiums released by the Committee are also available on the Digital Learning Hub on the website (https://learning.icai.org/iDH/icai/) of the ICAI.

We are extremely thankful to CA. Atul Kumar Gupta, President, ICAI and CA. Nihar N. Jambusaria Vice-President, ICAI for their direction and guidance in effective functioning of the Committee. I would also like place on record my deep appreciation towards CA. M. P. Vijay Kumar, Vice-Chairman EAC for sparing his valuable time in attending all the meetings of the Committee and for sharing best of his knowledge and wisdom to the Committee. I express my sincere gratitude towards my fellow Council Colleagues in the Committee, viz., Ms. Ritika Bhatia (Government Nominee), 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.

I acknowledge the efforts and unstinted support of the Co-opted members 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; and Special Invitees namely, CA. Mohit Bhuteria, CA. Navneet Mehta, CA. Venugopal C. Govind and CA. K. Vishwanath for sharing their consistent and valuable expertise, experience demonstrating their depth of knowledge to the Committee throughout the year.

I would also like to appreciate the untiring technical and administrative support of CA. Parul Gupta – Secretary, EAC, CA. Khushboo Bansal, Sr. Executive Officer and other members of the EAC Secretariat for their sincere hard work and commitment towards the activities of the Committee.

I firmly believe that Part I of Volume 40 will add great value to the members and other stake holders.

New Delhi	**CA. Babu Abraham Kallivayalil**
February 6, 2021	*Chairman*
	Expert Advisory Committee

Contents

Query No. 1

Subject: Recognition of non-convertible cumulative redeemable preference shares as borrowing and its measurement and disclosure requirements.[1]

A. Facts of the Case

1. A public sector undertaking (hereinafter referred to as 'the Company') is a subsidiary of M/s ABC. The Company is engaged in the business of petroleum refining and its products are sold predominantly to Oil Marketing Companies (OMCs).

2. During the financial year 2015-16, the Company has issued 100,00,00,000 non-convertible cumulative redeemable preference shares of Rs.10/- each for cash at par on private placement preferential allotment basis to M/s ABC, the holding Company for funding of an upgradation project through equity and also for improving the net worth of the Company as per Companies Act.

3. Features of the instrument:

(a) **Coupon rate:** 6.65% net of dividend distribution tax- Post tax yield of AAA rated corporate bond i.e., prevailing 10 year G-Sec yield plus a spread of AAA rated corporate bond.

(b) **Tenure:** 10 years with put and call option

(c) **Put/call option:** The put/call option can be exercised at any point of time at face value based on mutually agreed terms or at the end of 5 years at face value.

(d) **Mode of redemption:** Redemption out of profits which would otherwise be available for dividends or out of proceeds of fresh issue of preference shares made for the purpose of redemption in line with the requirements of the Companies Act, 2013.

(e) **Voting rights:** Preference shareholder has a right to vote only on resolutions placed before the shareholders which directly affect their rights attached to preference shares, like winding up of Company or repayment of preference shares etc.

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[1] Opinion finalised by the Committee on 16.3.2020.

4. *Views of the Company on recognition of non-convertible cumulative redeemable preference shares:*

As per paragraph 11 of Indian Accounting Standard (Ind AS) 32, 'Financial Instruments: Presentation':

"**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) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments...."

Classification of non-convertible cumulative redeemable preference shares as financial liability

5. The querist has stated that non-convertible cumulative redeemable preference shares are mandatorily redeemable at the end of 10 years at face value and hence, when an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at redemption exists. Therefore, the instrument qualifies as liability. Accordingly, the Company has classified the non-convertible cumulative redeemable preference shares as financial liability and recognised it under the head 'Long term borrowings'. Further, in the present case, the instrument carries a coupon rate of 6.65% net of dividend distribution tax (post tax yield of AAA rated corporate bond at the time of issue i.e., prevailing 10 year G-

Sec yield plus a spread of AAA rated corporate bond). The dividends are cumulative and shall be paid out of available distributable profits.

Initial measurement of financial liability

6. All financial liabilities are recognised initially at fair value and, in the case of liabilities measured at amortised cost net of directly attributable transaction costs. Since the effective interest rate for the given instrument is equal to market interest rate, *as the same was benchmarked to G-Sec + Spread of AAA rated Corporate Bonds at the time of issue,* the initial recognition of the financial liability at fair value is equal to face value of the share. Since the face value of the preference shares and the fair value at inception are the same, the amortised cost of the preference shares at the end of each reporting period will also be the same. Since the preference shares were issued and are redeemable at par, the question of amortisation of premium /discount does not arise. (Emphasis supplied by the querist.)

Subsequent measurement of financial liability

7. The accounting policy of the Company in line with the requirements of Ind AS is as follows:

> "Financial liabilities that are not held-for-trading and are not designated as at FVTPL are measured at amortised cost at the end of subsequent accounting periods. The carrying amounts of financial liabilities that are subsequently measured at amortised cost are determined based on the effective interest method. Gains and losses are recognised in profit or loss when the liabilities are derecognised as well as through the EIR amortisation process.
>
> Amortised cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR. The EIR amortisation is included as finance costs in the statement of profit and loss."

Disclosure requirements of financial liability

8. As per paragraph 25 of Ind AS 107, 'Financial Instruments: Disclosures',

> "Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the

> fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount."

Based on the above requirement, the comparison of fair value along with its carrying amount has been disclosed in Note 35 (fair values) for financial liabilities, viz., non-convertible cumulative redeemable preference share classified as borrowings in line with the requirements of Ind AS 32.

Moreover, paragraph 97 of Ind AS 113 states that,

> "For each class of assets and liabilities not measured at fair value in the balance sheet but for which the fair value is disclosed, an entity shall disclose the information required by paragraph 93(b), (d) and (i)…".

Paragraphs 93(b) and (d) read as follows:

> (b) for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3)
>
> (d) for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. …

Thus, as mandated by paragraphs 93(b) and (d) of Ind AS 113, the Company has disclosed the fair value hierarchy as Level 2 for non-convertible cumulative redeemable preference shares and the description of valuation technique for fair value measurement as estimated by discounting future cash flows.

Further, brief descriptions about the terms and conditions of the issue of preference shares have also been disclosed by the Company. The relevant extracts from the financial statements of the Company have been provided by the querist for the perusal of the Committee.

Accounting treatment of Dividend

9. As per paragraph 25 of Ind AS 32, "A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder

of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, *or the issuer's future revenues, net income* or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) …" (Emphasis supplies by the querist.)

The terms of issue of the preference shares are such that the dividends are cumulative in nature. Therefore, the Company would not have an unconditional right to avoid declaring dividend and would have to classify the financial instrument as a financial liability. The timing of payment of dividend is contingent to the extent of availability of profits in a particular year. However, *there is reasonable expectation that the preference dividends will be paid in time.* In the light of the above, dividend payments are not discretionary and hence, the Company has classified the dividend payable as a financial liability. (Emphasis supplied by the querist.)

10. The accounting entries are as follows:

1) *Recognition of non-convertible cumulative redeemable preference shares at the inception:*

Face Value of Non-convertible Cumulative Redeemable Preference shares: Rs. 1000 Crore

Market value of the Non-convertible Cumulative Redeemable Preference shares at the time of issue: Rs. 1000 Crore

Bank A/c Dr. 1000 Crore Dr.

To Financial Liability 1000 Crore Cr.

(Since the effective interest rate for the given instrument is equal to market interest rate, as the same was benchmarked to G-Sec + Spread of AAA rated corporate bonds at the time of issue, the initial recognition of the financial liability at fair value is equal to face value of the share)

2) *Treatment of interest expense for preference shares (including dividend distribution tax) treated as financial liabilities:*

Finance cost entry for the F.Y. 2015-16 (from the period 24.09.2015 to 31.03.2016)

Finance Cost 41.55 Crore Dr.

To interest accrued but not due on financial liabilities 41.55 Cr.

Finance cost entry for the F.Y. 2016-17

Finance Cost 80.04 Crore Dr.

To interest accrued but not due on financial liabilities 80.04 Cr.

Finance cost entry for the F.Y. 2017-18

Finance Cost 80.04 Crore Dr.

To Interest accrued but not due on financial liabilities 80.04 Cr.

(The finance cost has been arrived at considering the effective interest rate method including the dividend and dividend distribution tax)

There is no other cost involved for raising the preference shares and hence, the same has not been considered for calculating effective interest rate (EIR). Further, there are no premium or discount to the market rate at the time of issue of preference share and hence, no amortisation of premium / discount cost considered as part of EIR.

11. *Government auditors' view on the measurement principles of non-convertible cumulative redeemable preference shares classified as financial liability:*

The Company's contention of recognising non-convertible cumulative redeemable preference shares as financial liability in line with paragraph 11 of Ind AS 32 is accepted by the Comptroller and Auditor General of India (C&AG). However, the C&AG is of the opinion that the non-convertible cumulative redeemable preference shares recognised as borrowings should be valued at amortised cost and accordingly the carrying value of the financial liability at the end of each reporting period will not be the same.

B. Query

12. In the light of the above, the opinion of the Expert Advisory Committee is sought on the following:

(i) Whether the measurement principles followed by the Company on initial recognition and subsequent measurement of the non-convertible cumulative redeemable preference shares as detailed above is correct. If not, what would be the correct measurement of the financial liability?

(ii) Whether the disclosures made by the Company are full and adequate. If not, what additional disclosures are required to be made by the Company in this regard?

C. Points considered by the Committee

13. The Committee notes that the basic issues raised in the query relate to the initial recognition and measurement, subsequent measurement and disclosure requirements in respect of the non- convertible cumulative redeemable preference shares issued by the Company. The Committee, has therefore, considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, determination of fair value of the preference shares and the level of inputs used for determining such fair value, related party disclosures, etc. The Committee presumes from the Facts of the Case that there is no prepayment penalty/negative compensation in the extant case.

Recognition:

14. With regard to recognition of the non-convertible cumulative redeemable preference shares, the Committee notes the definition of 'financial liability' as per Ind AS 32, 'Financial Instruments : Presentation' as follows:

"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) a contract that will or may be settled in the entity's own equity instruments and is:

..."

"25 A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or

(c) the instrument has all the features and meets the conditions in paragraphs 16A and16B."

The Committee notes from the Facts of the Case that the non-convertible redeemable preference shares are to be mandatorily redeemed at the end of 10 years. The redemption represents a contractual obligation of the entity to deliver cash. Hence, the recognition of the financial instrument, viz., non-convertible cumulative redeemable preference shares, as a financial liability is in accordance with the requirements of Ind AS 32, 'Financial Instruments: Presentation'.

Classification:

15. At the outset, the Committee notes that in the extant case, the non-convertible cumulative redeemable preference shares have the put/call option, which can be exercised at any point of time at face value based on mutually agreed terms or at the end of 5 years at face value. In this context, the Committee notes the definition of 'derivative' as provided in Appendix A to Ind AS 109, 'Financial Instruments', as follows:

"**Derivative** A financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) it is settled at a future date."

From the above, the Committee notes that the call or put option in the extant case meets the definition of derivative. Now, the question arises as to whether it is required to be separated from the host contract, viz., financial liability on account of non-convertible cumulative redeemable preference shares in terms of the requirements of Ind AS 109. In this regard, the Committee notes the following requirements of Ind AS 109:

"**4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:**

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated)."

"B4.3.5 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

(b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

…

(e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

(i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or

(ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with Ind AS 32.

…"

In the extant case, the exercise price of the call/put option after 5 years or earlier is the face value of shares, which in the view of the Committee, will be approximately equal to the amortised cost. Therefore, the Committee is of the view that the economic characteristics and risks of embedded derivative (call/put option) in the extant case are closely related to the host contract and accordingly, there is no need for separation of such derivative from the host contract.

16. With regard to classification of non-convertible cumulative redeemable preference shares, the Committee notes the following paragraphs of Ind AS 109, "Financial Instruments", as follows:

"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. …"

"4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:

(a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or

(b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in Ind AS 24 Related Party Disclosures), for example, the entity's board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36)."

"4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

(a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

4.3.6 If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss."

Appendix A to Ind AS 10, 'Financial Instruments':

"financial liability at fair value through profit or loss	A financial liability that meets one of the following conditions: (a) it meets the definition of **held for trading**. (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5. (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1."

From the above, the Committee notes that these instruments do not have the following characteristics:

- are held for trading (assuming that the Company is not trading in its own preference shares),
- are derivative instruments and
- are liabilities that have arisen on transfer of a financial asset which does not qualify for derecognition.

Further, as appears from the Facts of the Case, these instruments have neither been designated upon initial recognition nor subsequently as at fair value through profit or loss in accordance with the requirements of paragraphs 4.2.2 or 4.3.5 and 6.7.1 of Ind AS 109 respectively. Moreover, as discussed above, since there is no requirement to separate the embedded derivative, the requirement to designate the entire contract as at fair value through profit or loss as per paragraph 4.3.6 of Ind AS 109 shall not be applicable in the extant case. Hence, the financial liability does not meet the requirements for classification as financial liability valued at fair value through profit or loss as specified in Ind AS 109: Financial Instruments. Accordingly, as per the requirements of Ind AS 109, the non-convertible cumulative redeemable preference shares shall be classified as subsequently measured at amortised cost.

Initial Measurement:

17. With regard to initial measurement, the Committee notes the following paragraphs of Ind AS 109:

> "**5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, 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."**

> "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. …"

From the above, the Committee notes that the financial liability (other than in the case of a financial liability measured at fair value through profit or loss) should be initially measured at fair value (which is normally the transaction price) minus transaction costs. The Committee also notes that in the extant case, there are no transaction costs/discount/premium on issue or redemption of preference shares. Further, as per the querist, since, the effective interest rate for the given instrument is equal to market interest rate, as the same was benchmarked to G- Sec + Spread of AAA rated corporate bonds at the time of issue, the initial recognition of the financial liability at fair value is equal to face value of the share. Thus, it appears that the face value of the preference shares is the transaction price in the extant case. Presuming that the Company has determined the fair value of the preference shares as their face value appropriately as per the principles of Ind AS 113, the Committee is of the view that the initial measurement at face value is correct.

Subsequent Measurement:

18. With regard to subsequent measurement of the preference shares, considering the requirements of paragraph 4.2.1 of Ind AS 109, as reproduced above and as discussed in paragraph 16 above, the Committee is of the view that the financial liability should be subsequently measured at amortised cost using the effective interest method. In this context, the Committee notes the following requirements of Ind AS 109, Ind AS 32 and the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013 (Revised July, 2019 Edition), issued by the Institute of Chartered Accountants of India (ICAI):

Ind AS 109

"Amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**."
"effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the

expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments)."

"Transaction costs

B5.4.8 Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs."

Ind AS 32

"35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.

35A Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12, *Income Taxes*.

36 The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as

income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements."

Guidance Note on Division II-Ind AS Schedule III to the Companies Act, 2013

"**9.5.5. Finance Costs**

…

Dividend on preferences shares, whether redeemable or convertible, is of the nature of 'Interest expense', only where there is no discretion of the issuer over the payment of such dividends. In such case, the portion of dividend as determined by applying the effective interest method should be presented as 'Interest expense' under 'Finance cost'. Accordingly, the corresponding Dividend Distribution Tax on such portion of non-discretionary dividends should also be presented in the Statement of Profit and Loss under 'Interest expense'.

…"

From the above, the Committee is of the view that since in the extant case, redeemable preference shares have been classified as financial liability in its entirety, the 'dividend' thereon is in the nature of interest expense. The related dividend distribution tax should also be regarded as part of interest cost. Therefore, the future cash payments of 'dividend' and 'dividend distribution tax' shall form part of EIR calculation. The Committee is also of the view that there being no transaction costs or discount or premium, etc. involved, the effective interest in the extant case would be equal to the dividend and dividend distribution tax paid/payable. Hence, in a scenario where the effective interest rate approximates the annual payouts (estimated future cash payments), subsequent measurement of the financial liability in respect of preference shares is unlikely to result in a material difference in the carrying amount of financial liability at the end of each reporting period. Thus, the contention of the C&AG that the carrying value of the financial liability at the end of each reporting period will not be the same is incorrect.

Disclosures:

19. With regard to disclosures, the Committee notes the following requirements of Ind AS 107:

> "8 The carrying amounts of each of the following categories, as defined in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:
>
> (a) …
>
> (b) …
>
> (g) financial liabilities measured at amortised cost.
>
> (h) …"

> "25 Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount."

> "29 Disclosures of fair value are not required:
>
> (a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
>
> …"

> "20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:
>
> (a) …
>
> (b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss.
>
> …"

From the Facts of the Case, the Committee notes that the Company has disclosed the financial liability for preference shares in the balance sheet/Notes as a financial liability measured at amortised cost under the head 'Long-term Borrowings'. The Committee is of the view that the same is in accordance with the requirements of paragraph 8 of Ind AS 107, 'Financial

Instruments: Disclosures'. The Committee also notes that in Note 13: Equity Share Capital, under 'Authorised' and 'issued' share capital, the Company has also disclosed the preference shares. In this context, the Committee notes the requirements of General Instructions for Preparation of Balance Sheet in Part I of Division II - Ind AS Schedule III to the Companies Act, 2013, as follows:

> "9. Preference shares including premium received on issue, shall be classified and presented as 'Equity' or 'Liability' in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in this regard applicable to the relevant class of equity or liability shall be applicable mutatis mutandis to the preference shares. For instance, redeemable preference shares shall be classified and presented under 'non-current liabilities' as 'borrowings' and the disclosure requirements in this regard applicable to such borrowings shall be applicable mutatis mutandis to redeemable preference shares."

Further, the Committee also notes the following paragraphs of the Guidance Note on Division II-Ind AS Schedule III to the Companies Act, 2013 (Revised July 2019 Edition):

> "**8.2.1.11. Clause (a) of Note 6(D)(I) - the number and amount of shares authorized:**
>
> As per the Guidance Note on Terms Used in Financial Statements "Authorised Share Capital" means *"the number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital."*
>
> This disclosure is to be provided for instruments entirely equity in nature as well as for compound instruments that have an equity component, to the extent applicable.
>
> **8.2.1.12. Clause (b) of Note 6(D)(I) - the number of shares issued, subscribed and fully paid, and subscribed but not fully paid:**
>
> The disclosure is for shares:
>
> - Issued;
> - Subscribed and fully paid;
> - Subscribed but not fully paid.

Though the disclosure is only for the number of shares under each of the above three categories, to make the disclosure relevant to understanding the company's share capital, even the amount for each category above should be disclosed. Issued shares are those which are offered for subscription within the authorised limit. It is possible that all shares offered are not subscribed to and to the extent of unsubscribed portion, there will be difference between shares issued and subscribed. As per the Guidance Note on Terms Used in Financial Statements, the expression 'Subscribed Share Capital' is *"that portion of the issued share capital which has actually been subscribed and allotted. This includes any bonus shares issued to the shareholders."*

Though there is no requirement to disclose the amount per share called, if shares are not fully called, it should be appropriate to state the amount per share called.

As per the definition contained in the Guidance Note on Terms Used in Financial Statements, the expression 'Paid-up Share Capital' is *"that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise."*

This disclosure is to be provided for instruments entirely equity in nature as well as for compound instruments that have an equity component, to the extent applicable."

From the above, the Committee is of the view that the disclosure of redeemable preference shares, which are neither in the nature of 'Equity' in entirety nor are compound instruments having an equity component, under authorised and issued Equity share capital is not recommended. The Committee further notes from the Facts of the Case that the effective interest rate amortisation is included as 'finance costs' in the statement of profit and loss. In this regard, the Committee notes the following requirements of the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013:

"9.5.5. Finance Costs

As per Note 4 of the General Instructions for the Preparation of the Statement of Profit and Loss, disclosure of Finance costs is to be bifurcated under the following:

(A) Interest;

(B) Dividend on redeemable preference shares

(C) Exchange differences regarded as an adjustment to borrowing costs;

(D) Other borrowing costs (specify nature).

…

B) Dividend on redeemable preference shares

Dividend on preferences shares, whether redeemable or convertible, is of the nature of 'Interest expense', only where there is no discretion of the issuer over the payment of such dividends. In such case, the portion of dividend as determined by applying the effective interest method should be presented as 'Interest expense' under 'Finance cost'. Accordingly, the corresponding Dividend Distribution Tax on such portion of non-discretionary dividends should also be presented in the Statement of Profit and Loss under 'Interest expense'.

On the other hand, where there is a discretion of issuer over the payments of dividend on preference shares, whether redeemable or convertible, the entire dividend is in the nature of distribution of profit and accordingly, shall be presented in Statement of Changes in Equity. Accordingly, the corresponding Dividend Distribution Tax should also be presented in Statement of Changes in Equity."

From the above, the Committee is of the view that since the preference shares are cumulative in nature, the disclosure of EIR amortisation under 'finance costs' is appropriate. Further, the disclosures regarding the comparison of the carrying amount and the fair value of the liability in the Notes by the Company is also in accordance with paragraph 25 of Ind AS 107, Financial Instruments: Disclosures'. The Committee also notes that in the extant case, the Company has disclosed the fair value hierarchy as Level 2 for non-convertible cumulative redeemable preference shares and has also disclosed the description of valuation technique for fair value measurement as estimated by discounting future cash flows, in accordance with the disclosure requirements as per paragraph 93 of Ind AS 113. In this context, the Committee notes the following requirements of Ind AS 113:

"72 To increase consistency and comparability in fair value measurements and related disclosures, this Ind AS establishes a fair value hierarchy that categorises into three levels (see paragraphs 76-90), the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (*Level 3 inputs*)."

"74 The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques (see paragraph 61). However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorised.

75 If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy. For example, if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a *Level 2 input* and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy.

Level 1 inputs

76 Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

77 A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 79."

"79 An entity shall not make an adjustment to a Level 1 input except in the following circumstances:

…

(c) when measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in active market and that price needs to be adjusted for factors specific to the item or the asset (see paragraph 39). If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorized within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorized within a lower level of the fair value hierarchy."

Level 2 inputs

"81 Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

82 If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

(a) quoted prices for similar assets or liabilities in active markets.

(b) quoted prices for identical or similar assets or liabilities in markets that are not active.

(c) inputs other than quoted prices that are observable for the asset or liability, for example:

(i) interest rates and yield curves observable at commonly quoted intervals;

(ii) implied volatilities; and

(iii) credit spreads.

(d) market-corroborated inputs."

"84 An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs."

Level 3 inputs

"86 Level 3 inputs are unobservable inputs for the asset or liability."

"93 To meet the objectives in paragraph 91, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities (see paragraph 94 for information on determining appropriate classes of assets and liabilities) measured at fair value (including measurements based on fair value within the scope of this Ind AS) in the balance sheet after initial recognition:

(a) …

(b) for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).

…

(d) for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement.…

…

(i) for recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use."

"97 For each class of assets and liabilities not measured at fair value in the balance sheet but for which the fair value is disclosed, an entity shall disclose the information required by paragraph 93(b), (d) and (i). However, an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy required by paragraph 93(d). For such assets and liabilities, an entity does not need to provide the other disclosures required by this Ind AS."

From the above, the Committee is of the view that the Company should keep in mind the above-reproduced requirements of Ind AS 113, while determining the fair value and giving disclosures as per Ind AS 107 and Ind AS 113.

D. Opinion

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

(i) For initial recognition and measurement, classification and subsequent measurement of the non-convertible cumulative redeemable preference shares, refer to paragraphs 14 to 18 above.

(ii) For disclosures to be made by the Company, refer to paragraph 19 above.

Query No. 2

Subject: Creation of regulatory deferral account balances.[1]

A Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a central public sector enterprise incorporated with an objective to plan, promote and organize an integrated and efficient development of hydroelectric power. The Company has extended its objective to include development of power in all aspects through conventional and non-conventional sources in India and abroad. The Company's shares are listed at Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). The Company has adopted Indian Accounting Standards (Ind ASs) during the 1st Phase, i.e. from April 1, 2016.

2. The Company constructs hydropower projects and operates them on build, own, operate and maintain (BOOM) basis. Electricity being a regulated product, tariff for each power station is determined by the Central Electricity Regulatory Commission (CERC) based on the CERC Tariff Regulations

[1] Opinion finalised by the Committee on 16.3.2020.

issued for a period of five years at a time. The currently applicable tariff period is 2014-15 to 2018-19, i.e. 2014-19 (a copy of the CERC Tariff Regulations 2014-19 has been supplied separately by the querist for the perusal of the Committee).

3. The querist has informed that the tariff is fixed by the CERC based on the capital cost incurred for the power station. Tariff Regulations provide for recovery of costs incurred on running & maintenance of the power station, depreciation of property, plant and equipment, interest on loans and borrowings for construction of the plant and interest on working capital, plus a specified rate of return on equity invested in the plant. Annual Fixed Charges (AFC) i.e. Tariff, for a hydropower station is the sum of the following items:

(a) *Return on Equity (ROE) (Regulation No. 19, 24 and 25 of the CERC Tariff Regulations, 2014-19):* ROE is allowed @ 15.5% for run-of-the-river type power stations and @ 16.5% for storage-type power stations grossed up at the effective tax rate. Normative Debt: Equity ratio of capital cost allowed by the CERC after prudence check is 70:30.

(b) *Interest on loan capital (Regulation No. 26 of the CERC Tariff Regulations, 2014-19):* Calculated on the normative average loan of the year by applying the weighted average rate of interest.

(c) *Depreciation (Regulation No. 27 of the CERC Tariff Regulations, 2014-19):* Depreciation is allowed at the rates prescribed in Appendix-II of the Tariff Regulations on Straight Line Method for the first 12 years from commercial operation date. The balance depreciation upto 90% of capital cost of the asset is spread over the balance life of 23 years. Total life of a hydro-power station is considered as 35 years.

(d) *Interest on Working Capital (Regulation No. 28 of the CERC Tariff Regulations, 2014-19):* Provided on normative basis @ bank rate prevailing as on 1st April of the relevant year on the following items:

(i) Receivables equivalent to two months of Annual Fixed Charges + (ii) Maintenance spares @ 15% of operation and maintenance expenses + (iii) Operation and maintenance expenses for one month.

(e) *Operation and Maintenance expenses (Regulation No. 29 of the CERC Tariff Regulations, 2014-19):* Provided on the basis of normalized actual O&M expenses after escalation @ 6.64% in case of existing power stations and @ 2.50% of capital cost (excluding cost of R&R) for the first year with annual escalation of 6.64% for new power stations.

4. Further, the AFC so arrived at is recovered in two parts: A) Capacity charges and B) Energy charges.

A. Capacity charges amounting to 50% of the AFC is recovered on the basis of Plant Availability Factor (PAF) which is defined as the declared capacity (in ex-bus MW) as certified by nodal Load Despatch Centre for all the days during the period expressed as a percentage of the installed capacity in MW less the normative auxiliary energy consumption.

B. Energy charges amounting to 50% of the AFC is recovered on the basis of energy scheduled to be supplied to the beneficiary, excluding free energy.

5. The querist has informed that the regulation 48 of the CERC Tariff Regulations 2014-19 (as quoted hereunder) allows deviation from the above norms for fixation of tariff:

> "**48. Deviation from norms:** (1) Tariff for sale of electricity by the generating Company or for transmission charges of the transmission licensee, as the case may be, may also be determined in deviation of the norms specified in these regulations subject to the conditions that:
>
> (a) The levelised tariff over the useful life of the project on the basis of the norms in deviation does not exceed the levelised tariff calculated on the basis of the norms specified in these regulations and upon submission of complete workings with assumptions to be provided by the generator or the transmission licensee at the time of filing of the application; and
>
> (b) Any deviation shall come into effect only after approval by the Commission, for which an application shall be made by the generating Company or the transmission licensee, as the case may be."

Moderation of tariff in one power station of the Company:

6. In the case of a recently commissioned power station of the Company (commissioned in May, 2018), tariff worked out on the basis of CERC Tariff Regulations 2014-19 was at higher side than the rate prevailing in the market. As such, CERC was petitioned that the following two parameters (in deviation to 2014-19 Tariff Regulations) be allowed for moderation of tariff so as to make the tariff saleable:

Sl. No.	**Parameters**	**Existing CERC norms**	**Deviated Norms on which AFC has been requested**
1	Depreciation	Weighted average rate of depreciation based on Straight Line Method (approximately 5.00% per annum) for 12 years. Remaining depreciation after 12 years of Commercial Operation Date (COD) to be spread over the balance useful life of assets (i.e. 23 years), which is approximately 1.30% per annum.	Rate of depreciation has been considered as **1.50% per annum for initial 10 years** from COD of the Station. Thereafter, the remaining depreciation is to be spread over the balance useful life of assets (i.e. 25 years) which is approximately 3% per annum.
2	O&M Expenses	O&M Expenses per annum @ 2.50% of original project cost (excluding cost of R&R works) for first year after COD of the Station.	O&M Expenses per annum @ 2 % of original project cost (excluding cost of R&R works).

7. As informed by the querist, the petition of the Company for moderation

of tariff has been approved by CERC as under:

> "21. In view of the fact that the proposal of the petitioner provides benefits to the respondents by way of reduction in tariff as compared to the CERC norms, the Commission is inclined to allow the depreciation rate of 1.50% for the first ten years and O&M expenses for the first year of operation at the rate of 2% of the original project cost."

8. The year-wise impact of moderation of tariff can be demonstrated by the following table:

Year	**Tariff for 35 years as per CERC Regulations 2014-19 (Rs. per unit of electricity sold)**	**Tariff for 35 years as per deviated norms approved by CERC (Rs. per unit of electricity sold)**
1	6.12	4.49
2	6.32	4.65
3	6.49	4.79
4	6.60	4.88
5	6.66	4.95
6	6.73	5.02
7	6.80	5.09
8	6.88	5.18
9	6.97	5.26
10	7.03	5.26
11	7.15	6.01
12	7.27	6.11
13	5.82	6.23
14	5.98	6.34
15	6.15	6.47
16	6.33	6.61
17	6.52	6.76
18	6.73	6.92
19	6.95	7.09
20	7.19	7.27

21	7.45	7.46
22	7.73	7.67
23	8.02	7.90
24	8.34	8.14
25	8.67	8.39
26	9.03	8.67
27	9.41	8.96
28	9.82	9.27
29	10.26	9.61
30	10.72	9.98
31	11.21	10.38
32	11.74	10.80
33	12.30	11.25
34	12.90	11.73
35	13.69	12.38

9. The Company has tied up long-term power purchase agreements (PPA) of (35 years' duration for the entire output of the power station with state discoms at the moderated tariff approved by the CERC. (Tariff of the power station as notified by the CERC has been supplied separately by the querist for the perusal of the Committee).

Charging of depreciation in the books of account:

10. As per the querist, paragraph 5.11 (c) of the Tariff Policy 2016, notified by the Central Government on 28th January, 2016 (a copy of the same has been supplied separately by the querist for the perusal of the Committee) provides as under:

> "**c) Depreciation**
>
> The Central Commission may notify the rates of depreciation in respect of generation and transmission assets. The depreciation rates so notified would also be applicable for distribution assets with appropriate modification as may be evolved by the Forum of Regulators.
>
> Provided that the Appropriate Commission shall specify, for the purpose of tariff determination, a upper ceiling of the rate of

depreciation to be applicable during the useful life of the project and the developer shall have the option of indicating, while seeking approval for tariff, lower rate of depreciation subject to the aforesaid ceiling.

The rates of depreciation so notified would be applicable for the purpose of tariffs as well as accounting."

11. Further, Regulation 27(5) of the CERC Tariff Regulations 2014-19 provides as under:

"Depreciation shall be calculated annually based on Straight Line Method and at rates specified in Appendix-II to these regulations for the assets of the generating station and transmission system:

Provided that the remaining depreciable value as on 31st March of the year closing after a period of 12 years from the effective date of commercial operation of the station shall be spread over the balance useful life of the assets."

12. Schedule-II of the Companies Act, 2013 provides the useful life of assets for charging of depreciation in the financial statements. Part-B of Schedule-II further provides as under:

"4. 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."

13. Keeping in view the above, the Company is charging depreciation on the assets of all its power stations in its financial statements as per Regulation 27(5) of the CERC Tariff Regulations 2014-19, i.e., on straight line method at the rates specified in Appendix-II to the said Regulations.

14. The querist has stated that the accounting policies of the Company as regards depreciation and amortization are as under:

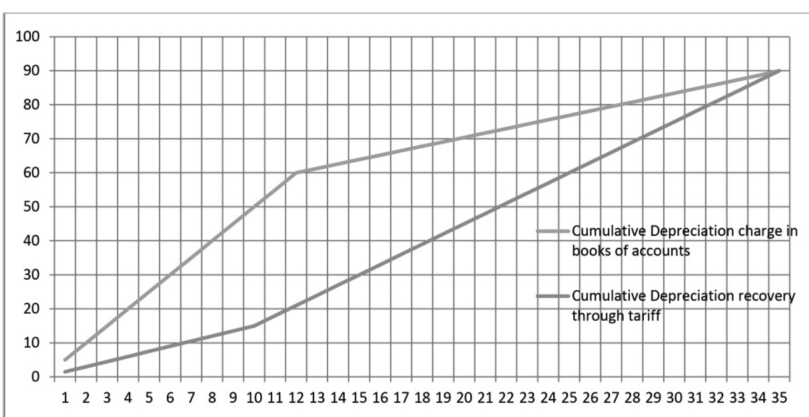
"Depreciation and amortization

a) Depreciation on additions to /deductions from Property, Plant & Equipment (PPE) during the year is charged on pro-rata basis from / upto the date on which the asset is available for use / disposal.

b) Depreciation on Property, Plant and Equipment of Operating Units of the Company is charged to the Statement of Profit & Loss on straight-line method following the rates and methodology as notified by CERC for the fixation of tariff except for Construction Plant & Machinery and Computer & Peripherals.

…"

15. Consequent upon application of the accounting policy at paragraph 14 above, depreciation will be charged in the books @ 5% approx. for the first 12 years of operation, while depreciation will be recovered through tariff @ 1.50% per annum for the first 10 years and @ 3% per annum for balance life of the plant. For the first 12 years of the life of the power station, approx. 60% of capital cost (@ 5% per year) shall be charged as depreciation, while only 21% (@ 1.50% per year for 10 years + @ 3% per year for the 11th & 12th years) shall be recovered through tariff. Beyond the initial 12 years, depreciation charge in the books shall reduce to 1.30% approx. per year, while recovery of depreciation through tariff shall increase to 3%. This is graphically presented as follows:



According to the querist, as illustrated above, the mismatch in revenue and cost would continue till the end of the useful life of the power station.

Recognition of Regulatory Deferral Account (RDA) Balance:

16. Provisions of Ind AS 114, 'Regulatory Deferral Accounts' and Guidance Note on Accounting for the Rate Regulated Activities, issued by the Institute of Chartered Accountants of India (ICAI): Creation of rate regulated assets is guided by Ind AS 114, 'Regulatory Deferral Accounts'.

Paragraph 11 of Ind AS 114 provides as under:

> "**11 On initial application of this Standard, an entity shall continue to apply previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances, except for any changes permitted by paragraphs 13–15. However, the presentation of such amounts shall comply with the presentation requirements of this Standard, which may require changes to the entity's previous GAAP presentation policies (see paragraphs 18–19).**"

Explanation to definition of Previous GAAP (Appendix A of Ind AS 114) provides that "*Guidance Note on Accounting for the Rate Regulated Activities, issued by the Institute of Chartered Accountants of India (ICAI) shall be considered to be the previous GAAP.*"

17. The Guidance Note on Accounting for the Rate Regulated Activities, issued by the ICAI (hereinafter referred to as the 'Guidance Note') defines 'Cost of Service regulation' as "a form of regulation for setting an entity's prices (rates) in which there is a cause-and-effect relationship between the entity's specific costs and its revenues."

18. The querist has stated that the Guidance Note is applicable to entities that provide goods or services whose prices are subject to cost-of-service regulation and the tariff determined by the regulator is binding on the customers (beneficiaries). Since the operating activities of the Company, where tariff is fixed by CERC, are subject to cost-of-service regulations, it meets the scope criteria set out in paragraph 14 of the Guidance Note.

19. Paragraph 22 of the Guidance Note provides that:

> "22. Rate regulation of an entity's business activities creates operational and accounting situations that would not have arisen in the absence of such regulation. With cost-of-service regulation, there is a direct link between the costs that an entity is expected to incur and its expected revenue as the rates are set to allow the entity to recover its expected costs. However, there could be a significant time lag between incurrence of costs by the entity and their recovery through tariffs. Recovery of certain costs may be provided for by regulation either before or after the costs are incurred. Rate regulations are enforceable and can create legal rights and obligations for the entity."

20. In the case of the power station under consideration, while higher costs on account of depreciation are being incurred during the first 12 years, recovery of such higher costs are to occur over the last 23 years of the life of the power station. This deferment of recovery of costs with the intent to reduce tariff in the initial years and its recovery in subsequent years demonstrates that an asset exists by way of the right to recover current costs in future through tariff and such right is enforceable.

21. As per paragraph 30 of the Guidance Note, "A regulatory asset should be recognised when it is probable that the future economic benefits associated with it will flow to the entity as a result of the actual or expected actions of the regulator under the applicable regulatory framework and the amount can be measured reliably."

22. Further, paragraph 33 of the Guidance Note provides that "As regards the criterion for reliable measurement, since the recoverable amount is linked to the specific costs incurred which are permitted to be recovered by the regulatory framework, meeting the same may not present much difficulty for regulatory assets."

23. According to the querist, in the current case, tariff notified by CERC (at moderated rates of depreciation) is binding upon the beneficiaries. The notification of tariff by CERC provides the necessary certainty regarding recovery of differential depreciation in future years as the beneficiaries have already signed PPAs for the entire useful life of the power station (for the saleable capacity).

24. Paragraph 28 of the Guidance Note provides that "Regulatory assets and regulatory liabilities that would be recognised as a result of application of this Guidance Note are not financial instruments since the entity does not have the right to request reimbursement from, or the obligation to make payments to, individual customers for fixed or determinable amounts under a contract."

25. Further, as per paragraph 37 of the Guidance Note, "On initial recognition and at the end of each subsequent reporting period, an entity should measure a regulatory asset or regulatory liability at the best estimate of the amount expected to be recovered or refunded or adjusted as future cash flows under the regulatory framework. *A regulatory asset or regulatory liability should not be discounted to its present value*." (Emphasis supplied by the querist.)

26. Accordingly, as per the querist, regulatory assets in respect of the power station are not financial assets within the scope of Ind AS 32, 'Financial Instruments: Presentation' and fall outside the scope of Ind AS 109, 'Financial Instruments' and would therefore, not be required to be fair valued.

Methodology adopted by the Company for recognition and measurement of RDA balances due to mismatch in depreciation charge and its recovery:

27. Since the RDA balance is on account of difference between depreciation charged in the books of account and depreciation allowed in tariff, RDA (Debit) balance is being created in the books at balance sheet date by way of passing the following entry:

RDA Balances- Depreciation differential due to moderation of tariff	Dr.	(B/S Item)
Regulatory Income- Depreciation differential due to moderation of tariff	Cr.	(P&L Item)

28. Paragraph 11 of Ind AS 114 provides as under:

> "**11 On initial application of this Standard, an entity shall continue to apply previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances, except for any changes permitted by paragraphs 13–15. However, the presentation of such amounts shall comply with the presentation requirements of this Standard, which may require changes to the entity's previous GAAP presentation policies (see paragraphs 18–19).**"

29. The Company is recognizing RDA balances in its accounts w.e.f. F.Y. 2014-15, i.e. prior to transition to Ind AS for other items. The accounting treatment as above is consistent with the existing accounting policy of the Company quoted as under:

> "Expense/ income recognised in the Statement of Profit and Loss to the extent recoverable from or payable to the beneficiaries in subsequent periods as per CERC Tariff Regulations are recognised as 'Regulatory Deferral Account Balances'.

Presentation and disclosure requirements of Ind AS 114 shall be complied with in the annual accounts.

B. Query

30. Considering the above, the Management of the Company wishes to seek the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) as to whether the creation of RDA balance in respect of difference between depreciation charged in the books and the depreciation allowed by way of tariff in the power station is proper.

C. Points considered by the Committee

31. The Committee notes that the basic issue raised by the querist relates to recognition of regulatory deferral asset account in respect of difference between depreciation charged in the books and the depreciation allowed by way of tariff for a particular power station of the Company. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for the difference (if any) between the amount charged in the books of account and that recovered through tariff on account of O & M expenses, determination of annual fixed charges (AFC) including its various components (i.e. operation and maintenance expenses, interest on working capital, return on equity etc.), measurement of regulatory assets/liabilities/income/expenses, appropriateness of the accounting policy of the Company for regulatory deferral account balances and depreciation in general, year-wise impact of moderation of tariff as provided in the query, presentation and disclosure of regulatory assets/liabilities/income/expenses as per the requirements of Ind AS 114, appropriateness of rate of depreciation used for charging depreciation for the power station in question in the books of account, i.e., whether the same should be charged as per the rate allowed as per existing CERC norms (2014-19 tariff regulations) or moderated rates as approved by the CERC (as the same requires interpretation of CERC tariff regulations/policy and the relevant provisions of the Companies Act, 2013) etc. Further, this opinion is restricted to the financial reporting requirements under Indian Accounting Standards (Ind ASs) notified and does not deal with the regulatory aspects of the CERC tariff regulation or any other related regulations or Electricity Act, 2003. The Committee also wishes to mention that Indian Accounting Standards cited hereinafter refer to Standards notified under the Companies (Indian Accounting Standards) Rules, 2015.

32. The Committee notes that the paragraphs 11, 12, 13 and 14 of Ind AS 114, Regulatory Deferral Accounts state as follows:

"**11 On initial application of this Standard, an entity shall continue to apply previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances, except for any changes permitted by paragraphs 13–15. However, the presentation of such amounts shall comply with the presentation requirements of this Standard, which may require changes to the entity's previous GAAP presentation policies (see paragraphs 18–19).**"

Further, Explanation to definition of Previous GAAP as given in Appendix A of Ind AS 114 states that "*Guidance Note on Accounting for the Rate Regulated Activities, issued by the Institute of Chartered Accountants of India (ICAI) shall be considered to be the previous GAAP*."

"**13 An entity shall not change its accounting policies in order to start to recognise regulatory deferral account balances. An entity may only change its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in paragraph 10 of Ind AS 8.**

14 This Standard does not exempt entities from applying paragraphs 10 or 14–15 of Ind AS 8 to changes in accounting policy. To justify changing its accounting policies for regulatory deferral account balances, an entity shall demonstrate that the change brings its financial statements closer to meeting the criteria in paragraph 10 of Ind AS 8. However, the change does not need to achieve full compliance with those criteria for the recognition, measurement, impairment and derecognition of regulatory deferral account balances.

15 Paragraphs 13–14 apply both to changes made on initial application of this Standard and to changes made in subsequent reporting periods."

From the above, as far as recognition of regulatory deferral account balances is concerned, the Committee notes that on initial application of Ind AS 114, the Company shall continue to apply previous GAAP accounting policies and shall not change its accounting policies in order to start recognizing regulatory deferral account balance. In this context, the Committee notes from the facts of the case (paragraph 19) that the Company has been recognizing regulatory deferral account balances in its accounts from financial year 2014-15 i.e. even prior to transition to Ind AS. Therefore, as per the above mentioned requirements of Ind AS 114, the Committee is of the view that the accounting policy of the Company in respect of recognition of regulatory deferral account balances shall continue to be governed by the previous GAAP, i.e. Guidance Note on Accounting for the Rate Regulated Activities, issued by the ICAI. The accounting requirements of the said Guidance Note in this regard are discussed in the subsequent paragraphs.

33. The Committee notes the following requirements of the Guidance Note on Accounting for the Rate Regulated Activities, issued by the Institute of Chartered Accountants of India:

> "14. An entity should apply this 'Guidance Note' to its operating activities that meet the following criteria:
>
> (i) the regulator establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and
>
> (ii) the price established by regulation (the 'rate') is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return. The specified return could be a minimum or range and need not be a fixed or guaranteed return."
>
> "22. Rate regulation of an entity's business activities creates operational and accounting situations that would not have arisen in the absence of such regulation. With cost-of-service regulation, there is a direct link between the costs that an entity is expected to incur and its expected revenue as the rates are set to allow the entity to recover its expected costs. However, there could be a significant time lag between incurrence of costs by the entity and their recovery through tariffs. Recovery of certain costs may be provided for by regulation either before or after the costs are incurred. Rate regulations are enforceable and can create legal rights and obligations for the entity.

23. An issue therefore arises as to whether an entity should recognize in its financial statements the right to recover incurred costs or the obligation to refund amounts received for which costs have not been incurred through future tariff adjustments. Recognition of the right to recover incurred costs in the future or the obligation to refund amounts received in the financial statements of the entity would arise if they meet the definition of assets and liabilities as provided in the *Framework for the preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India."

"30. A regulatory asset should be recognised when it is probable that the future economic benefits associated with it will flow to the entity as a result of the actual or expected actions of the regulator under the applicable regulatory framework and the amount can be measured reliably."

"31. Probability refers to the degree of uncertainty that future economic benefits associated with the regulatory asset 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 regulatory asset to the entity. A regulatory asset can be recognised when the regulatory framework provides for the recovery of the incurred cost and the entity has incurred such cost. …

32. In some cases, a regulator permits an entity to include in the rate base, as part of the cost of self-constructed (tangible) fixed assets or internally generated intangible assets, amounts that would otherwise be recognised as expense in the Statement of Profit and Loss in accordance with Accounting Standards. After the construction or generation is completed, the resulting cost is the basis for depreciation or amortisation and unrecovered investment for rate determination. A regulatory asset should be recognised by the entity in respect of such costs since the same is recoverable from the customers in future through tariffs."

34. The Committee notes from the above paragraphs that the operating activities of the Company meet the criteria specified in paragraph 14 of the Guidance Note as there is a direct link between the costs incurred by the Company and its expected revenue as the tariff fixed by the CERC (which is binding on the Company) allows the Company to recover its costs (although

there is a time lag between incurrence of costs by the Company and their recovery through tariffs), as the tariff is apparently binding on the customers as well. Therefore, the Guidance Note is applicable to the Company in the extant case. The Committee further notes that as per the requirements of the Guidance Note, the Company can recognise a regulatory asset when it is probable that the future economic benefits associated with it will flow to the entity as a result of the actual or expected actions of the regulator under the applicable regulatory framework and the amount can be measured reliably. With regard to 'probability' criterion, the Guidance Note provides that the same is said to be met when there is a reasonable assurance that future economic benefits will flow from the regulatory asset to the entity and that a regulatory asset can be recognised when the regulatory framework provides for the recovery of the incurred cost and the entity has incurred such cost.

35. In the extant case, the Company has incurred certain capital cost and depreciation is allowed to be included in Annual Fixed Charges (AFC) at certain specified rates. However, as informed by the querist, for a recently commissioned power station of the Company, the year-to-year rate of depreciation used for accounting purposes is different from the rate of depreciation allowed to be recovered through tariff by CERC, which is also recoverable from the customers in terms of Power Purchase Agreement (PPA). As noted from the paragraph 32 of the Guidance Note, reproduced above, a regulatory asset should be recognized by the entity in respect of costs that are recoverable from the customers in future through tariffs. Accordingly, the Committee is of the view that in the extant case, the Company should recognise a regulatory asset in respect of above-mentioned difference in depreciation rates on the basis of amount recoverable from customers.

D. Opinion

36. On the basis of above and as explained in paragraphs 34 and 35 above, the Committee is of the view that considering that the year-to-year depreciation rate used for accounting purposes is different from that allowed to be recovered through tariff by CERC, a regulatory asset should be recognised by the entity in respect of difference in depreciation rates on the basis of amount recoverable from customers.

Query No. 3

Subject: Accounting for decommissioning provision for oil and gas assets.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is engaged in exploration, development and production of crude oil, natural gas and value added products. The company, in course of its business, primarily undertakes drilling of exploratory and development wells. All exploration and evaluation costs incurred in drilling and equipping exploratory and appraisal wells, are initially capitalised as 'Intangible assets under development - Exploratory Wells in Progress' till the time these are either transferred to oil and gas assets on completion or expensed as exploration and evaluation cost (including allocated depreciation) as and when determined to be dry or of no further use, as the case may be. In case of abandonment / relinquishment of 'Intangible Assets under development - exploratory wells in progress', such costs are written off.

2. The querist has stated that a well drilled within the proved area of an oil and gas reservoir to the depth of a horizon known to be productive is called a development well and all costs relating to development are initially accounted for as 'oil and gas assets under development - development wells in progress'. Such costs are capitalised by transferring to oil and gas assets when a well is ready to commence commercial production.

3. Oil and gas assets are stated at historical cost less accumulated depletion and impairment losses. These are created in respect of an area / field having proved developed oil and gas reserves, when the well in the area / field is ready to commence commercial production. Cost of temporary occupation of land, successful exploratory wells, all development wells (including service wells), and allied facilities, depreciation on support equipment used for drilling and estimated future decommissioning costs are capitalised and classified as oil and gas assets.

4. Abandonment costs (or decommissioning costs) are the costs incurred on discontinuation of all operations and surrendering the property back to the owner. These costs relate to plugging and abandoning of wells; dismantling of wellheads, production and transport facilities; and for restoration of

[1] Opinion finalised by the Committee on 16.3.2020.

producing areas in accordance with license requirements, and the relevant legislations and adopted practices.

5. Till the financial year (F.Y.) 1998-99, there was no specific guidance on accounting for abandonment liability, and all expenditure relating to abandonment of well sites or allied facilities was charged to profit and loss account on actual expenditure basis. The wells and allied facilities were capitalised under two heads, expenditure and depreciation, which together formed oil and gas assets.

6. On the basis of recommendations of International Maritime Organization (IMO) Guidelines that all abandoned or disused installations or structures emplaced on the sea-bed on or after 1st January 1998, standing in less than 100 m of water and weighing less than 4,000 tonnes in air, excluding the deck and superstructure, should be entirely removed. A committee was constituted by the company which submitted its first report in the year 1999 on various removal and disposal options for abandonment and accordingly, from F.Y. 1999-2000, the company started providing for abandonment liability towards offshore well sites based on the technical assessment. Wells which were likely to be abandoned during next fifteen years were provided equally over the remaining useful life of such properties. The abandonment of onshore well sites was accounted for in the year in which such cost was incurred.

7. In July 2002, multidisciplinary committee was formed by the company to review and update the previous committee's report; the committee submitted its report in March 2003 as per its recommendations. From F.Y. 2002-03, abandonment liability towards offshore wells sites along with allied facilities was provided for on the basis of the latest technical assessment available with the company. Whereas there was no change in the accounting for abandonment liability of onshore well sites and the abandonment of onshore well sites was accounted for in the year in which such cost was incurred.

8. The querist has stated that the Institute of Chartered Accountants of India (ICAI) issued Guidance Note on Accounting for Oil and Gas Producing Activities (Issued 2003), which provided the following guidance on accounting for abandonment cost for the first time:

> "54. The *full eventual liability for abandonment cost net of salvage values* should be recognised at the outset on the ground that a liability

to remove an installation exists the moment it is installed. Thus, an enterprise should capitalise as part of the cost centre the amount of provision required to be created for subsequent abandonment. *Charge for abandonment costs should not be discounted to its present value*. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc.

55. *No gain or loss* should be recognized if only an individual well or individual item of equipment is abandoned as long as the remainder of the wells in the cost centre continue to produce oil or gas. Instead, the asset being abandoned be deemed to be fully depreciated. When *the last well on the cost centre ceases to produce* and the entire cost centre is abandoned, *gain or loss should be recognised*."

"43. Depreciation base of the cost centre should include

(a) Gross block of the cost centre (excluding acquisition costs)

(b) Estimated dismantlement *and abandonment costs net of estimated salvage* values pertaining to proved developed oil and gas reserves and should be reduced by the accumulated depreciation and any accumulated impairment charge of the cost centre."

(Emphasis supplied by the querist.)

9. The querist has further stated that from F.Y. 2003-04 to F.Y. 2008-09, based on the initial technical assessment, offshore well sites and allied facilities had huge abandonment cost but salvage value was negligible whereas, onshore wells and allied facilities had lesser abandonment cost than the salvage value. Accordingly, as per the requirements of the Guidance Note and technical assessment, the company recognised abandonment cost (net of salvage value) of offshore well site and allied facilities at initial stage and depreciated such abandonment cost (net of salvage value) along with other producing properties. Abandonment liability of onshore well site and allied facilities were not recognized at initial stage. Abandonment cost of onshore wells and facilities were charged to profit and loss account on the actual abandonment of the wells and facilities.

10. The company adopted to capture and deplete abandonment cost of offshore well sites separately in the following way under three components, viz., expenditure, depreciation and abandonment cost net of salvage value.

11. In F.Y. 2009-10, statutory auditors and Comptroller and Auditor General (CAG) audit insisted for review of abandonment policy for onshore sites and allied facilities. Accordingly, a committee was constituted with the members of finance and technical disciplines to ascertain the methodology and liability of existing onshore wells and allied facilities. The committee's report suggested that onshore well sites had considerable abandonment cost and its salvage value was lesser than its abandonment cost whereas the abandonment cost of onshore facilities was lesser than the salvage value.

12. Accordingly, from F.Y. 2009-10 to 2012-13, the company started providing for abandonment cost (net of salvage value) of onshore well site at initial stage and depreciated such abandonment cost (net of salvage value) along with oil and gas assets. Whereas the abandonment costs of onshore facilities were accounted for in the year in which such costs were incurred as the salvage value was expected to take care of the abandonment costs. The abandonment cost on dry well was expensed as exploratory well cost.

13. The ICAI revised Guidance Note on Accounting for Oil and Gas Producing Activities in 2013, which provided following guidance on accounting for abandonment cost:

> "36. *The full eventual liability for abandonment cost* should be recognised when the obligation arises, on the ground that a liability to remove an installation exists the moment it is installed. Thus, an enterprise should capitalise as part of the cost centre the amount of provision required to be created for subsequent abandonment. *Charge for abandonment costs should not be discounted to its present value*. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc.
>
> Changes in the measurement of existing abandonment costs that result from changes in the estimated amount of the outflow of resources embodying economic benefits required to settle the obligation should be added to, or deducted from the related cost center in the current period and would be considered for necessary depletion (depreciation) prospectively.
>
> **Abandonment of Properties**
>
> 37. No gain or loss should be recognised if only an individual well or individual item of equipment is abandoned as long as the remainder of

the wells in the cost centre continues to produce oil or gas. When the last well on the cost centre ceases to produce and the entire cost centre is abandoned, gain or loss should be recognised."

"31. The depreciation base of the cost centre should include

a. Gross block of the cost centre;

b. The estimated future expenditure (based on current costs) to be incurred in developing the proved oil and gas reserves referred to in paragraph32;

c. Estimated dismantlement and abandonment costs net of estimated salvage values (refer to paragraphs 35-36) for facilities set up for developing the proved oil and gas reserves referred to in paragraph 32;

and should be reduced by the accumulated depreciation and any accumulated impairment charge of the cost centre."

As per the revised Guidance Note 2013, full abandonment provisions were recognised to the respective assets. Earlier, abandonment cost (net of salvage value) used to be recognised but revised Guidance Note dropped the word *'net of salvage value'* from the cost. This cost should be considered at current prices and need not be fair valued. Any subsequent change in the abandonment cost was required to be adjusted with the related assets and would be depreciated prospectively. Paragraph 31 of the Guidance Note specifically states that, while calculating depletion, abandonment cost net of estimated salvage value need to be taken into account.

(Emphasis supplied by the querist.)

14. Accordingly, from *F.Y. 2013-14 to 2015-16*, the company capitalised the full abandonment provision (gross of salvage value) under four components, viz., *Expenditure, Depreciation, Abandonment cost (net) and Salvage Value for all onshore and offshore oil and gas assets*, however, while computing depletion on oil and gas assets, salvage value component was not considered.(Emphasis supplied by the querist.)

15. On notification of Companies (Indian Accounting Standards) Rules, 2015 by Ministry of Corporate Affairs, the ICAI again revised Guidance Note on Accounting for Oil and Gas Producing Activities (Issued 2016) for entities to whom Ind AS is applicable, which provided guidance on accounting for

abandonment costs as follows:

"Accounting for Abandonment Costs

33. Abandonment costs are the costs incurred on discontinuation of all operations and surrendering the property back to the owner. These costs relate to plugging and abandoning of wells; dismantling of wellheads; production; and transport facilities and to restoration of producing areas in accordance with license requirements and the relevant legislation.

34. In accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets,* an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources. Thus, an entity should capitalise as part of property, plant and equipment or intangible asset, as the case may be, the amount of provision required to be created for subsequent abandonment. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc. **Where the effect of the time value of money is material, the amount of the provision should be the present value of the expenditures expected to be required to settle the obligation.** The discount rate (or rates) should be a pre- tax rate (or rates) that reflect current market assessments of the time value of money and the risks specific to the liability. The discount rate should not reflect risks for which future cash flow estimates have been adjusted. **Changes in the measurement of existing abandonment costs** that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation or a change in the discount rate should be added to, or deducted from the related field in the current period and would be considered for necessary depletion (depreciation) prospectively. However, the change in the estimated provision due to the **periodic unwinding of the discount** should be recognized in statement of profit and loss as it occurs. Since abandonment costs do not reflect borrowed funds, the unwinding cost would not be a borrowing cost eligible for capitalization.

Abandonment of Properties

35. No gain or loss should be recognised if only an individual well or individual item of equipment is abandoned or decided as dry as long as the remainder of the wells in the field continues to produce oil or gas. When the last well on the field ceases to produce and the entire field is abandoned, gain or loss should be recognised."

"28. Depreciation base of the field should include:

(i) Gross block of the field (excluding acquisition costs)

(ii) Estimated, decommissioning and abandonment costs **net of estimated salvage values** pertaining to proved developed oil and gas reserves

and should be reduced by the accumulated depreciation and any accumulated impairment charge of the field."

(Emphasis supplied by the querist.)

16. Paragraph D21 of Appendix D, 'Exemptions from other Ind ASs' to Ind AS 101, 'First-time Adoption of Indian Accounting Standards' provides as follows:

"D21 Appendix 'A' to Ind AS *16 Changes in Existing Decommissioning, Restoration and Similar Liabilities* requires specified changes in a decommissioning, restoration or similar liability to be added to or deducted from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. A first-time adopter need not comply with these requirements for changes in such liabilities that occurred before the date of transition to Ind ASs. If a first-time adopter uses this exemption, it shall:

(a) measure the liability as at the date of transition to Ind ASs in accordance with Ind AS 37;

(b) to the extent that the liability is within the scope of Appendix A of Ind AS 16, estimate the amount that would have been included in the cost of the related asset when the liability first arose, by discounting the liability to that date using its best estimate of the historical risk adjusted discount rate(s) that would have applied for that liability over the intervening period; and

(c) calculate the accumulated depreciation on that amount, as at the date of transition to Ind ASs, on the basis of the current estimate of the useful life of the asset, using the depreciation policy adopted by the entity in accordance with Ind ASs."

17. Under the Previous GAAP, discounting of provisions was not required whereas under Ind AS, provisions are to be measured at discounted amounts, if the effect of time value of money was material. Availing exemption available under paragraph D21, the company measured the decommissioning provision in accordance with Ind AS 37 as at the transition date 01.04.2015 and computed the estimate of the amount that would be included in the cost of related oil and gas assets by discounting the decommissioning provision computed at transition date using the best estimate of historical risk adjusted discount rate to the date when the liability first arose. Thereafter, the company has computed depletion on oil and gas assets on the estimated amount using unit of production method.

18. Accordingly, the decommissioning provision was estimated and consequently adjustments to oil and gas assets and decommissioning provisions were made on transition to Ind ASs. The company re-measured decommissioning provisions at the transition date by availing the optional exemption as per paragraph D21 of Ind AS 101, 'First-time Adoption of Indian Accounting Standards'. This resulted in decrease in decommissioning provision by Rs. 61,250.20 million. Depletion was charged on the resulting present value from the date that the obligation first arose to the date of transition (on the basis of gross block/accumulated depletion ratio) subject to minimum of the salvage value of the assets as on the transition date. The difference between the written down value of the asset created towards abandonment provision and the amount calculated resulted in decrease in oil and gas assets by Rs. 65,876.14 million. Similarly, CWIP-Development wells in progress decreased by Rs. 259.58 million and CWIP-Other decreased by Rs. 120.00 million as at April 1, 2015.

Similarly, it also resulted in decrease in decommissioning provision by Rs. 88,388.01 million and decrease in oil and gas assets by Rs. 90,955.17 million, other property, plant & equipment by Rs. 187.50 million, CWIP-

Development wells in progress by Rs. 34.17 million, CWIP-Others by Rs. 1,222.70 million and Inventory by Rs. 164.89 million as at March 31, 2016. Further, there was also a reduction in transfer from CWIP-Development wells in progress by Rs. 202.66 million.

The net effect of aforesaid changes was decrease in total equity by Rs. 5,005.26 million as at April 1, 2015 and Rs. 4,396.16 million as at March 31, 2016.

For the aforesaid purposes, the salvage value was restricted to the abandonment provision. The capitalised portion of abandonment asset was bifurcated into salvage value and other depletable asset.

19. The querist has reproduced the following paragraphs of Appendix A, 'Changes in Existing Decommissioning, Restoration and Similar Liabilities' to Ind AS 16, 'Property, Plant and Equipment':

"4 Changes in the measurement of an existing decommissioning, restoration and similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, shall be accounted for in accordance with paragraphs 5–7 below.

5 If the related asset is measured using the cost model:

(a) subject to (b), changes in the liability shall be added to, or deducted from, the cost of the *related asset* in the current period.

(b) the amount deducted from the cost of the asset shall not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

(c) if the adjustment results in an addition to the cost of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the entity shall test the asset for impairment by estimating its recoverable amount, and shall account for any impairment loss, in accordance with Ind AS 36."

"7 The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur. This applies under both the cost model and the revaluation model.

8 The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under Ind AS 23 is not permitted."

(Emphasis supplied by the querist.)

20. The Current accounting policy of decommissioning provision has been reproduced by the querist hereunder:

"Decommissioning cost includes cost of restoration. Provision for decommissioning costs is recognized when the Company has a legal or constructive obligation to plug and abandon a well, dismantle and remove a facility or an item of Property, Plant and Equipment and to restore the site on which it is located. The full eventual estimated provision towards costs relating to dismantling, abandoning and restoring well sites and allied facilities are recognized in respective assets when the well is complete / facilities or Property, Plant and Equipment are installed.

The amount recognized is the present value of the estimated future expenditure determined using existing technology at current prices and escalated using appropriate inflation rate till the expected date of decommissioning and discounted up to the reporting date using the appropriate risk free discount rate.

An amount equivalent to the decommissioning provision is recognized along with the cost of exploratory well or Property, Plant and Equipment. The decommissioning cost in respect of dry well is expensed as exploratory well cost.

Any change in the present value of the estimated decommissioning provision other than the periodic unwinding of discount is adjusted to the decommissioning provision and the corresponding carrying value of the related asset. In case reversal of decommissioning provision exceeds the corresponding carrying amount of the related asset, the excess amount is recognized in the Statement of Profit and Loss. The unwinding of discount on provision is charged in the Statement of

Profit and Loss as finance cost.

Provision for decommissioning cost in respect of assets under Joint Operations is considered as per participating interest of the Company on the basis of estimates approved by the respective operating committee. Wherever the same are not approved by the respective operating committee, decommissioning cost estimates of the company are considered."

21. *Estimation of provision for decommissioning*

The company estimates provision for decommissioning as per the principles of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' for the future decommissioning of oil and gas assets at the end of their economic lives. Most of these decommissioning activities would be in the future, the exact requirements that may have to be met when the removal events occur are uncertain. Technologies and costs for decommissioning are constantly changing. The timing and amounts of future cash flows are subject to significant uncertainty.

The timing and amount of future expenditures are reviewed at the end of each reporting period, together with rate of inflation for escalation of current cost estimates and the interest rate used in discounting the cash flows. The economic life of the oil and gas assets is estimated on the basis of long term production profile of the relevant oil and gas asset. The General Consumer Price Index (CPI) for inflation i.e. 4.28% (Previous year 3.81%) has been used for escalation of the current cost estimates and pre-tax discounting rate used to determine the balance sheet obligation as at the end of the year is 7.56% (Previous year 7.12%), which is the risk free government bond rate with 10 year yield.

The abandonment provision is re-estimated annually by calculating the abandonment estimates at current cost and escalated @ CPI inflation and discounted at return on 10 year G- SEC. Any increase in provision is capitalised and decrease was adjusted with the written down value (WDV) of capitalised portion of abandonment provision and where the WDV was zero, the differential provision was taken to the statement of profit and loss. Accordingly, an amount Rs. 6,101.94 million, Rs. 20,048.04 million, Rs. 2,035.64 million, and Rs. 3,510.16 million, has been taken to statement of profit and loss towards excess provision written back in 2015-16, 2016-17, 2017-18 and 2018-19 respectively.

B. Query

22. The Expert Advisory Committee of the ICAI is requested to give opinion on the following queries:

(a) Whether the company is correct in accounting

   (i) for increase in decommissioning provision estimates by way of capitalizing with oil and gas assets,

   (ii) decrease in decommissioning provision estimates as an adjustment to the written down value (WDV) of capitalised portion of abandonment provision, and

   (iii) where the WDV of capitalised portion of abandonment provision is zero the differential provision is taken to the statement of profit and loss or

(b) The company should adopt any other accounting treatment?

(c) If the answer to (b) above is 'yes', whether the suggested accounting treatment will call for retrospective adjustment in the financial statements.

C. Points considered by the Committee

23. The Committee notes that the basic issue raised by the querist relates to accounting for decommissioning obligations arising in respect of removal and restoration expenditure for onshore and offshore wells and other facilities of the company under Indian Accounting Standards. These costs have been, hereinafter, broadly referred to as 'decommissioning costs'. The Committee has, therefore, restricted the opinion only to this issue and has not examined any other issue that may arise from the Facts of the Case, such as, compliance with IMO guidelines, determination/estimation of the removal/ restoration costs and salvage value, the appropriateness of the discount rate used by the company, accounting for decommissioning obligations arising towards removal and restoration under previous GAAP (i.e., before transition to Ind ASs), method used by the company for depreciation and depletion, accounting for exploration and evaluation expenditure, accounting for dry wells, accounting for interest in joint operation, accounting for decommissioning or restoration provision during the production phase, and transition accounting under Ind AS 101 on first time adoption of Ind ASs. Further, the Committee presumes that change in

decommissioning liability in the extant case is due to changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, as covered under Appendix A, 'Changes in Existing Decommissioning, Restoration and Similar Liabilities' to Ind AS 16 and not due to other factors, such as changes in exchange rates, etc. The Committee also wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended/revised from time to time.

24. The Committee notes that Ind AS 106, 'Exploration for and Evaluation of Mineral Resources', states the following:

> "5 An entity shall not apply this Ind AS to expenditures incurred:
>
> (a) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area.
>
> (b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable."
>
> "11 In accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets* an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources."

The Committee notes that after the technical feasibility and commercial viability of extracting a mineral resource is demonstrated, the accounting for decommissioning and restoration costs is governed by the requirements of Ind AS 37 and Appendix A, 'Changes in Existing Decommissioning Restoration and Similar Liabilities' to Ind AS 16. Further, Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable), issued by the ICAI provides guidance, inter alia, for decommissioning and restoration costs incurred in respect of oil and gas producing activities. The Committee notes the requirements of Ind AS 37, Guidance Note and Appendix A as follows:

> *Ind AS 37*
>
> **"36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present**

obligation at the end of the reporting period.

37 The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period."

"42 The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

43 Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

44 Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 85(b).

Present value

45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

46 Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more

onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted."

Appendix A to Ind AS 16

"4 Changes in the measurement of an existing decommissioning, restoration and similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, shall be accounted for in accordance with paragraphs 5–7 below.

5 If the related asset is measured using the cost model:

(a) subject to (b), changes in the liability shall be added to, or deducted from, the cost of the related asset in the current period.

(b) the amount deducted from the cost of the asset shall not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

(c) if the adjustment results in an addition to the cost of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the entity shall test the asset for impairment by estimating its recoverable amount, and shall account for any impairment loss, in accordance with Ind AS 36."

"7. The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur. This applies under both the cost model and the revaluation model.

8. The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under Ind AS 23 is not permitted."

Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable):

"**Accounting for Abandonment Costs**

33. Abandonment costs are the costs incurred on discontinuation of all operations and surrendering the property back to the owner. These costs relate to plugging and abandoning of wells; dismantling of wellheads; production; and transport facilities and to restoration of producing areas in accordance with license requirements and the relevant legislation.

34. In accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources. Thus, an entity should capitalise as part of property, plant and equipment or intangible asset, as the case may be, the amount of provision required to be created for subsequent abandonment. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc. Where the effect of the time value of money is material, the amount of the provision should be the present value of the expenditures expected to be required to settle the obligation. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect current market assessments of the time value of money and the risks specific to the liability. The discount rate should not reflect risks for which future cash flow estimates have been adjusted. Changes in the measurement of existing abandonment costs that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation or a change in the discount rate should be added to, or deducted from the related field in the current period and would be considered for necessary depletion (depreciation) prospectively. However, the change in the estimated provision due to the periodic unwinding of the discount should be recognized in statement of profit and loss as it occurs. Since

abandonment costs do not reflect borrowed funds, the unwinding cost would not be a borrowing cost eligible for capitalization.

Abandonment of Properties

35. No gain or loss should be recognised if only an individual well or individual item of equipment is abandoned or decided as dry as long as the remainder of the wells in the field continues to produce oil or gas. When the last well on the field ceases to produce and the entire field is abandoned, gain or loss should be recognised."

The Committee notes from the above that an entity should recognise a decommissioning or restoration provision in respect of the obligation to remove facilities and to restore the environment and that this obligation may arise even before any production takes place. The Committee further notes that the accounting for decommissioning provision will depend on how the related costs have been accounted for. If the related costs are capitalised, the associated decommissioning costs should also be capitalised. However, if the related costs are expensed (such as certain exploration and evaluation costs that do not meet the capitalization criteria under Ind AS 106), any associated decommissioning or restoration costs should also be expensed. Further, an increase in the decommissioning or restoration provision resulting from revised estimates would result in recognition of an addition to the cost of asset. However, Appendix A to Ind AS 16 specifically states that any addition to an asset as a result of an increase in a decommissioning or restoration provision may be considered to be a trigger for impairment testing. Resultantly, a significant increase in a decommissioning or restoration provision may lead to an immediate impairment of that asset.

Conversely, a decrease in the decommissioning or restoration provision could exceed the carrying amount of the related asset, in which case the excess (after adjusting the entire carrying amount of the related asset and not only to the extent of WDV of the capitalised portion of abandonment provision in the carrying amount of related asset) should be recognised in the statement of profit or loss. The Committee is of the view that as per the requirements of Appendix A to Ind AS 16, an entity reduces the carrying value of the whole asset (comprising its acquisition/ construction cost and decommissioning/abandonment cost) by the reduction in the present value of the decommissioning provision. The Appendix does not treat the decommissioning/abandonment element as a separate component of the asset. Accordingly, it would not be appropriate to recognise any gain until the carrying value of the whole asset is extinguished. Further, the adjusted depreciable amount capitalized is depreciated over the remaining useful life of the asset. Once the related asset has reached the end of its useful life (for example, in cases, where the carrying amount of the asset is zero), all subsequent changes in the decommissioning liability should be recognised in profit or loss as they occur.

25. The Committee notes that Ind AS 37 contains the above-reproduced guidance with regard to the measurement of decommissioning obligation, as per which the amount of provision should be made at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period and where the effect of time value of money is material, the amount of provision should be the present value of the expenditure expected to be required to settle the obligation. The Committee also notes that Ind AS 37 also requires that risk should be taken into account while determining the discount rate in the calculation of a provision. An entity should use a discount rate that reflects current market assessments of the time value of money and the risks specific to the liability (viz., a risk- adjusted rate). Thus, the Committee is of the view that the company in the extant case should adjust risk–free Government securities' rate for the risks specific to the liability, as discussed above.

D. Opinion

26. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 22 above:

(a) As discussed in paragraph 24 above, an increase in the decommissioning or restoration provision resulting from revised estimates would result in recognition of an addition to the cost of asset. However, a significant increase in a decommissioning or restoration provision may lead to an immediate impairment of that asset. Conversely, a decrease in the decommissioning or restoration provision could exceed the carrying amount of the related asset, in which case the excess (after adjusting the entire carrying amount of the related asset and not only to the extent of WDV of the capitalised portion of abandonment provision in the carrying amount of related asset) should be recognised in the statement of profit or loss. Further, the adjusted depreciable amount capitalized is depreciated over the remaining useful life of the asset. Once the related asset has reached the end of its useful life (for example, in cases, where the carrying amount of the asset is zero), all subsequent changes in the decommissioning liability should be recognised in profit or loss as they occur.

Further, as discussed in paragraph 25 above, with regard to the measurement of decommissioning obligation, the amount of provision should be made at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period and where the effect of time value of money is material, the amount of provision should be the present value of the expenditure expected to be required to settle the obligation. Furthermore, as Ind AS 37 requires that risk should be taken into account while determining the discount rate in the calculation of a provision, the company should use a discount rate that reflects current market assessments of the time value of money and the risks specific to the liability (viz., a risk- adjusted rate). Thus, the company in the extant case should adjust risk–free Government securities' rate for the risks specific to the liability, as discussed in paragraph 25 above.

(b) Refer to (a) above.

(c) To the extent the company's accounting treatment is deviant from that mentioned in paragraphs 26 (a) above, the company shall account for the same in accordance with the requirements of Ind AS 8, 'Accounting Policies, Changes in Estimates and Errors'.

Query No. 4

Subject: Presentation and classification of dues recoverable from banks on account of invocation of bank guarantee.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Corporation' or 'the Company') is a Government of India enterprise (public sector undertaking) under the Ministry of Micro, Small and Medium Enterprises (MSME). The Company has been working to promote, aid and foster the growth of micro, small and medium enterprises in the country. The Company operates through countrywide network of offices and technical centers in the country. In addition, it has set up training cum incubation centre managed by professional manpower.

2. The Company facilitates micro, small and medium enterprises with a set of specially tailored scheme to enhance their competitiveness. The Company provides integrated support services under marketing, technology, finance and other support service. Amongst the various schemes of the Company, financing for procurement of raw material (short term) is one of the flagship schemes and is being carried out by the Company. The scheme is called as 'Raw Material Assistance Scheme (RMA) against the Security of BG'.

3. The purpose of the scheme is to assist micro, small and medium enterprises (MSME) in procuring their essential raw material(s) (both indigenous and imported) on credit; the Company arranges to provide raw material as per specific needs and requirement of the unit(s). This gives an opportunity to MSMEs to focus better on manufacturing quality products.

4. The salient features of the scheme are as follows:

   a) Financial assistance for procurement of raw materials up to 90 days.

   b) Bulk purchase of basic raw materials at competitive rates.

   c) The Company facilitates import of scarce raw materials.

   d) The Company takes care of all the procedures, documentation and issue of letter of credit in case of imports.

   e) The facilitation under the scheme is for procurement of:

[1] Opinion finalised by the Committee on 21.4.2020.

- Bulk raw materials namely aluminum, zinc, copper, iron & steel, cement etc., which are arranged through the Company entering into a Memorandum of Understanding (MoU) with their manufacturers.
- Raw materials from the suppliers (other than with whom MOU arrangement is made) on the specific request of the micro, small and medium enterprises.

Under both arrangements, the supplier is selected by the MSMEs and payment at the request of unit is released by the Company directly to the supplier / manufacturer of the raw materials.

5. Accounting treatment for the financial assistance released by the Company for procurement of raw materials to the supplier on behalf of the MSME unit against the security of bank guarantee (BG):

1. Against the application from MSME for the purpose of sanctioning of limit for raw material assistance against the security of BG and after due compliance of procedure for sanctioning of the limit (comprising of pre-sanction inspection of the unit, credit worthiness report and financial appraisal), limit sanction letter is issued.
2. After sanctioning of limit and before disbursement of assistance, various documents which inter-alia includes agreement, material receipt note, demand promissory note, letter of continuity, BG from approved bank along-with its SFMS confirmation and/or confirmation from the BG issuing bank & its controlling office and personal guarantee of the Directors/ Partners/ Proprietor/ Society Office Bearers, are collected from the MSME unit. All the documents are thereafter vetted legally.
3. After confirming all the documents being in order, the MSME unit submits the invoice of the supplier for disbursement directly to the supplier against the vacant limit available w.r.t. the BGs submitted. It is apt to mention that maximum disbursement can be made is 95% of the BG value or the vacant limit available, whichever is lower.
4. While disbursement of the financial assistance, it is ensured that the total outstanding dues (including the proposed financial assistance), interest, processing fees and miscellaneous

expenses, if any, do not exceed the value of the BGs submitted against the overall limit sanctioned, at any point of time.

5. Since the bank guarantee is considered to be unsecured by virtue of an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) dated 15/09/82 (a copy of the opinion has been supplied separately by the querist for the perusal of the Committee), therefore the dues recoverable from MSMEs against the security of BG are also considered as '*Loans and Advances - Unsecured Considered Good*'. While preparing the annual accounts, such dues are reflected under Note-19 – '*Short Term Loans and Advances*' under the head '*Loans and Advances - Unsecured Considered Good (Backed by BG)*'. The extract of Note-19 of the audited annual accounts for the year 2017-18 has been provided separately by the querist for the perusal of the Committee.

6. In case, the BGs are invoked by the Corporation due to default made by the MSME unit in repayment of dues of raw material assistance and the respective bank has not honored/paid the invoked amount of BG to the Corporation as on 31st March of the financial year, the dues are shown as recoverable from the respective bank instead of the MSME unit, who has submitted the BG issued by the respective bank in favour of the Corporation. Such depiction has been followed by the Corporation since 2017-18 only. While preparing the annual accounts, such dues are reflected under Note-19 – '*Short Term Loans and Advances*' under the head '*Advance Recoverable in Cash or in Kind or for Value to be Received - Unsecured Considered Good – from banks (Backed by BG)*'. The extract of Note-19 of the audited annual accounts for the year 2017-18, has been provided separately by the querist for the perusal of the Committee.

7. It is apt to mention that in accordance with the Notification dated March 30, 2016, issued by the Ministry of Corporate Affairs, the Corporation has adopted Indian Accounting Standards (referred to as 'Ind AS') notified under the Companies (Indian Accounting Standards) Rules 2015 (as amended) with effect from April 1, 2018. Therefore, the corporation's first Ind AS financial statements is for the period ending 31/03/19 with comparative figures as on

31/03/18 and 01/04/17.

8. In the financial statements under Ind AS for the financial year 2019-20, the dues recoverable from MSMEs against the security of BG are continued to be reflected under Note-14 – "Loans and Advances" under the head "*Covered by Bank/ Government Guarantees*". The extract of Note-14 for the year 2018-19, has been provided separately by the querist for the perusal of the Committee. However, amount recoverable from banks against the BGs invoked but not yet received, have been reflected under Note-15- "*Other Financial Assets*" under the head "*Receivables from Banks-Others*", following the guidelines applicable under Ind AS. The extract of Note- 15 for the year 2018-19 has also been provided separately by the querist for the perusal of the Committee.

(Emphasis supplied by the querist.)

6. The querist has informed the basis for depicting amount recoverable from banks against the BGs invoked but not yet received under "*Advance Recoverable in Cash or in Kind or for Value to be Received - Unsecured Considered Good – from banks (Backed by BG)*" under Note-19 during 2017-18 and under Note-15- "*Other Financial Assets*" under the head "*Receivables from Banks-Others*" during 2018-19, respectively, inter-alia includes various covenants of the bank guarantee(s) as mentioned below:

1. *At the outset, it is pertinent to clarify that the bank guarantee is tripartite agreement between banker (bank), the beneficiary (the Corporation) and the MSME unit, in which the bank become the surety for the transaction between the beneficiary (the Corporation) and MSME unit. It is a written contract given by a bank on behalf of a customer (MSME unit), wherein the bank undertakes to pay or discharge the liability of the customer in case of any default. In case the beneficiary invokes the bank guarantee and a letter invoking the same is sent in terms of the bank guarantee, it is obligatory on the bank to make payment to the beneficiary.*

2. *On invocation of the BGs, the primary liability for the payment against such invoked BGs* ***is of the bank****. Hence, in the financial statements for the financial year (2017-18), it was felt necessary for showing the dues recoverable from the banks on account of*

invocation of BGs, separately so that the reader of financial statements of the Corporation should understand the correct picture.

3. *The querist has given some of the extracts from the Bank Guarantee Bond which are as follows:*

   - We, …, hereinafter referred to bank at the request of M/s … (Borrower) do hereby undertake to pay to the Corporation an amount … against any loss or damage caused to or suffered or would be caused or suffered by the Corporation by reason of any breach by the said Borrower of any of the terms and conditions … of the unit.

   - The Bank further agree that the Corporation shall be sole judge whether the said Borrower has committed any breach or breaches of any of the terms and conditions of the said agreement and the extent of loss, damage, cost, charges and expenses suffered due to any default / delay on the part of Borrower in payment of Corporation's dues, other charges, expenses or payment demanded by the Corporation in terms of the said agreement. The bank hereby also waive in favour of the Corporation all rights and defense / plea to which as guarantor the bank may be entitled to. *To give effect to this guarantee, the Corporation may act as though the bank were the principal debtors.*

   - *The Bank do hereby undertake to pay the amounts due and payable under this guarantee without any demur*, merely on a demand from the Corporation … Any such demand made on the bank shall be conclusive as regards the amount due and payable by the bank under this guarantee …

   - The bank undertake to pay to the Corporation any money so demanded notwithstanding any dispute or disputes raised by the Borrower in any suit or proceeding pending before any court or Tribunal relating thereto, bank's liability under these presents being absolute and unequivocal … "

   - The bank further agrees that the Corporation shall have the fullest liberty … and the bank shall not be relieved from its liability by reason of any such variation or extension being granted to the said Unit or for any forbearance, act or omission on the part of the Corporation or any indulgence by the Corporation to the said Unit or by any such matter or thing whatsoever which under the laws relating to sureties would, but for this provision have the effect of so relieving the bank.

- The copy of BG issued by Bank, has been provided separately by the querist for the perusal of the Committee.

(Emphasis supplied by the querist.)

7. The detailed *facts of the dispute* have been provided separately by the querist for the perusal of the Committee.

8. During the course of audit of accounts of the Corporation for the year ending 31st March, 2018, Dy. Director of Indian Audit & Accounts Department, Office of the Principal Director of Commercial Audit & Ex-Officio Member, Audit Board-1, New Delhi, had raised observation w.r.t. regrouping of disputed advance amount backed by BG carried out during 2017-18 requires to be modified and outstanding dues be restored to initial classification done in 2016-17. The copy of letter issued by the office of MAB has been supplied separately by the querist for the perusal of the Committee. In this regard, the observation raised and the corresponding reply along with assurance submitted by the management are reiterated as below:

<u>Half Margin (HM) No. 8</u> **Balance Sheet-Assets- Short Term Loan & Advances (Note 19)- Rs. 295128.12 lakh**	
The Corporation got reconfirmation of its BGs during 2016-17, whereupon it came to notice of the Corporation that BGs amounting to Rs. 17350 lakh against which outstanding RMA dues amounted to Rs. 17057.38 lakh, have been invoked by Union Bank of India (bank). Accordingly, the Corporation accounted for the above outstanding RMA dues	With reference to said HM, it is pertinent to mention that the bank referred therein should be read as … bank. Further, it is stated that during the financial year 2016-17, this amount was shown as a footnote against the relevant head in Note-19, which comprises of such amount. The BGs issued by the bank guarantees that the amount shall be paid by it '… under this guarantee without any

of Rs. 17057.38 lakh in above Account Head under Other Loans & Advances. Pay Orders (POs) amounting to Rs. 15350 lakh (Annexure I enclosed) in favour of the Corporation were directly received by MSME units from bank and were deposited on the pretext of settlement of RMA dues; these POs were issued by bank upon invocation of BGs during 2013-14 to 2015-16.	demur ….’. As in these cases, the outstanding dues are backed by original valid BGs and invocation claim by the Corporation has been submitted with the bank within the validity period of the BGs, the amount is recoverable from the bank (bank). On invocation of the BGs, now the primary liability for the payment against such invoked BGs is of the bank. Hence, in the current year (2017-18) financial statements, it has been felt necessary for showing it separately so that the reader of financial statements of the Corporation should understand the correct picture.
During 2017-18, the Corporation has regrouped outstanding dues of Rs. 17057.38 lakh by deducting from Other Loan & Advances (which includes outstanding RMA dues of MSME units) and adding it to Advance Recoverable in Cash or in Kind or for value to be received (which includes BGs sent by the Corporation for invocation against which amount has not been received from Bank). The above regrouping has resulted in following accounting errors:	Accordingly, in order to depict correct, true and fair picture of the state of affairs in the Consolidated Financial Statements of the Corporation for the year 2017-18, the amount recoverable from the bank towards invoked BGs has been shown separately along with re-grouping of the outstanding dues w.r.t. corresponding previous year figures has been carried out.
1. BG is in the nature of a guarantee and no accounting entry is passed at the time of its receipt. Hence accounting a guarantee as “Advance Recoverable” is not correct.	Though the BG is in the nature of guarantee and no accounting entry is passed in the books of account in respect of BG as such, the amount receivable from any person/unit irrespective of the security backing such receivables are shown under

2. The above regrouping leads to an inference that no due is recoverable from MSME units, whereas the fact is that MSME units have improperly invoked the BGs and adjusted their Outstanding RMA dues of Rs. 15350 lakh by depositing POs directly obtained from bank upon invoking BGs without notice of the Corporation. In view of above, regrouping done in 2017-18 requires to be modified and outstanding dues be restored to initial classification done in 2016-17. The fact of POs amounting to Rs. 15350 lakh improperly utilized by MSME units to settle RMA dues needs disclosure.	the head "Advance Recoverable in cash or in kind or for value to be received" under Note 19 itself. Hence, accounting of receivables from bank as "Advance Recoverable" is correct. In view of the above, audit is requested to kindly drop the para. Since, the Corporation is in possession of original BGs issued by bank and invocation in respect of those BGs has already been made, the contention/claim of the bank is not tenable and would not immune bank in any way from their obligation for making payment. It is pertinent to mention that on invocation of any bank guarantee the primary responsibility to make the payment of rightful invocation of the BGs is lying with the bank. In view of the above, regrouping done in 2017-18 requires no modification and Outstanding dues need not to be restored to initial classification done in 2016-17. In view of the above, audit is requested to kindly drop the para.
Provisional Comment (PC) 1 : **Balance Sheet** **Assets** **Short Term Loan & Advances (Note 19)- Rs. 295128.12 lakh** The Corporation got reconfirmation of its BGs during 2016-17, where upon it	 This is further to our reply dtd. 04.09.2018 to the HM-8.

came to notice of the Corporation that BGs amounting to Rs. 17350 lakh against which outstanding RMA dues amounted to Rs. 17057.38 lakh, have been invoked by Bank. Accordingly, the Corporation accounted for the above outstanding RMA dues of Rs. 17057.38 lakh in above Account Head under Other Loans & Advances. Pay Orders (POs) amounting to Rs. 15350 lakh (Annexure I enclosed) in favour of the Corporation were directly received by MSME units from bank and were deposited on the pretext of settlement of RMA dues; these POs were issued by bank upon invocation of BGs during 2013-14 to 2015-16.	At the outset, it is pertinent to clarify that the bank guarantee is tripartite agreement between banker (bank), the beneficiary (the Corporation) and the MSME unit, in which the bank becomes the surety for the transaction between the beneficiary (the Corporation) and MSME unit. It is a written contract given by a bank on behalf of a customer (MSME unit), wherein the bank undertakes to pay or discharge the liability of the customer in case of any default. In case the beneficiary invokes the bank guarantee and a letter invoking the same is sent in terms of the bank guarantee, it is obligatory on the bank to make payment to the beneficiary. In this regard, we would like to refer the covenants of the bank guarantee(s) issued by the bank, Kolkata, which inter-alia includes the following:
During 2017-18, the Corporation has regrouped outstanding dues of Rs. 17057.38 lakh by deducting from Other Loan & Advances (which includes outstanding RMA dues of MSME units) and adding it to Advance Recoverable in Cash or in Kind or for value to be received (which includes BGs sent by the Corporation for invocation against which amount has not been received from Bank). The above regrouping has resulted in following accounting errors:	"*We, … hereinafter referred to … bank at the request of M/s… (Borrower) do hereby undertake to pay to the Corporation an amount ….against any loss or damage caused to or suffered or would be caused or suffered by the Corporation by reason of any breach by said Borrower of any of the terms and conditions ….* 1) *The Bank further agree that the Corporation shall be sole judge whether the said Borrower has committed any breach or breaches of any of the terms and conditions of the said agreement*

1. BG is in the nature of a guarantee and no accounting entry is passed at the time of its receipt. Hence accounting a guarantee as "Advance Recoverable" is not correct. 2. The above regrouping leads to an inference that no due is recoverable from MSME units, whereas the fact is that MSME units have improperly invoked the BGs and adjusted their Outstanding RMA dues of Rs. 15350 lakh by depositing POs directly obtained from bank upon invoking BGs without notice of the Corporation. 3. Classification and sub classification of Short-Term Loan & Advances is not in accordance with Schedule III of Companies Act, 2013 In view of above, regrouping done in 2017-18 requires to be modified and outstanding dues be restored to initial classification done in 2016-17. The fact of POs amounting to Rs. 15350 lakh improperly utilized by MSME units to settle RMA dues needs disclosure.	*and the extent of loss, damage, cost, charges and expenses suffered due to any default / delay on the part of Borrower in payment of Corporation's dues, other charges, expenses or payment demanded by the Corporation in terms of the said agreement. The bank hereby also waive in favour of the Corporation all rights and defense / plea to which as guarantor the bank may be entitled to.* ***To give effect to this guarantee, the Corporation may act as though the bank were the principal debtors.*** 2) *The Bank do hereby undertake to pay the amounts due and payable under this guarantee without any demur, merely on a demand from the Corporation ... Any such demand made on the bank shall be conclusive as regards the amount due and payable by the bank under this guarantee….* 3) *The bank undertake to pay to the Corporation any money so demanded notwithstanding any dispute or disputes raised by the Borrower in any suit or proceeding pending before any court or Tribunal relating thereto, bank's liability under these presents being absolute and unequivocal… .... "* As in these cases, the outstanding dues are backed by original valid BGs and invocation claim by the Corporation has been submitted with the bank within the validity period of the BGs, the amount is

	recoverable from the bank (bank). On invocation of the BGs, *now the primary liability for the payment against such invoked BGs is of the bank, which is also in line with the conditions agreed by the bank in the Bank Guarantee(s).* Further in this regard, it is pertinent to mention that the Ministry of MSME after examination of the case and finding of the CID, based on the QDEB report, has regularly taken up the matter with Department of Financial Services (DFS), Ministry of Finance asking the later to impress upon the bank to honour the Corporation's rightful invocation of bank guarantee worth Rs. 173.50 crore together with interest from the date of invocation. Copy of the letters dated 26.02.2018 and 09.05.2018 of Secretary, Ministry of MSME addressed to Secretary, DFS, Ministry of Finance is attached herewith, wherein this fact is reiterated that rightful invocation claims are payable by bank to the Corporation. We would also like to refer the OM No. 017/IND/009/388778 dated 03/08/18, of Central Vigilance Commission addressed to Cabinet Secretary wherein it is mentioned that the Cases of wrongful invocation of BGs / BGs not issued valuing Rs 173.50 crore, has been examined by the commission. '*The commission has observed several lapses on part of concerned banks in banking procedures while dealing with invocation of BGs in this case*'.

	'Hence, commission is of the opinion that a meeting may be convened with the senior officers from Directorate of Financial Services and Ministry of Small and Medium Enterprises by Cabinet Secretary to resolve the issue'. From the facts stated above, it can be seen that the primary liability for making the payment of invocation claim is of bank. Hence, in the current year (2017-18) financial statements, in order to depict correct, true and fair picture of the state of affairs in the Consolidated Financial Statements of the Corporation for the year 2017-18, the amount recoverable from the bank towards invoked BGs has been shown separately under the head "Advance Recoverable in cash or in kind or for value to be received" under Note 19 itself. This has been disclosed in the Note-35 para 5(b). On invocation of the BG while the primary liability for the payment against such invoked BG is of the bank as undertaken by the bank in the guarantee itself (refer para 1 above), the regrouping does not lead to any inference that no dues is recoverable from the unit. In view of the above, regrouping done in 2017-18 requires no modification and Outstanding dues need not to be restored to initial classification done in 2016-17. Further, it is pertinent to mention that the facts related to alleged invocation of bank guarantees by issuance of POs have already been

	disclosed appropriately in Note 35 para 5(b). As the separate disclosure of the said recoverable amount does not have any impact of the result / profitability as well as state of affairs of the Corporation as on 31.03.2018, audit is requested to drop the PC.
Assurance on the Provisional Comment (PC) -1 on the Audited Accounts for the FY 2017-18	This is further to our letter dated 14.9.2018 on the subject of 'Clarification w.r.t. Provisional Comment on the Audited Accounts of the Corporation for the year 2017-18', wherein it was assured that an appropriate disclosure will be made in the notes/ policies for the BGs invoked but amount not realized as on the Balance Sheet date in the ensuing financial year 2018-19. It is also submitted that such depiction will be reviewed in the current financial year 2018-19. Further, in this regard, Corporation will take note of provisions of Ind AS regarding disclosure of such items and in case it is not addressed adequately in the Ind AS, the Corporation shall seek expert opinion from the Institute of Chartered Accountants of India. The depiction / disclosure in the annual accounts for the year 2018-19 will be made in compliance with the provisions of Ind AS / ICAI opinion, as applicable. In view of the above, it is requested to drop the provisional comment.

The copy of replies as referred above has been provided separately by the querist for the perusal of the Committee.

B. Query

9. Considering the facts of the case, the querist seeks the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India in respect of the following:

Whether the following accounting errors have resulted in due to the reason of re-grouping of outstanding dues of Rs. 17057.38 lakh by shifting from Other Loan & Advances (which includes outstanding RMA dues of MSME units) to Advance Recoverable in cash or in kind or for value to be received (which includes BGs sent by the Corporation for invocation against which amount has not been received from bank) during 2017-18, as mentioned by the Office of Indian Audit & Accounts Department, Office of the Principal Director of Commercial Audit & Ex-Officio Member, Audit Board-1:

1. BG is in the nature of a guarantee and no accounting entry is passed at the time of its receipt. Hence, accounting a guarantee as 'Advance Recoverable' is not correct.

2. The above regrouping leads to an inference that no due is recoverable from MSME units, whereas the facts are that MSME units have improperly invoked the BGs and adjusted their outstanding RMA dues of Rs. 15350 lakh by depositing POs directly obtained from the bank upon invoking BGs without notice of the Corporation.

3. Classification and sub-classification of Short-Term Loan & Advance is not in accordance with Schedule III of Companies Act, 2013.

4. As Ind AS are applicable to the Corporation for the year 2018-19, therefore, in the financial statements under Ind AS for the year 2019-20, the dues recoverable from MSMEs against the security of BG are continued to be reflected under Note-14 – 'Loans and Advances' under the head '***Covered by Bank/ Government Guarantees***'. The draft extract of Note-14 for the year 2018-19, has been provided by the querist for the perusal of the Committee.

   However, amount recoverable from banks against the BGs invoked but not yet received, have been reflected under Note-15-

'*Other Financial Assets*' under the head '***Receivables from Banks-Others***', following the guidelines applicable under Ind AS.

Whether such depiction requires to be modified and outstanding dues to be restored to initial classification done in 2016-17 i.e amount recoverable from banks against the BGs invoked but not yet received to be shown as dues recoverable from MSMEs against the security of BG and continued to be reflected under Note-14 – 'Loans and Advances' under the head '***Covered by Bank/ Government Guarantees***'.

5. Further, in terms of ICAI opinion dated 15/09/82 (copy has been provided separately by the querist for the perusal of the Committee), bank guarantee is considered to be unsecured, and accordingly, the dues recoverable from MSMEs against the security of BG are also depicted as '*Loans and Advances - Unsecured Considered Good*', in the annual accounts of the respective field offices & Corporation as a whole. Whether ICAI opinion dated 15/09/82 as on date still holds good i.e. considers the bank guarantee as unsecured.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised in the query relate to (i) presentation of amount recoverable/receivable from the bank against the bank guarantees invoked but not yet received for the financial year 2017-18 (i.e., when Accounting Standards (ASs) notified under the Companies (Accounting Standards) Rules, 2006 and not Indian Accounting Standards (Ind ASs), are applicable to the Company) and for the financial year 2018-19, (i.e., when the Ind ASs, notified under Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time are applicable to the Company) and (ii) regrouping of the amount recoverable or outstanding dues from MSME unit by deducting from 'Other Loans and Advances' and adding to 'Advances recoverable in cash or kind or for value to be received'. The Committee has, therefore, considered only these issues and has not examined any other issue arising from the Facts of the Case, such as, measurement and impairment of receivables from MSMEs or receivables against bank on account of bank guarantee under ASs or Ind ASs, accounting for transition from ASs to Ind ASs as per the requirements of Ind AS 101, 'Firsttime Adoption of Indian Accounting Standards' including

accounting for prior period items, if any, recognition of interest (if any) on the BGs invoked against bank but not yet paid by the bank, presentation of receivables from MSME, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from legal perspective, such as, legal interpretation of guarantee bond, etc. Further, the Committee hereinafter has not examined the legal validity or genuineness of the bank guarantees and has presumed that the same are in order and valid from legal perspective. The Committee also notes from the Facts of the Case that the Company is a Non-banking Financial Company and therefore, the Ind ASs are applicable to the Company from the financial year 2018-19 (as also stated by the querist in the Facts of the Case) and in respect of which the financial statements shall be presented in accordance with Division III of Schedule III to the Companies Act, 2013, which has been notified by the Ministry of Corporate Affairs vide Notification dated 11th October, 2018.

11. With regard to presentation of amount recoverable from banks against the bank guarantees invoked but not yet received for the financial year 2017-18 under Accounting Standards (ASs), notified under the Companies (Accounting Standards) Rules, 2006, the Committee notes that the first issue to be examined is whether the receivable from the MSME should be continued to be recognised and disclosed or the same should be derecognised and instead a new receivable against the bank in respect of the bank guarantee should be recognised. In this context, the Committee notes that there is no specific requirement in the accounting standards that deal with derecognition of receivables. Therefore, in this context, the Committee notes the following requirements of the Framework for the Preparation and Presentation of Financial Statements (hereinafter referred to as 'the Framework'), issued by the ICAI:

> "49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined 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.
>
> …
>
> 50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions

embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 81 to 97. ...”

“52. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.”

“54. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:

(a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;

(b) exchanged for other assets;

(c) used to settle a liability; or

(d) distributed to the owners of the enterprise.”

“56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.”

12. Drawing an analogy from the above, the Committee is of the view that an asset should be derecognised from the financial statements when it ceases to meet the definition of ‘asset’ as per paragraph 49(a) of the Framework, i.e., when the asset is no longer a ‘resource controlled’ by the enterprise from which future economic benefits are expected to flow to the enterprise. Therefore, the Committee is of the view that in the extant case,

the receivable from the MSME unit should be derecognised by the Company when the receivable is not 'controlled' by the Company in such a way that it can no longer obtain expected future benefits out of these. In the extant case, since the Company has obtained BG from the bank in respect of the receivables from MSME units, it shall evaluate that whether on invocation of the BG, the Company still controls the receivables so as to obtain benefits out of these. In other words, whether the Company still has the legal rights or the capacity to control benefits expected to flow from the receivables. Accordingly, the Committee is of the view that the Company in the extant case, should evaluate based on its own facts and circumstances and considering the relevant provisions/terms of the Bank Guarantee Bond and any other Agreement between the Company and the MSME unit or the bank, as to whether in the extant case, on invocation of the BG, the Company still has a control (through legal right or otherwise as explained above) over the receivables from the MSME units. If after such evaluation, it is concluded that the Company does not have such control, the Company should derecognise the 'Receivable from MSME units' from its financial statements. However, at the same time, since the Company acquires a right to obtain the value of receivables from the bank to the extent of bank guarantee, the Company should also recognise an asset in the form of 'Receivable from bank due to invocation of bank guarantee' provided it meets the definition of 'asset' and the recognition criteria of asset, as reproduced above. In such a case, with regard to the presentation of the receivable from the bank, for the financial year 2017-18, the Committee notes the following requirements of Division I of Schedule III to the Companies Act, 2013 (the requirements of Division III to Schedule III are not effective for financial year 2017-18):

"**8.8.5 Short-term loans & advances**

(i) Short-term loans and advances shall be classified as:

- (a) Loans and advances to related parties (giving details thereof);
- (b) Others (specify nature).

(ii) The above shall also be sub-classified as:

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

…

8.8.6 Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories e.g. unbilled Revenue, unamortized premium on forward contracts etc.

In case any amount classified under this category is doubtful, it is advisable that such doubtful amount as well as any provision made there against should be separately disclosed."

From the above, the Committee notes that, if a current receivable/asset does not fit into any other category, the Company should classify and present such receivables from the bank under 'Other current assets' and in case any amount is doubtful, it is advisable that such doubtful amount as well as any provision made there against should be separately disclosed. However, in this context, the Committee notes that the Company has presented the receivables from banks under 'Advance recoverable in Cash or in Kind or for value to be received' under 'Short-term Loans and Advances'. In this regard, the Committee wishes to point out that this sub-head is not specifically given under the Schedule III. Moreover, under such head, expenses which have been prepaid or paid in advance from which either something in cash/kind or their value is to be received in future, should be presented. Further, since receivable from bank against BG invoked cannot be treated as loan and advances by the Company to the bank, these receivables should be classified under 'Other current assets' along with a disclosure of the amount, if any, considered doubtful, considering the legal position of dispute with regard to recoverability of the bank guarantee.

13. For the financial year 2018-19, when the Ind AS become applicable to the Corporation, in the context of amount recoverable from MSME or from the bank on invocation of bank guarantee, the Committee notes the following

paragraphs of Ind AS 32, 'Financial Instruments: Presentation':

> **"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) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or**
>
> **..."**

From the above, the Committee notes that amounts receivable from MSME as well as receivable from bank on invocation of guarantee are in the nature of financial asset being a contractual right to receive cash or another financial asset from another entity. In this context, as noted from the above, under previous GAAP, the Company has already derecognised the financial asset in the form of recoverable from MSME and has recognised a new financial asset in the form of recoverable from the bank in its financial statements. The Committee notes that under Ind AS 109, the Company would have been required to assess whether the invocation of bank guarantees would result in the derecognition and the recognition of a new financial asset. However, paragraph 13 and Appendix B of Ind AS 101, 'First-time Adoption of Indian Accounting Standards' prohibit retrospective application of some aspects of other Ind ASs. The Committee notes that paragraphs B2 and B3 of Ind AS 101 provide as follows:

> "B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in Ind AS 109 prospectively for transactions occurring on or after the date of transition to Ind ASs. For example, if a first- time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to Ind ASs, it shall not recognise those assets and liabilities in

accordance with Ind ASs (unless they qualify for recognition as a result of a later transaction or event).

B3 Despite paragraph B2, an entity may apply the derecognition requirements in Ind AS 109 retrospectively from a date of the entity's choosing, provided that the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions."

14. From the above and if the Company in the instant case has not exercised the option under B3, the Committee is of the view that since the Company had already derecognised the recoverable from MSME and recognised the financial asset as recoverable from the bank on invocation of BGs in the financial year 2017-18 under the previous GAAP, on transition, the Company should not reassess whether the derecognition of the receivables from MSME and recognition of the new receivables/recoverable from the bank (on invocation of BGs) would have been appropriate under Ind AS. However, if the company exercises the option under B3, the Company should reassess that whether the derecognition of financial asset, viz., receivables from the MSME is appropriate or not considering the following requirements of Ind AS 109, 'Financial Instruments':

"3.2.3 An entity shall derecognise a financial asset when, and only when:

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6.

(See paragraph 3.1.2 for regular way sales of financial assets.)

3.2.4 An entity transfers a financial asset if, and only if, it either:

(a) transfers the contractual rights to receive the cash flows of the financial asset, or

(b) retains the contractual rights to receive the cash

flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 3.2.5."

"3.2.6 When an entity transfers a financial asset (see paragraph 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

...

(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:

(i) ... "

"3.2.7 The transfer of risks and rewards (see paragraph 3.2.6) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg. because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 3.2.5)."

"3.2.9 Whether the entity has retained control (see paragraph 3.2.6(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control."

From the above, the Committee notes that an entity shall derecognise a financial asset when it transfers the financial asset, viz., transfers the contractual rights to receive the cash flows of the financial asset and transfers substantially all the risks and rewards of ownership of the financial asset. Paragraph 3.2.6(a) further states that the entity shall recognise separately as assets or liabilities any rights and obligations created or retained in the transfer. In the extant case, since the Corporation has obtained BG from the bank in respect of the receivables from MSME units, it should evaluate that whether on invocation of the BG, the contractual rights to the cash flows from the MSME are transferred to the bank and whether the Corporation has transferred substantially all the risks and rewards of ownership of the financial asset i.e. receivable from MSME, based on its own facts and circumstances and considering the relevant provisions/terms of the Bank Guarantee Bond and any other Agreement between the Company and the MSME unit or the bank. If after such evaluation, it is concluded that the financial asset, viz., receivable from MSME should be derecognised, the Company should derecognise the 'receivable from MSME units' from its financial statements. Further, at the same time, considering the requirements of Ind AS 109, the Company should recognise a new financial asset in the form of receivable/recoverable from the bank.

15. With regard to the presentation of the receivable from the bank, for the financial year 2018-19 and onwards, the Committee notes that Division III to Schedule III to the Companies Act, 2013 requires the head 'Financial Asset' on the 'Assets' side of the balance sheet to be sub-classified as under :

Balance Sheet as on…

	Particulars
	ASSETS
(1)	**Financial assets**
(a)	Cash and cash equivalents
(b)	Bank Balance other than (a) above
(c)	Derivative financial instruments
(d)	Receivables
	(I) Trade Receivables
	(II) Other Receivables
(e)	Loans
(f)	Investments
(g)	Other Financial assets (to be specified)

Further, the Committee notes paragraph 8.1.7 of the Guidance Note on Division III to Schedule III to the Companies Act, 2013 for NBFC that is required to comply with Ind AS, issued by the ICAI states as follows:

> **"8.1.7. Other Financial assets:**
>
> Other financial assets should include items such as dues in respect of insurance claims, sale of Property, Plant and Equipment, contractually reimbursable expenses, security deposits etc. In case advances are of the nature of a financial asset as per Ind AS 32, these are to be disclosed under 'other financial assets' separately.
>
> Other financial assets may also include receivables emanating from items that are classified as 'other Income'."

From the above, the Committee notes that the receivables from the bank should be presented under the head 'Other financial assets' with an appropriate nomenclature and disclosure so as to reflect and explain nature thereof appropriately.

D. Opinion

16. With reference to the queries raised in paragraph 9 above, the Committee is of the following opinion:

1 and 2. At the time of receipt of BG, no accounting entry is required. However, on invocation of BG, the Company should evaluate based on its own facts and circumstances and considering the relevant provisions/terms of the Bank Guarantee Bond and any other Agreement between the Company and the MSME unit or the bank, as to whether on invocation of the BG, it still has a control (through legal right or otherwise as explained above) over the receivables from the MSME units. If after such evaluation, it is concluded that the Company does not have such control, the Company should derecognise the 'Receivable from MSME units' from its financial statements, as discussed in paragraph 12 above. Further, an asset in the form of 'Receivable from bank due to invocation of bank guarantee' should be created, provided it meets the definition of 'asset' as discussed in paragraph 12 above for the financial year 2017-18, i.e., when Accounting Standards (ASs) notified under the Companies (Accounting Standards) Rules, 2006 were applicable to the Company. With respect to the financial year 2018-19 (when Indian Accounting Standards are applicable), the Company should evaluate considering the requirements of Ind AS 109 that, whether on invocation of the BG, the contractual rights to the cash flows from the MSME are transferred to the bank and whether the Corporation has transferred substantially all the risks and rewards of ownership of the financial asset i.e. receivable from MSME, based on the facts and circumstances and considering the relevant provisions/terms of the Bank Guarantee Bond and any other Agreement between the Company and the MSME unit or the bank. If after such evaluation, it is concluded that the financial asset, viz., receivable from MSME should be derecognised, then the Company should derecognise the 'receivable from MSME units' from its financial statements. Further, at the same time, the Company should recognise a new financial asset in the form of Receivable/recoverable from the bank, considering the requirements of Ind AS 109, as discussed in paragraph 14 above.

3 and 5. The receivables from bank on invocation of BGs for the F.Y. 2017-18, should be classified under 'Other current assets'

along with a disclosure of the amount, if any, considered doubtful, considering the legal position of dispute with regard to recoverability of the bank guarantee, as discussed in paragraph 12 above. With regard to the issue raised by the querist in context of earlier opinion issued by the Committee in respect of bank guarantee, the Committee is of the view that after Division III to Schedule III to the Companies Act, 2013 becoming applicable to the Company, this question is no longer relevant as it contains specific disclosure requirements in respect of bank guarantees.

4. Subject to paragraphs 13 and 14 above, for the financial year 2018-19 and onwards, the receivables from the bank should be presented under the head “Other financial assets’ with an appropriate nomenclature and disclosure so as to reflect and explain the nature thereof appropriately, as discussed in paragraph 15 above.

Query No. 5

Subject: Valuation of inventories of iron ore fines.[1]

A. Facts of the Case

1. A Company, a maharatna public sector undertaking (PSU) (hereinafter referred to as ‘the Company’), is the leading steel-making company in India having five Integrated Steel Plants and three Special Steel Plants. The Company produces both basic and special steels for domestic construction, engineering, power, railways, automotive and defence industries as well as for sale in export markets. The turnover of the company in the financial year 2018-19 was approximately Rs. 66,267 crore.

2. The Company also owns iron ore, flux and coal mines located in various states of the country. The entire iron ore required for the production of steel is sourced from the captive mines of the Company located in the states of Jharkhand, Odisha, Chhattisgarh and Madhya Pradesh. All the mining activities are administered by the Raw Materials Division (RMD) of the Company, having Head Quarter at Kolkata.

[1] Opinion finalised by the Committee on 21.4.2020.

3. During the mining of iron ore, both Lumps and Fines are generated, having Iron content ranging from 61% to 66%. Both these products are used in the Integrated Steel Plants and therefore mining costs (including royalty) are allocated to Lumps and Fines as per the costing system in vogue in the Company.

4. However, during the process of mining and washing the ore, some quantity of tailings and sub-grade Iron Ore Fines (Iron content < 60%) are also generated. These sub-grade materials cannot be directly used in the manufacture of steel. Earlier, due to the absence of sufficient number of ore beneficiation plants in the country, there was very little demand for these materials in the market. Small quantities sold from time to time were accounted for as income as and when such sales occurred.

5. The Central Government, vide its order dated 19th September, 2012, stated that in the case of captive miners, "*the entire ore produced in the mining operation shall be used exclusively for own consumption in Iron or Steel making and cannot be either sold in India or exported to other countries".* Effectively, this notification prevented the company from selling these sub-grade fines in the market. Since these materials could neither be consumed nor sold, they had no economic value, and therefore, no costs were assigned to the tailings and sub-grade fines. (Emphasis supplied by the querist.)

6. Raw Material Division (RMD) of the Company has been disclosing the quantity of subgrade fines and tailings lying at different locations. As on 31st March, 2019, 41.52 million tonnes of such fines were lying in stock. This quantity was disclosed in the Notes to Accounts but was not valued as inventory. The relevant accounting policy in this regard is as follows:

> "The iron ore fines not readily usable/saleable are included in inventory and revenue is recognised on disposal."

7. The Government of India, Ministry of Mines, vide its order no.F.No.16/30/2019-M.VI dated 16th September, 2019 directed the concerned State Governments to allow the sub-grade minerals lying at the captive mines of the Company to be sold in the open market (copy of the Order has been supplied by the querist for the perusal of the Committee). On an application made by the company in this behalf, the State Government, in consultation with the Indian Bureau of Mines (IBM), shall by an order permit the Company to dispose of the mineral.

8. It is mentioned in the said Order that considering the economic rationale for realization of full value of mineral extracted from the captive mines and also for providing flexibility for complete utilization of all grades of minerals, it is imperative that the sub-grade ores/fines, which are not suitable for end use of captive purposes be allowed to be sold to the domestic end-user companies. The disposal of such stock piles would also enhance the availability of iron ore for the purpose of beneficiation and pelletisation which can be used in steel plants and sponge iron plants.

9. As the iron ore reserves in the country get depleted, there is a dearth of quality ore. The ore in the lower strata have high level of impurities (and consequently low iron content). However, such low-grade ore can be beneficiated and pelletized into usable inputs for blast furnaces. The stock of sub-grade iron ore fines lying in the mines of the company have iron content ranging from 56% to 61%. Such fines can be beneficiated by the buyers to increase the iron levels to 62% - 64%, which can then be converted into pellets and sold to steel plants for use in blast furnaces.

10. The deterioration in the quality of ore in the country has spawned an industry of ore beneficiation and pelletisation plants. In the Budget of 2012-13, the Government reduced the customs duty on import of plant and machinery for setting up iron ore pelletisation/ beneficiation plants from 7.5% to 2.5%. As on date, there are 43 pelletisation plants in India with an installed capacity of 85 million tonnes per annum, and 25 beneficiation plants with an installed capacity of 117 million tonnes per annum. Use of pellets in steel making greatly increases the efficiency of the blast furnace and reduces the cost of production of steel.

11. The Company is of the view that the Notification referred to in paragraph 7 above has imparted economic value to the material lying in inventory and therefore, subject to statutory clearances being given by the respective State Governments, the Company can value the inventory at an appropriate cost.

12. Paragraph 33 of Indian Accounting Standard (Ind AS) 2, 'Inventories', inter alia, states as follows:

> "33 A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net

realisable value because of changed economic circumstances, the amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of cost and the revised net realisable value. ..."

13. The querist has also clarified that the sub-grade iron ore fines are neither joint products nor by-products. Earlier, mining was done manually by employing contractual labour. During manual mining, the fines, having low Fe content and higher level of impurities, which could not be directly used in steel manufacturing were categorised as sub- grade iron ore fines and stored separately in the mining areas. However, with the technological advancement, mining activities have been shifted from manual to mechanical. Further, bringing in advance beneficiation techniques and use of unutilized already generated waste at the mines have ensured utilization of the entire run of mines and zero wastage.

B. Query

14. The opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the following issues:

(i) Whether the present policy of the company, as mentioned in paragraph 6, violates the accrual method of accounting mandated under section 128(1) of the Companies Act, 2013.

(ii) Whether the inventory of iron ore fines lying in stock can be valued in the accounts at a suitable discount to the net realisable value or some other appropriate method.

(iii) If yes, what will be accounting treatment in the books (whether the accretion in inventory needs to be shown as Other Comprehensive Income, or in the body of the P&L Statement) and what accounting policy should be disclosed in the accounts?

C. Points considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to accounting treatment in respect of accumulated sub-grade iron ore fines lying in the stores in the financial statements of the Company. 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, revenue recognition in

respect of sale of sub-grade iron ore fines, accounting treatment in respect of other products, such as, lumps and fines, etc. The Opinion expressed hereinafter is purely from accounting perspective and not from legal perspective including legal interpretation of Orders by Central Government dated 19th September, 2012 and 16th September, 2019. Further, the Accounting Standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time.

16. At the outset the Committee notes the following paragraphs of Indian Accounting Standard (Ind AS) 2, 'Inventories':

> "14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. 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. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost."

> **"*Net realisable value* is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale."**

> "7 Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell."

“30 Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.

31 Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices. Provisions may arise from firm sales contracts in excess of inventory quantities held or from firm purchase contracts. Such provisions are dealt with under Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.”

“33. A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value. This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.”

From the above, the Committee notes that during a production process, more than one product may be produced simultaneously which may either be joint products or a main product and a byproduct. Although, what can be treated as a joint product or a main product and a by- product has not been explicitly defined in the standard, it states that most by- products are by their nature immaterial. Further, although the Standard does not mention about the waste products or wastes; sometimes the production process also results in waste products.

The Committee is of the view that whether a product/material is to be classified as joint-product/co-product or by-product or waste product depends on facts and circumstances of the case and based on a number of factors like objective of manufacture, whether the material was deliberately produced, certainty of use of the products, readiness for use without further processing, whether the intended use of the material is lawful, etc.

17. In this context, the Committee notes from the Facts of the Case that earlier due to the Government Order of 2012 and due to lack of advanced techniques and facilities, the sub-grade iron ore fines could neither be lawfully sold nor used by the Company. Further, the Committee notes that the querist has asserted that these iron ore fines are neither joint products nor byproducts; had no economic value for the Company; and no costs were assigned to the sub-grade fines, which indicate that these were considered as waste product by the company. The Committee is of the view that classification of sub-grade iron ore fines as a waste product or a by-product requires judgement based on various factors, as afore-mentioned, which should be exercised by the Company itself. Accordingly, without exercising the said judgement, the Committee relies on the judgement of the Company and presumes that till these fines become useable/saleable for the Company; these were waste products for the Company. However, in the absence of any specific accounting requirements in respect of waste products in Ind AS 2 or any other Ind AS and considering the requirements of paragraphs 10 and 11 of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', the Committee is of the view that in the extant case, accounting prescribed in respect of immaterial by-product may be applied. Accordingly, considering the requirements of paragraph 14 of Ind AS 2, the waste stock should have been measured at net realisable value, which due to the then prevailing conditions (viz., Government Notification preventing sale and non-availability of facilities with the company for captive consumption), could be considered to be nil. Therefore, disclosing the quantity of sub-grade iron ore fines in the Notes to Accounts was sufficient and appropriate till the time these fines are not useable/saleable for the Company.

18. However, the Committee is of the view that from the time these fines become useable/saleable for the Company due to Government Order of 2019 or due to advanced techniques and facilities, these cannot be considered as waste products and will need to be classified as a joint product or by-product. However, considering that these sub-grade fines having low iron (Fe) content

are incidental and were not intended to be produced, the Committee is of the view that these would normally be of the nature of by-products. Therefore, the accounting prescribed in Ind AS 2 in respect of by-product should be followed by the Company in the extant case. In this context, the Committee notes that as per the requirements of Ind AS 2, when joint products and material by-products are also produced along with the main product during the production process, the cost is allocated between the products on a rational and consistent basis. Further, by-products which are immaterial are measured at net realisable value and the same is deducted from the cost of the main product. Accordingly, the Committee is of the view that if the sub-grade iron ore fines are in the nature of immaterial by-product, the same should be measured at net realisable value. However, if the same are in the nature of material byproduct, their cost should be determined in accordance with the above-reproduced requirements of paragraph 14 of AS 2 and then these should be valued as per paragraph 9 of Ind AS 2 which states that "Inventories shall be measured at the lower of cost and net realisable value". In this context, the Committee wishes to point out that while determining material/immaterial byproduct, the quantity as well as value of the products at the time when these products are produced should be considered.

19. As far as the stock of accumulated sub-grade fines is concerned, which has either become useable due to advanced techniques/facilities or has become saleable due to Government Order of 2019, the Committee notes that the same should be valued as per the principles of Ind AS 2, as discussed above. Further, an increase in the carrying amount of such inventories due to new developments, in the view of the Committee, should be recognised in the statement of profit and loss, considering it as a change in accounting estimates in accordance with the following requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors':

> **"*A change in accounting estimate* is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and accordingly, are not corrections of errors."**
>
> **"36 The effect of change in an accounting estimate, other than a change to which paragraph 37 applies, shall be**

recognised prospectively by including it in profit or loss in:

(a) the period of the change, if the change affects that period only; or

(b) the period of the change and future periods, if the change affects both.

37 To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change."

From the above, the Committee notes that change in estimates should be recognised prospectively in the statement of profit or loss.

20. The Committee also wishes to point out that on the basis of above discussion, if there has been an error in the accounting for sub-standard iron ore fines, the company should rectify and account for the same, considering it as 'prior period items' in accordance with the requirements of Ind AS 8.

D. Opinion

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

(i) and (ii) Without exercising the judgement of whether the sub-standard or low grade fines are waste products or not and relying on the judgement of the Company, the Committee presumes that till these fines become useable/saleable for the Company; these were waste products for the Company. Therefore, in the absence of any specific accounting requirements in respect of waste products in Ind AS 2 or any other Ind AS and considering the requirements of paragraphs 10 and 11 of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', in the extant case, accounting prescribed in respect of immaterial by-product may be applied. Accordingly, considering the requirements of paragraph 14 of Ind AS 2, the waste stock should have been measured at net realisable value, which due to the then prevailing conditions (viz., Government Notification preventing sale and non-availability of facilities with the company for captive consumption), could be considered to be nil. Therefore, disclosing the quantity of sub-grade iron ore fines in the Notes to Accounts by the company was sufficient and appropriate till the time these fines are not useable/saleable for the Company, as discussed in paragraph 17 above. Further, from the time these fines become useable/saleable for the Company due to Government Order of 2019 or due to advanced techniques and facilities, these cannot be considered as waste products and these would normally be of the nature of by-products. Therefore, the accounting prescribed in Ind AS 2 in respect of by-product should be followed by the Company in the extant case, as discussed in paragraph 18 above.

(iii) As far as the stock of accumulated sub-grade fines are concerned, which has either become useable due to advanced techniques/facilities or has become saleable due to Government Order of 2019, the Committee notes that the same should be valued as per the principles of Ind AS 2. Further, the Committee is of the view that an increase in the carrying amount of such inventories due to new developments, should be recognised in the statement of profit and loss, considering it as a change in accounting estimates in accordance with the requirements of Ind AS 8, as discussed in paragraph 19 above. The accounting policy of the company should be in accordance with the above-mentioned accounting treatment.

Query No. 6

Subject: 'Principal vs. Agent' classification under Ind AS 115.[1]

A. Facts of the Case

1. XYZ Electricity Trading Ltd. ('the Company') is primarily engaged in the business of trading of electricity. The Company sources power from various utilities and generating companies across India/neighbouring countries and supplies to its customers. Electricity trading is a licenced

[1] Opinion finalised by the Committee on 6.5.2020 and 7.5.2020.

activity under Electricity Act (EA), 2003. Section 2(26) of the EA defines 'electricity trader' as "a person who has been granted a licence to undertake trading in electricity...". Section 12 of EA specifies that "No person shall, (a) transmit electricity; or (b) distribute electricity; or (c) undertake trading in electricity, unless he is authorised to do so by a licence issued under section 14…". Central Electricity Regulatory Commission (CERC) has granted electricity trading license to the Company under section 14 of EA.

'Trading' has been defined in section 2(71) of EA as "purchase of electricity for resale thereof…". CERC has prescribed regulations regarding eligibility criteria, performance obligation, maintenance of accounts, reporting of data by an electricity trader. CERC (Fixation of trading margin) Regulations specifies the trading margin that an electricity trader can charge from its customers.

2. In the normal course of trading business, a trader enters into the following types of trading arrangement:

- Over the Counter Trade (OTC) – Trade between buyers and sellers of electricity through the trader, where the price and terms of the contract are determined through negotiations, competitive bidding and regulatory approval process. Depending on the duration of power supply, the contracts are further classified into long-term (upto 25 years), medium-term (upto 5 years) and short-term contracts (upto 1 year). Depending on the nature of arrangement, these contracts can either be:
    - Back to back -Trade where the trader buys a specific quantity of power for a particular duration from one party and simultaneously sells it to another party on same terms and conditions.
    - Deals with Open position – Trade where the trader takes a position in a power purchase or sale contract based on price/other factors.
- Power Exchange Trade (PX) – Trade between buyers and sellers through a trader, being a member of Power Exchange, on standardised contracts. The trade is carried out through the power exchange, who is always a counter party to the contract.

3. As per CERC trading licence condition regulation, the Company enters into Power Purchase Agreement (PPA) and Power Sale Agreement (PSA) for

purchase and sale of power for the trading business. Key terms and conditions of the different contracts have been separately provided by the querist for the perusal of the Committee.

4. As per CERC trading licence condition regulation (clause 7(h)), the trader is required to "take such safeguards as he may consider necessary with regard to payment security mechanism from the buyers, but shall always ensure timely payment of dues to the seller for purchase of the agreed quantum of electricity either through a letter of credit or any other appropriate instrument or as may be mutually agreed between the seller and the licensee."

5. For the purpose of GST, the trading transaction is considered as that of Buy/Sell of electricity and accordingly GST is not applicable on the trading margin/commission.

6. Ind AS 115 'Revenue from Contract with Customers' supersedes Ind AS 18 'Revenue' and related interpretations and it applies, with limited exceptions, to all revenue arising from contracts with its customers. Ind AS 115 establishes a five-step model to account for revenue arising from contracts with customers and requires that revenue be recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer.

Accounting for sale of electricity:

7. The Company recognises revenue from sale of electricity, net of estimated rebates and other similar allowances when the units of electricity are delivered. Revenue from such contracts is recognised over time for each unit of electricity delivered at the pre-determined rate. As the customer simultaneously receives and consumes the benefits of the Company's performance obligation, it best depicts the value to the customer and completes satisfaction of performance obligation.

8. The Company determines its revenue on below contracts, net of power purchase cost based on the following factors:

a. Another party is primarily responsible for fulfilling the contract as the Company does not have the ability to direct the use of power supplied or obtain benefits from supply of power.

b. The Company does not have inventory risk before or after the power has been delivered to customers as the power is directly supplied to customer.

c. The Company has no discretion in establishing the price for supply of power. The Company's consideration in these contracts is only based on the difference between sales price charged to procurer and purchase price given to supplier.

Type of Arrangement
Trade deal on back-to-back basis as well as trade through power exchanges

9. For other contracts, which do not qualify the conditions mentioned above, revenue is determined on gross basis.

Type of Arrangement
Trade Deals on Open Position

10. The criteria considered for determination of principal-agent relationship specified under paragraphs 34-38 of Appendix B of Ind AS 115[2] have been provided by the querist as follows:

"B34 When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for the other party to provide those goods or services (i.e. the entity is an agent).

B35 An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer. An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. When an entity that is a principal satisfies a performance obligation, the entity recognises

[2] The paragraphs reproduced by the querist are from Ind AS 115, which was initially notified vide Notification G.S.R. 310(E) dated 28th March, 2018; however Ind AS 115 was subsequently amended vide Notification G.S.R. 273(E) dated 30th March, 2019.

revenue in the gross amount of consideration to which it expects to be entitled in exchange for those goods or services transferred."

B36 An entity is an agent if the entity's performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

B37 Indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer) include the following:

(a) another party is primarily responsible for fulfilling the contract;

(b) the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;

(c) the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;

(d) the entity's consideration is in the form of a commission; and

(e) the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services."

The querist has further stated that in the Exposure Draft issued by the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) in respect of revised Ind AS 115, paragraph B37 provides for indicators pertaining to an entity to be a 'principal'. In the Exposure Draft of revised Ind AS 115, the criteria of the entity possessing credit risk was not considered as an indicator for assessing the entity to be a principal. Thus, even though the entity possesses any credit risk, that does not make the entity a principal. In other words, the credit risk cannot be an indicator of assessing principal-agent relationship.

11. Before the adoption of Ind AS 115, the Company concluded that based on the existence of credit risk and the nature of the consideration in the contract, it has an exposure to the significant risks and rewards associated with the sale of power to its customers, and accounted for the contracts as if it is a principal. Upon the adoption of Ind AS 115, the Company has determined that in back-to-back OTC and power exchange contract, it does not control the goods before they are transferred to customers, hence, recognises revenue as an agent.

12. Summary analysis of the accounting implications of contracts:

Indicators	Trade deal on back-to-back basis and trade through power exchanges	Trade Deals on Open Position
Primary Obligation [Para B37(a)]	**Agent -** since the ultimate responsibility of generation lies with the generator.	**Principal** - the Company is primary obligor of selling the power since deal is not on back to back basis.
Inventory Risk [Para B37(b)]	**Agent** - Electricity as a commodity can't be stored. Deviation risk, if any passed on back-to-back basis to the buyer/seller.	**Principal** - the Company has guaranteed off take obligation from the generator/seller.
Price Determination and Fixed Fee [ParaB37(c & d)]	**Agent** - Price is determined on back-to-back basis. Trading margin of the Company is regulated by CERC.	**Principal** – The price is determined by the Company since the deal is not back to back.
Credit Risk [ParaB37(d)]	**Principal** - Credit Risk is with the Company.	**Principal** - Credit Risk is with the Company.
Overall	**Agent**	**Principal**

13. The querist has also separately supplied copies of PPAs/PSAs with power generating entity/buyers for different arrangements and has provided the following clarifications for the perusal of the Committee:

(i) In respect of trade deals on back to back basis, the quantum of power purchased from the power generating Company (viz., M Ltd.) is 300 MW, which, is utilized for onward sale to one of the buyer entity, viz., W Ltd., as per the Power Sale Agreement. This cannot be sold to any other party than the W Ltd. However, Third Party sale is allowed under the specific conditions as per the PSA (clause No. 7.5 of PSA). The Company has no role to play with regard to conversion/ stabilisation of the power supplied by M Ltd.

(ii) In respect of trade deals on back to back basis, the PPA with power generating entity (M Ltd.) is entered into and signed prior to the PSA with the buyer entity (W Ltd.).

(iii) In respect of trade deals on back to back basis, with regard to the question that whether the buyer entity (W Ltd.) can directly contact the power generating entity (M Ltd.) for any issues with regard to power supply or whether it essentially has to go through the Company in the extant case, it has been submitted by the querist that except power scheduling, requisition of power & other operational activities in relation to scheduling & requisition of power, everything is essentially required to be gone through the Company.

(iv) In respect of trade deals on back to back basis, trading margin is being charged by the Company from the buyer entity (W Ltd.) for scheduled power. As per Clause No. 4.3.1 of PSA, trading margin is a part of variable charges and is payable only for scheduled power. In case power is not scheduled, the Company will not earn any trading margin. Further, this margin has been commercially negotiated. CERC regulates margin only when both power purchase and power sale agreement are for a period of up to one year. As the PPA and PSA in the present case are for a period of more than 1 year, the margin has been commercially negotiated.

(v) In respect of trade deals on open position, the Company considers itself as the primary obligor as the amount to be paid to another power generating entity (D Corporation) is fixed/ per unit or as per schedule given irrespective of sale of power to the ultimate buyer entity (W Ltd.). Moreover, the contract with the power generating Company (D Corporation) is of 25 years; however, the contract with the ultimate buyer entity (W Ltd.) is of 4 years only. The terms and conditions are altogether different in both the PPAs under trade deals on back to back basis and open position and accordingly, the arrangement may not be classified as back to back contract. As per the market practice and current regulations, the generator has to be identified in advance when contract of sale is executed.

(vi) The CERC power tariff regulations prescribed rules for determination of tariff on the basis of cost plus method between generator and Discom; however, the tariff can be mutually decided by both the parties on the basis of competitive bidding/ mutual agreement. The justification for the same is required to be given and regulator adopts the same. However, in the extant case, in the case of open arrangement, the arrangement is between generator and trader and accordingly the regulations prescribed above are not applicable.

(vii) In respect of trade through power exchange, with regard to the issue whether there are some limit/ cap on the quantum of power to be purchased by the ultimate buyer, the querist has informed that as per current regulations, the ultimate buyer (N Ltd.) has to intimate about the quantum it wishes to purchase on 15 minutes basis during the day i.e. quantum should be uniform for each 15 minute time block. Before trading in Power Exchange, N Ltd. has to take a No Objection Certificate (NOC) from its State Load Despatch Centre (SLDC). The quantum in each 15 minute time block cannot exceed the quantum for which NOC has been taken.

(viii) Further in respect of trade through power exchange, with regard to the issue that whether the selling price charged by the Company to N Ltd. is regulated by CERC or it is negotiated commercially and whether trading margin of the Company paid by N Ltd. also regulated by CERC, the querist has clarified that the selling price is not regulated by CERC. The price as discovered in Power Exchange is the sale price charged from N Ltd. CERC has given a ceiling for the Trading Margin which can be charged for such transactions. The Company commercially negotiates a trading margin ensuring that it remains within this ceiling.

B. Query

14. Considering the nature of electricity trading business, whether the Company's revenue recognition policy from electricity trading business is in conformity to the principles of principal-agent relationship specified under paragraphs 34-38 of Appendix B of Ind AS 115.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised by the querist relates to the assessment of principal or agent as per the requirements of Ind AS 115, 'Revenue from Contracts with Customers', with respect to various types of arrangements in relation to its power trading activities. The Committee has, therefore, restricted its opinion only to this issue and has not looked into other issues that may arise from the Facts of the Case, such as, applicability of Ind AS 114, 'Regulatory Deferral Accounts'; the assessment, whether the Company's activities and contracts to buy or sell power are within the scope of Ind AS 109, 'Financial Instruments'; whether the Company's contracts contain embedded derivatives under Ind AS 109 or whether the arrangements entered into by the Company are within the scope of Appendix D to Ind AS 115, 'Service Concessions Arrangements' or within the scope of Ind AS 116, 'Leases'; and the point at which revenue from sale of electricity shall be recognised under Ind AS 115. Further, the Committee wishes to point out that its assessment of the issue under Ind AS 115 of principal and agent is purely from an accounting perspective. This opinion would neither affect the legal status of the Company vis-à-vis other parties or assessment under tax regulations and, as such, the Committee has not assessed any legal and tax implications or issues related to the matter.

16. The Committee notes that Ind AS 115, 'Revenue from Contracts with Customers' states as follows with regard to principal versus agent assessment:

"B34 When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by the other party (ie the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 27–30). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

B34A To determine the nature of its promise (as described in paragraph B34), the entity shall:

(a) identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party (see paragraph 26)); and

(b) assess whether it controls (as described in paragraph 33) each specified good or service before that good or service is transferred to the customer.

B35 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

B35A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

(a) a good or another asset from the other party that it then transfers to the customer.

(b) a right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.

(c) a good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 29(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which includes goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

B35B When (or as) an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

B36 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

B37 Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal (see paragraph B35)) include, but are not limited to, the following:

(a) the entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

(b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits itself to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

(c) the entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

B37A The indicators in paragraph B37 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

B38 If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (ie the entity is no longer acting as the principal), the entity shall not recognise revenue for that performance obligation. Instead, the entity shall evaluate whether to recognise revenue for satisfying a performance obligation to obtain a contract for the other party (ie whether the entity is acting as an agent)."

"26 Depending on the contract, promised goods or services may include, but are not limited to, the following:

(a) sale of goods produced by an entity (for example, inventory of a manufacturer);

(b) resale of goods purchased by an entity (for example, merchandise of a retailer);

(c) resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs B34–B38);

(d) performing a contractually agreed-upon task (or tasks) for a customer;

(e) providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides;

(f) providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs B34–B38);

(g) granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer);

(h) constructing, manufacturing or developing an asset on behalf of a customer;

(i) granting licences (see paragraphs B52–B63B); and

(j) granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs B39–B43)."

"33 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

(a) using the asset to produce goods or provide services (including public services);

(b) using the asset to enhance the value of other assets;

(c) using the asset to settle liabilities or reduce expenses;

(d) selling or exchanging the asset;

(e) pledging the asset to secure a loan; and

(f) holding the asset."

The Committee notes that as per the requirements of Ind AS 115, where another party is involved in providing goods or services to the customer, the entity should first determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by the other party (ie the entity is an agent). Further to determine the nature of its promise, the entity should identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party). Thus, the Committee notes from the above that, in accordance with paragraph B34A(a) of Ind AS 115, the specified good may be the underlying good a customer ultimately wants to obtain (power supply in the extant case) or a right to obtain that good or service (right to supply of power). When the specified good or service is a right to a good that will be provided by another party, the entity would determine whether its performance obligation is a promise to provide that right (and it is, therefore, a principal) or whether it is arranging for the other party to provide that right (and it is, therefore, an agent). The fact that the entity will not provide the underlying goods or services itself is not determinative under Ind AS 115.

Further, as per the requirements of Ind AS 115, the entity should assess whether it *controls* each specified good or service before that good or service is transferred to the customer.

The Committee is of the view that the condition described in paragraph B35A(a) of Ind AS 115 would include contracts in which an entity transfers to the customer a right to future goods to be provided by another party. If the specified good or service is a right to a good to be provided by another party, the entity evaluates whether it controls the right to the goods before that right is transferred to the customer (rather than whether it controls the underlying goods). The Committee further notes from the above-reproduced requirements of Ind AS 115 that in assessing such rights, one of the criterion that may be relevant in assessing 'control' is to assess whether the right is created only when it is obtained by the customer or whether the right exists before the customer obtains it. If the right does not exist before the customer obtains it, an entity would not be able to control right before it is transferred to the customer.

Further, the Standard provides three indicators of when an entity controls the specified good or service (and is, therefore, a principal) in paragraph B37. The Committee notes that these indicators are meant to support an entity's assessment of control, not to replace it. These indicators do not override the assessment of control; and should not be viewed in isolation. Furthermore, they should not be considered as a checklist of criteria to be met or factors to be considered in all scenarios. As per paragraph B37A of Ind AS 115, these indicators, depending on the facts and circumstances, may be more or less relevant or persuasive to the assessment of control.

17. Considering the aforesaid requirements of Ind AS 115, in case of back-to-back arrangements, based on the sample power sale agreement shared, the Committee notes that there are mainly three parties, viz., the Company i.e. a trader, a buyer (who is the ultimate buyer) and an identified

seller, who is generator of power. The company is not itself power generator, but there is a separate power generator, which is identified in the power sale agreement between the Company and the buyer. There is either a separate power purchase agreement (PPA) between the Company and the power generator or sometimes a tripartite agreement between the above parties is entered into. The Company is not licensed to generate power itself and sources power from power generating Company and sells it to other entities. The Committee further observes the following from the sample power sale agreement (PSA) with the ultimate buyer (W Ltd.), as shared for back-to-back arrangements by the querist for the perusal of the Committee:

- In Article 1 of the PSA, the terms such as ‘Declared Capacity’, ‘Delivery Point’ and ‘Power Station’ have been defined with reference to the power generator’s capacity/delivery point/power station.
- The power generator has been identified in the agreement. The power sale agreement states that the delivery point for the agreement shall be the power generator’s outgoing terminal of power station i.e. at the power generator’s periphery. Furthermore, Clause 3.2 of the agreement mentions conditions precedent including, the power generator’s financial closure, valid leasehold rights and existence of the PPA between the Company and the power generator. Clause 3.3 of PSA requires each party be informed about the continuing confirmation about these conditions precedent to the contract.
- Clause 2.3 (a) of PSA provides that the agreement stands extended by the period for which the power generator is not able to supply electricity due to any Force Majeure event which indicates that the arrangement between the Company and its customers is entirely dependent on the supply from the generating entity and is not primary responsible for the power supply.
- As per Clause 4.3.1, the buyer has an obligation to pay to the Company, the capacity charges for un-availed/ unscheduled power in case the buyer does not avail/ schedule power upto the net declared capacity. This means that the buyer is assuring the seller (vz., power generating entity) and the trader (the Company), at a minimum, the capacity charges in case of any

un-availed/ unscheduled power units from the power station. Therefore, the Company is exposed to minimal demand risk.

- As per Clause 7.8.1, the buyer is required to pay a trading margin on the entire energy delivered, to the seller, in addition to the CERC tariff for the project. Further, Clause 7.2.2 states that the monthly bills shall include, amongst others, the seller's computation of various components of the monthly tariff payable in accordance with Tariff as approved/ determined by the CERC and the sellers trading margin as per the Tariff.
- Clause 7.5.1 permits third-party sale by the Company only in case of payment default by the buyer beyond certain number of days.

Further, as per separate clarifications provided by the querist;

- The trader (the Company) has no role to play with regard to conversion/ transmission/stabilisation of the power supplied by the power generator.
- Trading Margin being charged by the trader (the Company) from the buyer is for scheduled power. As per Clause 4.3.1 of PSA, the trading margin is a part of variable charges and is payable only for scheduled power. In case power is not scheduled, the Company will not earn any trading margin.

Further, if the arrangement is examined for the indicators stated in paragraph B37 of Ind AS 115, the Committee notes the following:

- Primary responsibility: the power generator (the seller) has been identified in the agreement and aspects such as, delivery point, declared capacity and capacity charges are identified with respect to the power generator. This suggests that the primary responsibility for fulfilment of the contract is not with the Company.
- Inventory risk: Declared capacity is defined as specifically in relation to the capability of the power generator's power station. The buyer is obliged to offtake the energy output i.e. the metered output delivered by the power generator. Further, as per Clause 4.3.1 of the sample power sale agreement, the buyer has an obligation to pay for the Capacity charges for unavailed/

unscheduled power in case the buyer does not avail/ schedule power up to the Declared capacity, in case the sale realisation to third parties is less than the capacity charges. This indicates that there is no inventory risk with the trader (the Company) on account of lack of demand.

- Pricing discretion: The Company does not have pricing discretion since the power tariff is regulated.

The Committee also notes that in the tripartite agreement for purchase and sale of power between M Ltd. (seller), the Company (trader) and N Ltd. (Buyer), Clause 4.4.2 states that if the seller (power generating entity) is generating and is making the net declared capacity available to the trader, and trader fails to supply such net declared capacity to the buyer, then the seller and buyer shall have the right to suspend sale and purchase from the trader, and may undertake direct sale and purchase of such energy. During such sale and purchase, the trader shall not be entitled to receive any trading margin.

The Committee also notes from the PPA between the power generating entity (M Ltd.) and the Company in the extant case that the Company has entered into a Memorandum of Understanding with the power generating entity *to tie up sale* of power generated by the generating entity to *potential customers.* Further, the PPA states that pursuant to the aforesaid MoU, the Company would *facilitate* the power purchase agreements of power generated as well as the open access and evacuation arrangements and other related activities *for a consideration/trading margin* of 4 paise per unit payable by the ultimate buyers for the duration of this Agreement. Thus, from the language of the PPA itself, it is apparent that the Company in the extant case is merely acting as a facilitator for the power generating entity in making sale arrangements with the ultimate buyers for an agreed consideration or trading margin.

The Committee further notes from the PPA with the M Ltd. (a power generating entity) that transmission losses for sale of the contracted capacity of power beyond the Delivery Point shall be on account of buyer and shall be borne by the buyer (viz., the Company). Similarly, it is noted from the copies of PSA with the ultimate buyer that the transmission losses beyond the delivery point shall be borne by the ultimate buyer and the delivery point in both the PPA and PSA is the power generating entity's switchyard outgoing terminal. From this, it implies that in substance, any transmission loss beyond the delivery point shall be borne by the ultimate buyer and not the trader, viz., the Company in the extant case.

The Committee notes that as per Ind AS 115, 'control' refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. In this context, in case of back-to-back type of arrangements, the Committee notes from the PPA between M Ltd. (a power generating entity) and the Company that even the ultimate buyer entity to whom the Company intends to sell has been identified, which indicates the Company's restrictions on its ability to direct the use of power supply to another entity. Further, based on the above clauses in the PPA/PSA and the aforesaid discussion, it can be said that the Company does not have the ability to direct the right to use the power that it obtains under the power purchase agreement with the power generator to fulfil another customer contract and that the Company doesn't control the right to the power to be supplied before that right is transferred to the buyer. Therefore, it can be inferred that the Company is acting as an agent for the purpose of accounting under Ind AS 115 and its performance obligation is to arrange for the right to power supply rather than supplying power itself.

18. In case of arrangements under open position i.e. not on back-to-back basis, the Committee observes that:

- The Company enters into the power purchase agreement with power generators (D Corporation) to purchase power before entering into power sale agreement with the buyer of power.
- As per Clause 4.2.1 and Clause 4.3.1 of the sample power purchase agreement shared, the Company is obliged to offtake and purchase all the power generated and delivered by the power generator at the identified delivery point and pay the agreed tariff.
- The sample power sale agreement for open contracts does not contain any minimum offtake obligation clause requiring the buyer to purchase minimum quantity of power from the Company.
- The tariff for the power to be supplied as mentioned in Clause 1 of Annexure I of the sample power sale agreement, is not regulated by CERC, but negotiated by the Company with the buyer of power. The CERC power tariff regulations prescribe rules for determination of tariff on the basis of cost plus method

between generator and customer. However, the tariff can be mutually decided by both the parties on the basis of competitive bidding/ mutual agreement. The justification for the same is required to be given and regulator adopts the same.

As per the separate clarifications provided by the Company, the amount to be paid to the power generator is fixed per unit or as per schedule given irrespective of sale of power to the customer. Generally, the contract with the power generator is of 25 years, however the contract with customer is of 4 years only.

Further, in contrast to the back-to-back arrangements, in case of open trade deals, in the PPA between the Company and power generating entity (D Corporation), ultimate buyer entity has not been identified. Further, the PPA also specifically states that the Company "shall have the right to sell the delivered power to any person at its cost and responsibility", which indicates that the Company is the buyer for the power generating entity and has an autonomy and independence to decide the terms of subsequent sale. In other words, the Company has the ability to direct the use of the right to supply of power received from the power generating entity.

Furthermore, the Committee observes in case of such an arrangement, that the Company is assuming the obligation to offtake the minimum quantity of power from the power generator. However, the customer of the Company, i.e. the ultimate buyer of the power is not assuming such an obligation in the power sale agreement since there is no minimum offtake clause in the power sale agreement. It is to be noted that the right is not created only when it is obtained by the customer and the right exists with the Company, by virtue of the power purchase agreement, before the customer obtains it. Therefore, it can be said that the Company's right to get power supply from the power generator exists before the customer obtains it, and, resultantly, the company is able to control right to the power to be supplied before it is transferred to the customer. Accordingly, the Committee is of the view that in such arrangements, the Company is 'principal' under Ind AS 115 and therefore, should recognise revenue from sale of power and corresponding costs on gross basis.

19. In case of power trading through power exchange, the Committee observes the following:

- The Company is bidding on behalf of the customer on the power exchange. The Company is not selling or purchasing power on its own as a principal.

- The power price is discovered in power exchange. The Company earns a trading margin in such an arrangement. CERC, the regulator provides a ceiling for the trading margin which can be charged by the Company for such transactions. The Company commercially negotiates the trading margin with the customer.

Further, if the arrangement is examined for the indicators stated in paragraph B37 of Ind AS 115, the Committee notes the following:

- Primary responsibility: The primary responsibility for fulfilment of the contract i.e. power supply is not with the Company.
- Inventory risk: There is no inventory risk that the Company is exposed to.
- Pricing discretion: The Company does not have pricing discretion since the price for power is discovered through power exchange.

Based on the above, it seems that the Company doesn't control the right to the power traded through power exchange before that right is transferred to the customer. The Company is merely bidding for power on behalf of the customer. Therefore, it can be inferred that the Company is acting as an agent for the purpose of accounting under Ind AS 115 and its performance obligation is to arrange for the right to power supply rather than supplying power itself.

D. Opinion

20. The Company should account for revenue in case of back to back arrangements and where power is traded through power exchange as an agent under Ind AS 115 for the reasons discussed in paragraphs 17 and 19 above. The Company should account for revenue arising in case of open contracts as a principal under Ind AS 115 for reasons stated in paragraphs 18 above.

Query No. 7

Subject: Accounting treatment of Aviation Turbine Fuel (ATF) dead stock.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') had been incorporated by ABC Private Ltd. as a private Company limited by shares under the Companies Act, 1956, as its wholly owned subsidiary. Thereafter, on 6th March 2014, three other oil public sector undertakings (collectively referred to as the 'Oil PSUs') and ABC Pvt. Ltd. entered into the Shareholders Agreement; and Oil PSUs, ABC Pvt. Ltd. and its wholly owned subsidiary entered into Share Purchase Agreement. ABC Pvt. Ltd. and the Oil PSUs have formed a joint venture Company, viz., the Company in the extant case. The objectives of the Company are given below:

- To take over existing aviation fuelling facilities and businesses including without limitation aviation fuelling stations, tankage, hydrant infrastructure.
- To create, establish, design, construct, develop, upgrade, modernise, integrate, optimize and modify fuelling facilities for the Airport.
- To operate, manage and maintain and to provide services in relation to the fuelling facilities for the Airport, on an open access basis.

2. The Company is in the process of creating a modern and efficient aviation fuel facility to cater to the needs of airlines operating from Chhatrapati Shivaji International Airport (CSIA). The Company has also undertaken the development of the Integrated Facility and linking thereof to the Hydrant System. The Company has executed License Agreement with Airport Operator (ABC Pvt. Ltd.) for two locations, Location 1 and location 2. The fuel farm operations are being carried out at Location 1 and the project of development of integrated fuel farm facility is carried out at Location 2.

3. The querist has also provided the following facts:

(a) Dead stock is the minimum level of material needed to be

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[1] Opinion finalised by the Committee on 23.5.2020.

maintained in the plant and machinery for the plant and machinery to operate for its intended use.

(b) The aviation turbine fuel (ATF) dead stock in the present case is the minimum level of material required in the storage tanks to operate for its intended use. Minimum level of fuel is required to be maintained in the storage tanks by design/nature as, below this level, the fuel cannot be withdrawn from the tanks. It is not at the discretion of the Company.

(c) The dead stock held by the Company is not held for sale in its ordinary course of business since the Company's business is to provide storage space for storing fuels and not to buy or sell fuel.

(d) This dead stock quantity will never undergo any changes and shall remain intact till the life of the facility.

4. The querist has referred to the following paragraphs of various Indian Accounting Standards (Ind ASs):

Ind AS 2, 'Inventories':

"***Inventories*** **are assets:**

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering or services."

"8 Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. Costs incurred to fulfill a contract with a customer that do not give rise to inventories (or assets within the scope of another Standard) are accounted for in accordance with Ind AS 115, *Revenue from Contracts with Customers*."

Ind AS 16, 'Property, Plant and Equipment':

"**7 The cost of an item of property, plant and equipment shall**

be recognised as an asset if, and only if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably."

5. The dead stock held by the Company is not held for sale in its ordinary course of business since the Company's business is to provide storage space for storing fuels and not to buy or sell fuel. Accordingly, conditions (a) and (b) of paragraph 6 of Ind AS 2 are not applicable to the Company. Moreover, the dead stock is not consumed in the services related to storage of fuel, since this is the minimum level of material which is required to be held at all times in the oil storage tank in order to make it operational throughout its life. Hence, the stock is not consumed during the production process. As a result, condition (c) of paragraph 6 of Ind AS 2 is also not applicable to the Company.

6. Based on the facts of the case, according to the querist, it is evident that the dead stock is held with the intention of enabling the machinery to perform its intended functions and render storage services. Accordingly, the cost of acquiring dead stock is in the nature of a cost that is directly attributable cost of bringing the oil storage tanks/plant and machinery to its working condition for its intended use of providing storage services.

7. The querist has stated that the basic principle to be applied while capitalising an item of cost to a fixed asset/project under construction is that it should be directly attributable to the fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the acquisition of a fixed asset for bringing it to its working condition are those costs that would have been avoided if the acquisition had not been made. These are the expenditures without the incurrence of which, the asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The above-discussed principle of avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by Ind AS 16. In the given case, the dead stock is necessary to bring the property, plant and equipment in a condition necessary for it to be operating in a manner as intended by the Company.

8. As per paragraph 6 of Ind AS 16, "***Depreciation*** **is the systematic allocation of the depreciable amount of an asset over its useful life**." As

per the querist, depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is pre-determined. Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

9. As per paragraph 6 of Ind AS 16,

> ***Useful life*** **is*:***
>
> **(a) the period over which an asset is expected to be available for use by an entity; or**
>
> **(b) the number of production or similar units expected to be obtained from the asset by an entity.**

Accordingly, even if the assets have a longer physical useful life, if the management estimates that they will actually be used for a period shorter than the physical life, the period over which the asset is expected to be used by the management would be considered for the purposes of determining the depreciation charge.

10. The querist has further referred to the requirements of Schedule II to the Companies Act, 2013 (the Act) with respect to depreciation as below:

> "The useful life of an asset shall not be longer than the useful life specified in Part C and the residual value of an asset shall not be more than five percent of the original cost of the asset:
>
> Provided that where a company uses a useful life or residual value of the asset which is different from the above limits, justification for the difference shall be disclosed in its financial statements."

Thus, according to the querist, the Company may on the basis of an objective technical and economic evaluation, determine a residual value of more than 5% and a useful life of plant and machinery different from that prescribed in the Act. However, it would be required to disclose the facts and disclose reasons for the same.

11. The querist has stated that the useful life for plant and machinery

(storage tanks and related equipment) used in exploration, production, and refining oil and gas, as prescribed in the Act is 25 years. However, it may be noted that Schedule II recognises the concept of component accounting. Note 4 in Schedule II, *inter alia*, states as below:

> "a) Useful life specified in Part C of the schedule is for whole of the asset and where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately."

Two issues arise in this context. Firstly, is the value of dead stock significant to the total cost of the storage tank. If so, the Company should treat it as a separate component. Its useful life should be evaluated and it should be considered whether it would need recharging or whether there is an expected loss in the quantity or value of dead stock over the life of the asset of which it is a part. If so, depreciation should be charged on this component separately. This would also depend upon the fact whether loss relating to dead stock (if any) is borne by the Company or whether as per fuel sale agreements, it is compensated by the customers. In this context, reference to clause 18.03.1 of License Agreement between the Company and ABC Pvt. Ltd. may be made, which spells that for transfer back of property including dead stock, the transfer payment will be as mutually discussed and agreed.

12. The querist has informed that as per an independent accounting opinion obtained by the Company, depreciation should be charged on the dead stock over its expected useful life.

13. Accounting treatment by the Company and disclosure in its books of account:

(a) The Company is accounting for ATF dead stock held by it in storage tanks as part of 'Fixed Assets' under the head 'Plant & Machinery'.

(b) The dead stock has been accounted for in the books at the actual cost of acquisition. However, out of the total dead stock, 553.73 KL of ATF was transferred by ABC Pvt. Ltd. to the Company at Rs. 10.20 crore, which was duly certified by their statutory auditors. The purchase cost works to approx. Rs. 1,84,205/- per KL as against the current market price of Rs. 64,321/- per KL.

(c) The dead stock is not subject to depreciation and disclosure is being made in the books accordingly.

14. As per an independent accounting opinion obtained by the Company and advice from the statutory auditor, adequate disclosure is given in the books of account of the Company related to treatment of dead stock. The same is reproduced below:

i. Paragraph 2.5 (vi) of Notes to Financial Statements, "Dead stock is the minimum level of material needed to be maintained in the plant and machinery for its intended use. Minimum level of fuel is required to be maintained in the storage tanks by design / nature, below this level the fuel cannot be withdrawn from the tanks. The dead stock held by the Company is not held for sale in its ordinary course of business. Accordingly, as per paragraph 16 of Ind AS 16, the cost of acquiring dead stock is in the nature of a cost that is directly attributable cost of bringing the oil storage tanks / plant and machinery to its working condition for its intended use of providing storage services and accordingly form part of Fixed Assets."

ii. Para 2.6 (iv) of Notes to Financial Statements, "Depreciation on dead stock forming part of Fixed Assets is provided on the basis of diminution in the value of the dead stock calculated on realization price method, if such diminution in value is not temporary."

B. Query

15. On the basis of above, the querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issues:

(i) Whether accounting for dead stock as part of property, plant and equipment is appropriate or it should be classified as inventory.

(ii) Whether the dead stock value needs to be impaired based on current net realizable value or to be continued at acquisition cost.

(iii) No depreciation is being claimed by the company, considering the diminution in value is temporary in nature and not permanent. Whether depreciation is to be claimed on dead stock valuation and if so, whether prospectively or retrospectively and methodology of depreciation.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised in the query relates to accounting for the dead stock acquired/purchased by the Company from ABC Pvt. Ltd. and oil PSUs. 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, whether the joint arrangement between the ABC Pvt. Ltd. and oil PSUs is a joint venture or not, accounting for the arrangement between the Company and ABC Pvt. Ltd. and oil PSUs, accounting for storage tanks held by the Company as licensee, accounting treatment of other assets which are part of the license agreement or transfer deed between the Company and ABC Pvt. Ltd./oil PSUs, the appropriateness of the cost/value at which ATF is acquired by the Company from ABC Pvt. Ltd. etc. Further, the opinion is expressed purely from the accounting perspective and not from any other perspective, such as, interpretation of license agreement or transfer deed, as referred/supplied by the querist. Further, in the context of the query raised, the Committee presumes that the dead stock has been acquired/purchased by the Company from ABC Pvt. Ltd. and oil PSUs and is not held in fiduciary capacity or on their behalf.

17. At the outset, the Committee notes from the license agreement that at the expiry/end of the license term, the company will transfer back the ownership of and all rights, title and interest including ATF at a mutually discussed and agreed value to ABC Pvt. Ltd. Thus, the price for the transfer-back or repurchase by the licensor has not been fixed or pre-determined. Further, this indicates that the company shall keep the ATF dead stock till the expiry of the license term and will return the dead stock in the condition at that point of time, at the then prevailing prices. Therefore, the risks and rewards of inventory price changes during the license period vest with the company. Moreover, since the company has acquired legal title of the ATF stock and apparently, during the term of the license agreement, the company shall keep this minimum stock of ATF for providing storage services to its customers, it has the ability to prevent other entities from directing the use of and obtaining the benefits from it. This indicates that the company has the ability to direct the use of the dead stock of ATF for its storage service rendering activities, and obtain substantially all of the remaining benefits

therefrom during the license term. Therefore, the company in the extant case acquires 'control' over the ATF stock and the same is an 'asset' of the company.

18. Further, in order to determine the classification of the asset, the Committee notes the definition of the term 'inventories' as given in Indian Accounting Standard (Ind AS) 2, 'Inventories', and the definition of the term 'property, plant and equipment' as given in Ind AS 16, 'Property, Plant and Equipment', as follows:

> ***"Inventories*** **are assets:**
>
> **(a) held for sale in the ordinary course of business;**
>
> **(b) in the process of production for such sale; or**
>
> **(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."**
>
> ***"Property, plant and equipment*** **are tangible items that:**
>
> **(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and**
>
> **(b) are expected to be used during more than one period."**
>
> "16 The cost of an item of property, plant and equipment comprises:
>
> (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period."

From the above, the Committee notes that the classification of an asset as a 'property, plant and equipment' or 'inventory' depends on its intended primary use for an entity. If an asset is essentially held for use in the production or providing goods or services or for rental or administrative purposes, it is classified as 'property, plant and equipment'. However, if it is held for sale in the ordinary course of business, or if it is used in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services, the asset should be classified as inventory.

19. The Committee notes from the Facts of the Case that the minimum level of oil is not held by the company for sale in its ordinary course of business since the company is in the business of providing storage services rather than buying or selling fuel. The Committee also notes that the key characteristic of ATF dead stock is that a minimum constant level of such stock is required to be maintained in the storage facility/tanks. As such, the minimum level of inventories of the same quantity, characteristics and use is always present in the storage facility, whether these are comingled with other inventories or not. Consequently, the Committee is of the view that this part of the inventories should be looked at collectively, ie as if it were a single item, notwithstanding the fact that this ATF stock is comingled with fresh stock continuously. The Committee notes that this minimum level can neither be extracted and sold in ordinary course of business nor it is consumed in the process of rendering of the services (storage services in the extant case). Therefore, the same does not meet the definition of 'Inventory'. Moreover, although the composition of dead stock may change over a period of time, a minimum quantity of ATF is always required to be maintained in oil tanks for them to be capable of operation, viz., in providing the storage services. Thus, the Committee notes that this minimum level of stock is necessary to ensure that the facility is functional; it is inseparable from the facility for its operation and is always required to be maintained in the storage tanks/facility by design/nature to make them operative. Thus, it is in the nature of cost which is directly attributable to bringing the asset (storage tanks) to the location and condition necessary for it to be capable of operating in the manner intended by management and therefore, it is an element of cost of another PPE (viz., the storage tanks) and should be recognized as part of cost of storage tanks.

20. With regard to the measurement of ATF dead stock, the Committee notes the following requirements of Ind AS 16:

"**15 An item of property, plant and equipment that qualifies for**

recognition as an asset shall be measured at its cost.

"Measurement after recognition

29 **An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.**

Cost model

30 **After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.**

Revaluation model

31 **After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.**"

From the above, the Committee notes that the storage tank should be initially measured at its cost, which will be its purchase price and any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. After recognition, the entity can use cost model or revaluation model as per the policy followed for entire class of Property, Plant and Equipment. Further, impairment should also be tested and provided for as per the requirements of Ind AS 36, 'Impairment of Assets'.

21. As far as depreciation is concerned, the Committee notes the following requirements of Ind AS 16 and Schedule II to the Companies Act, 2013 as follows:

Ind AS 16:

"***Depreciation*** **is the systematic allocation of the depreciable amount of an asset over its useful life.***"*

***"Depreciable amount* is the cost of an asset, or other amount substituted for cost, less its residual value."**

"The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life."

"Useful life* is*:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity."

"43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately."

"50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

52 Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

53 The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

54 The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the

asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount."

"57 The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets."

Schedule II to the Companies Act, 2013:

"The useful life of an asset shall not ordinarily be different from the useful life specified in Part C and the residual value of an asset shall not be more than five percent of the original cost of the asset:

Provided that where a company adopts a useful life different from what is specified in Part C or uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice."

Further, Note 4 in Schedule II, *inter alia*, states as below:

"(a) Useful life specified in Part C of the schedule is for whole of the asset and where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately."

From the above, the Committee notes that depreciation is a systematic allocation of depreciable amount of an asset over its expected useful life. Further, where the cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately. Furthermore, where a company uses a useful life or residual value of the asset which is different from the limits prescribed in Schedule II to the Companies Act, 2013, justification for the difference shall be disclosed in its financial statements. Thus, in the extant case, the company should first assess whether cost of ATF dead stock is significant to total cost of the storage tanks and whether useful life of that part is different from the useful life of the remaining asset and if yes, depreciation on ATF dead stock should be provided for separately from the storage tanks of which it is a component. For this purpose, the useful life and the residual value shall be determined and reviewed as per the above-reproduced requirements of Ind AS 16. Thus, the depreciable amount of ATF dead stock should be depreciated over its useful life in accordance with the requirements of Ind AS 16. However, if the residual value of ATF dead stock increases to an amount equal to or greater than its carrying amount, the depreciation charge should be zero unless and until its residual value subsequently decreases to an amount below the carrying amount, as per paragraph 54 of Ind AS 16.

However, if cost of ATF dead stock is not significant to total cost of the storage tanks and/or useful life of ATF dead stock is not different from the useful life of the remaining asset, no separate depreciation needs to be determined for this stock and the depreciation on ATF dead stock will be provided as a part of depreciation on storage tanks, as per the requirements of Ind AS 16 and Schedule II to the Companies Act, 2013.

D. Opinion

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

(i) The accounting for ATF dead stock by the company as part of ‘property, plant and equipment’ is appropriate, for the reasons mentioned in paragraphs 18 and 19 above. However, the same should be adequately and appropriately presented and disclosed from the perspective of users of financial statements as per the requirements of paragraph 122 of Ind AS 1.

(ii) The ATF dead stock, being a part of Property, Plant and Equipment, should be measured as per the requirements of Ind AS 16, as discussed in paragraph 20 above. Further, impairment should also be tested and provided for as per the requirements of Ind AS 36, ‘Impairment of Assets’.

(iii) Refer paragraph 21 above.

Query No. 8

Subject: Disclosure of Feedstock Subsidy.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a joint venture (JV) company of G Ltd., O Ltd., N Ltd. and Government of Assam, (GoA) under the administrative control of Department of Chemicals & Petrochemicals, Ministry of Chemicals & Fertilizers. As per JV agreement, G Ltd. holds 70% of the equity stake and O Ltd., N Ltd. and GoA shall hold 10% each. The Company has set up a 280 KTPA petrochemical complex at Lepetkata, district Dibrugarh, Assam and implemented the flagship project of Government of India called "Assam Gas Cracker Project (AGCP)". The Assam Gas Cracker project is outcome of famous Assam Accord signed on 15th August, 1985 between the Government of India and the leaders of the Assam Movement in New Delhi with the motive of overall socio-economic development of the region.

2. The Cabinet Committee on Economic Affairs (CCEA) at its meeting held on 24.12.2019 inter alia accorded approval of feedstock subsidy to the Company for 15 years of plant operation to maintain minimum internal rate of return (IRR) of 10% (post-tax). To bring the IRR to 10%, the Company has estimated feedstock subsidy of approximately Rs. 4,600 crore for the project for 15 years of plant operation as per the approved methodology. To work out the feedstock subsidy, the Company shall carry out a study to ascertain the IRR considering the current scenario w.r.t. polymer, naphtha and gas prices and actual capital cost without changing the fixed cost parameters (as approved by the Government). Based on the current IRR, the feedstock subsidy amount shall be worked out to ensure minimum post-tax Project IRR of 10% while maintaining the bankability of the project. In the proposed methodology, it has been ensured that feedstock subsidy is provided to the project only to compensate for change in gas, naphtha and polymer prices while keeping all other cost/parameters same as considered by the Government.

3. As per the approved methodology, claims for subsidy since commissioning till the last financial year (F.Y.), shall be submitted immediately after the approval of CCEA. The feedstock subsidy for previous years has been computed as differential of projected and actual gross margins per unit of actual production. The methodology ensures that subsidy is only a function of gas, naphtha and polymer prices and the total subsidy is limited to actual production only. The subsidy for 3 years has been worked

[1] Opinion finalised by the Committee on 23.5.2020.

out to be Rs. 930.49 crore. The claim was accordingly submitted to the Government on 07.01.2020.

Accounting for feedstock subsidy pertaining to previous years

4. The Company has submitted its claim of Rs. 930.49 crore for financial years 2015-16 (3 months), 2016-17 and 2017-18 and accounted for the same as an 'exceptional item' in the third quarter of the financial year. Referring to the Educational Material on Ind AS 1, issued by the erstwhile Ind AS Implementation Committee of the Institute of Chartered Accountants of India (ICAI), the Company has accounted for the feedstock subsidy for past years as an exceptional item considering the following:

i. the accounting for past years of feed stock is a one-time incidence which will not recur in future;

ii. it is arising from ordinary activity since the feedstock subsidy has been sanctioned based on initial commitments to the project for sustaining 10% post-tax IRR for a period of 15 years commencing from commissioning date;

iii. it is a material amount considering that the income to be recognised for period ended up to 31.03.2019 will amount to estimated Rs. 1300 crore which is near to 50 % of revenue from overall operations in the year of accounting;

iv. separate disclosure will be relevant to users of financial statements by enabling clear understanding of the nature of this income.

5. The presentation of the receivable amount of feedstock subsidy for the past periods as an 'Exceptional Item' is however a matter, which requires review since the term 'Exceptional Item' is neither defined nor used in Indian Accounting Standards (Ind ASs). The term 'Exceptional Items' to some extent has been clarified under the 'Guidance Note on Division II - Ind AS Schedule III to the Companies Act, 2013', issued by the Institute of Chartered Accountants of India. While noting the absence of definition of the term 'Exceptional Items' in Ind ASs, paragraph 9.6 of the Guidance Note states that Ind AS 1 has reference to such items in paragraphs 85, 86, 97 and 98 of that Standard. The said paragraphs conclude that separate disclosure of an item of income/ expense is warranted considering factors including materiality and the nature and function of the items of income and expense. Further, an entity shall present additional line items, headings and subtotals

in the statement of profit and loss, when such presentation is relevant to an understanding of the entity's financial performance. Similar view was also been expressed in the erstwhile Accounting Standard 5.

6. *Detailed Methodology*

To work out the feedstock subsidy, the Company shall carry out revised study to ascertain the IRR considering the current scenario w.r.t. polymer, naphtha & gas prices, actual capital cost and other costs as per approved projections. Based on the current IRR, the feedstock subsidy amount shall be worked out to ensure minimum post-tax project IRR of 10% while maintaining the bankability of the project. The detailed methodology is given below:

Part A: Methodology for determination of subsidy on yearly basis shall be as under:

I. Subsidy Amount

Subsidy amount shall be calculated on yearly basis as under:

(i) Projected yearly subsidy as per the model with Projected Gross Margin (PGM) to ensure minimum Post Tax Project IRR of 10% while maintaining Bankability of the Project.

Plus

(ii) [PGM (A) – AGM (B)] (If Positive) X Quantity (C)

A. Projected Gross Margin (PGM) per unit of polymer as per the model for the relevant year.

B. Actual Gross Margin (AGM) per unit of polymer earned during that year.

C. <u>Quantity for determination of Subsidy:</u>

Plant Capacity Utilisation of the relevant year as per DFR or Actual Production during the relevant year, whichever is lower.

Total Yearly Subsidy Amount = (i) + (ii)

II. Computation of Gross Margin:

Total revenue of Polymer net of discounts divided by net sales quantity of Polymer for the relevant year.

less:

Total Cost of Feed Stock (i.e. Naphtha, Natural Gas etc.) divided by net production quantity of Polymer during the period.

Part B: Procedure for claiming subsidy

- Within 1 month after the audit of accounts of financial year, the Company shall submit its claim of subsidy to the administrative Ministry, as per methodology mentioned above.
- Claim for subsidy since commissioning till the last F.Y., shall be submitted immediately after the approval of CCEA.

Submission of claims for previous years:

As per the approved methodology, claims for subsidy since commissioning till the last F.Y., has been submitted immediately after the approval of CCEA. The feedstock subsidy for previous years has been computed as differential of projected and actual gross margins per unit of actual production. The methodology ensures that subsidy is only a function of gas, naphtha and polymer prices and the total subsidy is limited to actual production only. The subsidy for 3 years has been worked out and claimed as below:

	Projections as Per RCE-II			
	Year ended	**31-Mar-16**	**31-Mar-17**	**31-Mar-18**
	Projected Capacity Utilization	80.00%	90.00%	94.00%
	Projected Production (MT)	54,180	2,23,493	2,46,519
	Projected Sale (MT)	40,389	2,23,062	2,45,054
A	**Projected Gross Margin (PGM) Per MT (Rs./MT)**	**57,667**	**61,310**	**65,056**
	Actuals as per Audited Accounts			
	Actual Capacity Utilization	5%	37%	78%
	Actual Production (MT)	3,349	99,540	2,12,569
	Actual Sale (MT)	223	87,012	2,05,275

B	**Actual Gross Margin(AGM) Per MT (Rs./MT)**	**-2,72,289**	**25,444**	**43,273**
A-B	**PGM- AGM**	**3,30,074**	**35,867**	**21,778**
(A-B) X Actual Production	Feedstock Subsidy [(PGM-AGM) X Actual Qty of Production] (Rs. in Cr)	110.54	357.02	462.93
Total for 3 years (Rs. in Cr)				**930.49**

B. Query

7. On the basis of above, the opinion of the Expert Advisory Committee is sought as to whether the feedstock subsidy claims for previous years (till 31.03.2019) is to be presented as an 'Exceptional Item' in the statement of profit and loss for the financial year ended 31.03.2020. Alternatively, whether the above transaction can be considered as 'Other Income' as a separate line item and recognized in the financial statements accordingly.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to presentation of feedstock subsidy claims for previous years, viz., whether the same should be considered as an exceptional item and should be disclosed on the face of the statement of profit and loss under the head 'Exceptional Items' or the same should be considered as 'other income' as a separate line item in the financial statements. 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, measurement and methodology for calculation of feedstock subsidy claims for previous years, accounting in relation to joint venture agreement, timing of accrual and recognition of feedstock subsidy, applicability of the requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', etc. Further, the opinion has been expressed in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as 'the Rules'). At the outset, the Committee notes from the Facts of the Case that claims for subsidy since commissioning (which is apparently in financial year 2015-16) till the financial year 2017-18 have been submitted immediately to the Government on 07.01.2020 after the approval of CCEA on 24.12.2019, which amounts to Rs.

930.49 crore and the same has been accounted for as an 'exceptional item' in the third quarter of the financial year 2019-20. Further, it appears that the subsidy claim for the financial year 2018-19 is yet to be submitted and the total estimated amount of subsidy claim upto financial year 2018-19 would be Rs. 1300 crore.

9. The Committee notes that Part II of Division II of Schedule III to the Companies Act, 2013 (hereinafter referred to as the 'Ind AS Schedule III'), which prescribes the format of statement of profit and loss applicable for companies adopting Ind ASs, requires presentation of 'Exceptional Items' as a separate line item in the statement of profit and loss. Further, Note 7 of the 'General Instructions for Preparation of Statement of Profit and Loss' applicable for companies adopting Ind ASs requires that a Company should disclose by way of notes, additional information regarding aggregate expenditure and income on some items. One of the items to be disclosed in this regard is 'details of items of exceptional nature'. However, the term 'exceptional item' is not defined in 'Ind AS Schedule III'. Further, the term 'exceptional item' is neither defined nor used in Ind ASs.

10. The Committee also notes the following paragraphs of Indian Accounting Standard (Ind AS) 1, 'Presentation of Financial Statements', notified under the Rules:

> "31 Some Ind ASs specify information that is required to be included in the financial statements, which include the notes. An entity need not provide a specific disclosure required by an Ind AS if the information resulting from that disclosure is not material except when required by law. This is the case even if the Ind AS contains a list of specific requirements or describes them as minimum requirements. An entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in Ind AS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance."

> **"85 An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement of profit and loss, when such presentation is relevant to an understanding of**

the entity's financial performance."

"86 Because the effects of an entity's various activities, transactions and other events differ in frequency, potential for gain or loss and predictability, disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future financial performance. An entity includes additional line items in the statement of profit and loss, and it amends the descriptions used and the ordering of items when this is necessary to explain the elements of financial performance. An entity considers factors including materiality and the nature and function of the items of income and expense. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. An entity does not offset income and expense items unless the criteria in paragraph 32 are met."

"**97 When items of income or expense are material, an entity shall disclose their nature and amount separately.**

98 Circumstances that would give rise to the separate disclosure of items of income and expense include:

(a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;

(b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;

(c) disposals of items of property, plant and equipment;

(d) disposals of investments;

(e) discontinued operations;

(f) litigation settlements; and

(g) other reversals of provisions."

Further, the Committee notes that the concept of 'materiality' has been discussed in paragraph 7 of Ind AS 1 as below:

"*Material Omissions* or misstatements of items are material if they

could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

11. From the above, the Committee notes that material items need to be presented as line items and/or disclosed in financial statements, which includes the notes. As per Ind AS 1, materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. Further, as per the requirements of paragraphs 85 and 86 of Ind AS 1, events and transactions which differ in frequency should be presented as additional line items/headings when such presentation is relevant to understanding of the entity's financial performance having regard to factors including materiality and the nature and function of the items of income and expense.

The Committee also notes that paragraph 12 of Accounting Standard (AS) 5, 'Net profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006 states that, "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately".

Therefore, the Committee is of the view that exceptional items are those items which meet the test of 'materiality' (size and nature) and the test of 'incidence'; and that all material items are not exceptional items. The Committee is further of the view that 'incidence' refers to frequency of occurrence and the meaning of the term 'material' should be construed as per paragraph 7 of Ind AS 1, as reproduced above. Thus, the Committee is of the view that for an item to be classified as an 'exceptional item', it has to be both 'material' as well as infrequent/non-recurrent in nature.

In the above context, the Committee notes that the querist has stated in the facts of the case that the accounting for past years of feedstock is one time incidence which will not recur in future, it is arising from the ordinary activities and the same is of material amount as the income to be recognized for period ended 31.03.2019 is around 50% of the revenue from overall operations in the year of accounting.

However, the Committee is of the view that feed stock subsidy of past years is only previous years' accumulated subsidy, which without the approval of CCEA could not be processed earlier and accounted for. Just because it is an accumulated amount pertaining to past years, it cannot be considered as having one time incidence or non-recurring. Further, considering that feedstock subsidy will be received by the Company for a period of 15 years from the date of commissioning, the Committee notes that such item will arise even after the financial year 2019-20 as well (although may be pertaining to the current reporting period only). Furthermore, the Committee is of the view that considering the nature of the industry to which the Company belongs to, although the methodology of determining feed stock subsidy in the extant case may not have been used in the past, but the granting of subsidy of this nature may not be irregular and uncommon.

As far as the issue regarding disclosure under the head 'other income', as raised by the querist, the Committee is of the view that feedstock subsidy is of the nature of grant related to income as per the requirements of Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance'. Accordingly, with regard to presentation of such grant, the Committee notes paragraph 29 of Ind AS 20, which states as follows:

> "**Presentation of grants related to income**
>
> 29 Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense."

From the above, the Committee is of the view that the feedstock subsidy in the extant case may be presented as a part of the statement of profit and loss either separately or under the general head of 'other income' considering the materiality of the item. Further, with regard to whether the item is 'material' or not and accordingly whether or not it requires separate disclosure, the Committee is of the view that it is a matter of judgement. In this regard, the Committee notes from paragraph 7 of Ind AS 1, reproduced above, that an item should be considered material if it can influence the economic decisions of the users and that materiality depends on both size and/ or nature of an item. Accordingly, the Committee is of the view that the same should be decided by the Company in its own facts and circumstances considering the factors as discussed above and accordingly, if it is material, the Company should comply with the disclosure requirements of paragraph 97 of Ind AS 1.

However, since both the materiality and incidence tests are required to evaluate whether an item is exceptional or not and in this case, even though the item is material, it does not meet the test of incidence merely on the basis of being related to past years, as discussed above, the Committee is of the view that the feedstock subsidy claims of previous years cannot be classified as 'exceptional item'.

D. Opinion

12. On the basis of the above paragraphs, the Committee is of the opinion that the feedstock subsidy claims of previous years cannot be classified as 'exceptional item'. Further, considering the requirements of Ind AS 20, the feedstock subsidy in the extant case may be presented as a part of the statement of profit and loss either separately or under the general head of 'other income' considering the materiality of the item. However, whether this item is material or not and accordingly whether or not it requires separate disclosure, is a matter of judgement and the same should be decided by the Company in its own facts and circumstances, considering the factors as discussed in paragraph 11 above; and accordingly, if it is material, the Company should comply with the disclosure requirements of paragraph 97 of Ind AS 1, as discussed in paragraphs 10 and 11 above.

Query No. 9

Subject: Accounting treatment of expenditure incurred for rejuvenation of petrochemical plant.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a central public sector undertaking under the administrative control of Department of Fertilizers, Government of India. The Company is engaged in manufacture and marketing of fertilizers and petrochemicals; engineering design & consultancy services; and fabrication & erection of equipments.

[1] Opinion finalised by the Committee on 23.5.2020.

2. The Company had closed down one of its plants known as caprolactam plant in the year 2012 due to uneconomic realisation on sale of caprolactam. The plant related to the production of caprolactam had been in shutdown condition for the last 7 years. This plant used to contribute Rs. 400 to Rs. 500 crore to the top line of the Company.

3. The querist has informed that being a petrochemical plant which is hazardous in nature, its re-start requires substantial capital investment. The assets of the plant are already substantially depreciated and no reassessment of life or value were conducted in the year 2013 consequent to changes in the method of accounting notified as per Companies Act, 2013/accounting standards. Consequent to the commissioning of LNG terminal at Kochi in the year 2013 and subsequent softening of prices of LNG globally, the profitability perspective of caprolactam production has changed drastically. Under this juncture, the Company reviewed the financial viability of caprolactam operations and it was decided to rejuvenate the caprolactam plant to generate reasonable value addition/contribution on restart of caprolactam production.

4. Accordingly, the Company decided to proceed with the activities for rejuvenation of the caprolactam plant and restart of its operations. The rejuvenation process and consequent restart of operations involved substantial investment and expenditure, including replacement/purchase of major equipments like gas scrubbing tower, SO2 line, KHI boiler internal & water wall, etc. and other expenditures like additional fuel, power and labour. The Company incurred a total expenditure of Rs. 18.24 crore during the financial year 2019-20, for the above. These additional investments provided an additional life to the plant for about 10 to 15 years. The Company has obtained opinion from its technical team on the remaining useful life of the plant, after the rejuvenation process. If the expenditure was not incurred, the plant would not have had any useful life and would have to be retired/scrapped.

5. The querist has provided the break-up of the expenditure incurred as follows:

i. Machinery including spares : 2.55 crore

ii. Fuel & Power : 13.73 crore

iii. Labour : 1.96 crore

6. The Company is following cost model of accounting for its property, plant and equipment. The Company's accounting policy on property, plant and equipment is as follows:

> "All Property, Plant and Equipment are stated at acquisition cost less accumulated depreciation / amortisation and cumulative impairment".

7. The Company's accounting policy on depreciation is as follows:

   i. Depreciation is charged on fixed assets based on the useful life of assets, prescribed under the Schedule II to the Companies Act, 2013. The Company has adopted straight line method of depreciation for all the categories of assets, acquired on or after 1st April, 2014.

   ii. Effective from 1st April, 2014, the Company has reassessed the useful life of its existing fixed assets (considering component approach wherever necessary) and has charged depreciation over the remaining useful lives, after retaining residual value, in accordance with the transitional provisions contained in the Schedule II to the Companies Act, 2013.

   iii. Residual value of 5% has been retained for all the Fixed Assets, which is in line with the provisions of the Schedule II.

8. The querist has stated that as per Indian Accounting Standard (Ind AS) 16, 'Property Plant and Equipment', the cost of an item of property, plant and equipment shall be recognised as an asset if it is probable that *future economic benefits* associated with the item will flow to the entity; and the cost of the item can be *measured reliably*. For the expenditure incurred for rejuvenation of caprolactam plant, the additional cost incurred has brought in future economic benefits and the cost can be measured reliably and therefore, the Company intends to capitalise the expenditure incurred for the modernisation of caprolactam plant. Incurrence of an expenditure of Rs. 18.24 crore, has resulted in conversion of a non-operative plant to the operating level, having a residual life of 10 to 15 years. Otherwise, according to the querist, the financial statements of the Company would not show a true and fair view of its operating results for the financial year 2019-20. (Emphasis supplied by the querist.)

9. The querist has provided following details regarding the nature and specific purpose(s) for which fuel and power expenditure (as mentioned

above) is required to be incurred and the reasons/justifications for treating such expenditure as initial cost of the plant and capitalising this expenditure:

> "The caprolactam plant of the Company has served its normal life and has been in shut down condition for the last six years. But it has not been written off/ scrapped in the books of account. Considering the present economic scenario, the Company has decided to rejuvenate / revive the plant by incurring additional expenditure including expenditure for fuel and power. By incurring these additional expenditure, the plant can be used for productive purpose for some more years. Trial run of various sub-systems of the Plant was done separately to ascertain the remaining fruitful life/ and its capability. These expenditures are onetime and the benefit of the same will be available throughout the useful life of the plant.
>
> As explained above, unlike fertilizer plants, caprolactam is a petrochemical complex comprising of critical equipments handling highly hazardous and combustible chemicals (organic & inorganic) which have to be properly installed and tested to ensure safety in operation. The situation become more complicated when the plant is kept idle for more than six years. Restarting a complex Petrochemical plant after a long down time requires more care and additional precautions to ensure safety in operation.
>
> Here the first priority of the Company was to ensure the technical viability and safety of operation of the plant after a long down time. All the equipments in the complex were inspected and necessary renewals were done wherever required. Considering the complexity of the system, it was decided to do the trial runs in stages. All the equipments and instruments were tested and calibrated. For the test runs for ensuring safety & integrity of the plants, energy is needed by way of electricity and steam. Rotating equipments need electrical energy whereas equipment like distillation columns need steam energy in order to ensure all the required process & safety parameters during test run.
>
> Being a critical petrochemical complex, the plant is designed to operate with captive power, for its safety and continuity. This captive power is generated through turbo generators, consuming regasified liquefied natural gas (RLNG). The Company has been conducting the

process of such rejuvenating tests of various equipments during 2019-20 and accordingly power and fuel were consumed during this period. This test run is essential for ensuring the safety and integrity of the plants before planning the restart of the complex on a continuous scale.

In this connection, it may also be noted that even during the commissioning of a new petrochemical plant also, power and fuel consumption for such type of installation had to be incurred prior to capitalisation. This being a peculiar requirement in complex petrochemical plants, testing and ensuring the safety parameters is an unavoidable part of capital cost for setting up and commissioning. At this juncture, the querist has also invited attention of the Committee to paragraph 17 of Ind AS 16, Property, Plant and Equipment, wherein it is clearly specified that cost of testing to ensure proper functioning of the asset has to be a part of capital cost.

This expenditure is in the nature of expenditure incurred to have another lease of life of the equipment. The original equipment has served its major part of its economic life, there is a possibility of having another lease of life. Parallel could be drawn in power sector, where the life extension programme of power plant is prevailing, wherein a residual life study is conducted towards the end of normal economic life and based on the recommendation, additional capital expenditure is incurred by way of major repairs, renewals and replacement of major spares. The residual cost of the plant embedded with additional capital expenditure forms a new asset with revised life. Power regulator, Central Electricity Regulatory Commission (CERC) is also recognising this as capital expenditure with a revised normative life lesser than that of earlier one.

At times, a plant build-up for normative capacity, may be running at lower capacity owing to the market requirement. Sometimes, when market improves, the plants' capacity may be ramped up by incurring some cost. These types of ramp-up and rampdown are seasonal and expenditure incurred on ramp-up are treated as revenue. In the Company's caprolactam plant, the expenditure incurred may not be equated to such ramping up, which may be frequent, where as in caprolactam, it is not regular; only once in its life time.

The existing petrochemical plants are already in unserviceable condition. The renewals and other expenditure for rejuvenating the plant would provide an additional life of 10 to 15 years. According to the querist, considering the residual life of the original plant, the expenditure incurred by way of test run and associated capital expenditure have to be capitalised and need to be written off over the period of expected useful life of the plant."

B. Query

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

i. How the expenditure incurred for modernisation of a closed plant so as to make it productive and to increase the expected life time to 10 to 15 years, can be accounted?

ii. Whether the expenditure incurred on rejuvenation/modernisation of the caprolactam plant, as detailed above, can be capitalised or to be treated as revenue expenditure.

iii. Whether the total amount incurred amounting to Rs. 18.24 crores can be written off over the remaining useful life of the asset as assessed by the technical team and in line with the accounting policy of the Company.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised in the query relates to the accounting treatment of the expenditure (comprising of machinery including spares, fuel & power and labour) incurred for modernisation/rejuvenation of a closed plant to make it productive and increase the expected life. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for any other expenditure incurred by the Company in relation to the plant, consideration of materiality, impairment of the closed plant, applicability of the requirements of Ind AS 105, 'Non-current Assets Held for Sale and Discontinued Operations' in respect of closed plant, etc. Further, the Committee presumes from the Facts of the Case that fuel and power cost is not in nature of raw material cost which would have resulted in production of finished goods. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

12. In the context of the issue raised, the Committee notes the following requirements of Indian Accounting Standard (Ind AS) 16:

"Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period."

"7 The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably.

8 Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory."

"10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. The cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets."

"12 Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

13 Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a nonrecurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 67–72).

14 A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed."

"Elements of cost

16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees."

"Depreciation

43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately."

"Depreciable amount and depreciation period

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 The residual value and the useful life of an asset shall be

reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*."

"57 The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets."

"Depreciation method

60 The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

61 The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8."

"Derecognition

67 The carrying amount of an item of property, plant and equipment shall be derecognised:

(a) on disposal; or

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

68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless Ind AS 116,

> ***Leases*, requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.”**

13. At the outset, the Committee notes from the facts provided by the querist that the Company was not required to perform regular major inspections for faults and consequently no costs for such major inspections/ testing was recognised in the carrying amount of the property, plant and equipment (PPE) and consequently, it is presumed that component accounting in respect of such major inspection cost was not necessary. The Committee does not opine in regard to whether in the Facts of the Case, component accounting is necessary or not.

14. The Committee notes from the Facts of the Case that the Company had closed down one of its plants known as caprolactam plant in the year 2012 due to uneconomic realisation on sale of caprolactam. Assets of the existing caprolactam plant are already substantially depreciated and if the expenditure was not incurred, the plant did not have any useful life and would have been retired/scrapped. The plant has been in shut down condition for the last six years, but was not written off/ scrapped in the books of account. From this, the Committee notes that no future economic benefits were expected to be available from the use of the plant without the incurring of the expenditure as stated by the querist.

In this context, the Committee notes from the above-reproduced requirements of Ind AS 16 that recognition principle as laid down in the Standard do not distinguish between costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. In both cases, any and all expenditure has to meet the recognition principle, and be expensed in profit or loss if it does not.

The Committee further notes that Ind AS 16, however, distinguishes between servicing and major expenditure. Paragraph 12 of Ind AS 16 requires that expenditure on repairs and maintenance, including replacement costs of small parts and cost of day-to-day servicing of the items is charged to profit or loss as and when incurred. The Committee presumes from the facts of the case that the expenditure incurred by the Company does not include expenditure of the nature described in paragraph 12 of Ind AS 16.

The Committee further notes from paragraph 13 of Ind AS 16 that when the conditions of recognition as per paragraph 7 of Ind AS 16 are met, an entity recognises in the carrying amount of an item of property, plant and equipment, the cost of replacing part of such an item when that cost is incurred and the carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of Ind AS 16.

Accordingly, in the extant case, all major subsequent expenditure incurred including the cost of replacing various assets of the caprolactam plant should be capitalised provided it is probable that the future economic benefits will flow to the Company and the cost of the asset to the Company can be measured reliably. As mentioned by the querist, the assets of the caprolactam plant are already substantially depreciated. Therefore, the Committee believes that an entity will generally choose to incur additional expenditure on an asset when it expects that expenditure to generate net future economic benefits.

Further at the same time, the carrying amount of those assets that are replaced should be derecognised as per the derecognition provisions of Ind AS 16. However, if there are any expenditure on regular repairs and maintenance as afore-mentioned, the same should not be capitalised. Further, from the above-reproduced paragraphs 16 and 17 of Ind AS 16 dealing with the items of costs that can be capitalised as part of an item of PPE, the Committee is of the view that in the extant case, while rejuvenation/ modernisation of the plant, only those costs that are directly attributable to bringing the various asset(s)/plant to the location and condition necessary for it/them to be capable of operating in the manner intended by management should only be capitalised as part of the cost of asset(s)/plant, such as, cost of site preparation, installation, trial/test runs, etc. Thus, as far as the costs relating to labour and power and fuel are concerned in the extant case, same can be capitalised only if these are directly attributable to bringing the various asset(s)/plant to the location and condition necessary for it/them to be capable of operating in the manner intended by management. In this context, the Committee notes from the Facts of the Case that the fuel and power was consumed for both trial/test runs of new equipments as well for ascertaining the serviceability of existing sub-systems of the plant. The Committee is of the view that any fuel and power consumed for ascertaining the serviceability of existing plant and equipment or costs incurred to arrive at a decision whether to modernise/rejuvenate the caprolactam plant should not be capitalised as this expenditure is not required for bringing the plant to an operating condition.

15. Further, the amount added or capitalised to the plant should be depreciated over the useful life of the asset/plant in accordance with the principles enunciated in above-reproduced paragraphs 43, 50, 51, 60 and 61 of Ind AS 16. In this context, the Committee also notes that considering the background of shutting down the plant due to uneconomic price realisation, this factor should be considered while determining the useful life of the petrochemical plant.

D. Opinion

16. On the basis of the above and subject to paragraphs 11 and 13 above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

i. and ii. As discussed in paragraph 14 above, all major subsequent expenditure incurred including cost of replacing various assets of the caprolactam plant should be capitalised provided it is probable that the future economic benefits will flow to the Company and the cost of the asset to the Company can be measured reliably, as per the requirements of paragraph 7 of Ind AS 16. Further at the same time, the carrying amount of those assets that are replaced should be derecognised as per the derecognition provisions (paragraphs 67 and 68) of Ind AS 16. However, if there are any expenditure on regular repairs and maintenance as afore-mentioned, the same should not be capitalised. Further, as far as the costs relating to labour and power and fuel are concerned in the extant case, same can be capitalised only if these are directly attributable to bringing the various asset(s)/plant to the location and condition necessary for it/them to be capable of operating in the manner intended by management. Thus, any fuel and power consumed for checking the serviceability of existing plant and equipment should not be caiptalised as this expenditure is not required for bringing the plant to an operating condition.

iii. As discussed in paragraph 15 above, depreciation should be provided in accordance with the principles enunciated in paragraphs 43, 50, 51, 60 and 61 of Ind AS 16.

Query No. 10

Subject: Amortisation of stamp duty and registration charges paid/payable towards execution of mining lease deeds.[1]

A. Facts of the Case

1. A Maharatna Public Sector Undertaking (PSU) (hereinafter referred to as 'the Company'), is the leading steel-making Company in India having five integrated steel plants located at Bhilai, Durgapur, Rourkela, Bokaro and Burnpur; and three special steel plants at Salem, Durgapur and Bhadravati. The Company produces both basic and special steels for domestic construction, engineering, power, railways, automotive and defence industries as well as for sale in export markets.

2. The Company also owns iron ore, flux and coal mines located in various states of the country. The entire iron ore required for the production of steel is sourced from the captive mines of the Company. The mines are located in the states of Jharkhand, Odisha, Chhattisgarh and Madhya Pradesh i.e. close to the steel plants and ensure easy availability of iron ore, limestone, and dolomite to the steel plants.

3. The Company is carrying out mining activities on the leasehold lands for which the mining leases have been granted by the respective State Governments. Most of the leases have been granted way back in 1945, 1947, 1948, 1960 etc. At present, there are 13 leasehold lands in the state of Jharkhand, besides other mining leases in Odisha, Madhya Pradesh and Chhattisgarh.

4. For execution of lease deeds, Stamp duty and registration charges are applicable for renewal/extension of mining leases. It is also to note that there are no other major payments made towards execution of mining lease deeds.

5. As per the relevant Acts and Rules, mere renewal/extension & execution of mining leases does not enable the Company to carry out mining activities. The Company has to obtain approval of mining plan from Indian Bureau of Mines and also to obtain clearances such as forest clearance (if there is forest land involved) & environmental clearance under relevant Act and Rules of Ministry of Environment and Forest (MOEF). Payments towards obtaining these approvals and clearances are treated separately as intangible asset which are booked under 'Mining Right'.

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[1] Opinion finalised by the Committee on 4.6.2020.

6. The grant and renewal of such mining leases were earlier governed by Mines and Minerals (Development & Regulation) Act, 1957 (MMDR Act, 1957). There has been a substantial change in the framework of original MMDR Act, 1957 concerning the grant and renewal of mining leases and in this regard, MMDR Amendment Act, 2015 has come into force w.e.f. 12.01.2015(C/1 to C/12). In pursuance to the provisions as stipulated under section 8A(8) of MMDR Amendment Act, 2015 (relevant extracts have been supplied by the querist for the perusal of the Committee), and in exercise of the powers conferred by section 13 of MMDR Act, 1957, the Central Government by Notification dated 03.12.2015 has formulated the Mineral (Mining by Government Company) Rules, 2015. The matters related to extension of periods of mining leases held by Government Companies are being governed by MMGC Rules, 2015(C/13 to C/15). As per Rule 3 of the said Rules, the period of leases granted prior to 2015, are extended as herein under:

> "(1) All mining leases for minerals granted to a Government Company or corporation before the date of commencement of the Mines and Minerals (Development and Regulation) Amendment Act, 2015 (10 of 2015), namely, the 12th January, 2015 shall be deemed to have been granted for a period of fifty years.
>
> (2) The State Government, upon an application made to it in this behalf by the Government Company or corporation at least twelve months prior to the expiry of the mining lease, may, for reasons to be recorded in writing, extend the period of the mining lease for further periods of upto twenty years at a time.
>
> (3) Subject to sub-rule (1), all applications made by a Government Company or corporation for renewal of mining leases and which were pending as on the date of commencement of the Mines and Minerals (Development and Regulation) Amendment Act, 2015 (10 of 2015) shall be deemed to be applications for extension of the period of the mining lease and shall be disposed of in accordance with the provisions of sub-rule (2)."

7. As per the provisions of MMGC Rules, 2015, the mining leases granted prior to 12th January, 2015 (i.e. date of effect of MMDR Amendment Act, 2015) shall be deemed to have been granted for a period of 50 years. The mining lease periods shall be extended for further period of 20 years at a

time provided an application for extension of the lease has been filed at least 12 months before expiry of mining leases.

8. Though the leases are pending for formal extension order, by virtue of the deemed extension clause, as the Company has submitted necessary application and carried out required formalities as per the Act/Rules to obtain further extension, the Company is carrying out mining activities on the leasehold land. As such, execution of mining lease deeds are also pending for the applications submitted for extensions.

9. It is also to note that as per the provisions of MMDR Amendment Act, 2015 & MMGC Rules, 2015, there are all probabilities that the State Government would accord approval for the extension (of the Leases) in favour of the Company.

10. The Company has calculated internally the lease period allowed for extension of the mining leases and accordingly considered in accounts the amount towards stamp duty and registration charges on estimated basis considering best information available with the Company, which might be paid while State Government accord for formal extension of such leases.

11. The querist has stated that due to specific exclusions on applicability of Indian Accounting Standard (Ind AS) 17, 'Leases' to leases 'to explore for or use minerals, oil, natural gas, and similar non-regenerative resources', the amount of stamp duty and registration charges is estimated and capitalised under leasehold land and amortisation is charged over the remaining useful life of the leasehold land. If any revision of estimation is carried out in a year, the revised gross block less accumulated depreciation till date, is amortised over the remaining lease period. Every year, the Company reviews the estimate and necessary accounting adjustments are carried out as under:

Previous estimated gross amount	=	A
Accumulated amortisation	=	B
Remaining lease period	=	15 years
Revised estimated gross carrying amount	=	X
Amortisation per year	=	(X-B)/15

The reason for revision of estimates is due to change in certain factors viz., changes in monthly royalty rates and frequent changes in the methodology adopted by the Government Authorities.

The Company has been following the above practice consistently over the years. The querist has further submitted an illustrative example explaining the treatment being followed by the Company and the treatment suggested by the Auditor as Annexure I.

12. The instant matter is related to three mining leases under the state of Jharkhand.

a) Dhobil mining lease covering an area of 513.036 hectare was initially granted on 8th March, 1948 for a period on 30 years. Further, the State Government renewed the lease for another 20 years period i.e. from 08.03.1978 to 07.03.1998. The lease was due for renewal on 7th March, 1998, and necessary application for renewal of mining lease for another 20 years period upto 07.03.2018 was submitted to the State Government under the provisions of the then Act/Rules. The stamp duty and registration charges were estimated and being amortised considering remaining useful life upto 7th March, 2018. Till 2016-17, no formal renewal/extension order was issued for 1998 to 2018 by the State Government. Meanwhile, the Company also submitted application for further renewal of lease period for another twenty years period upto 07.03.2038 under the provisions of the then Act/Rules. Based on the available information, the Company estimated stamp duty and registration charges amounting to Rs. 3.00 crore and amortised the gross carrying amount upto 7th March, 2018. After promulgation of MMGC Rules, 2015, the Company submitted an application for extension of lease as per the provisions of said rules. On 8th March, 2018, the concerned department under State Govt. of Jharkhand issued necessary Order towards extension of the lease upto 8th March, 2038. The State Govt. has also issued Order towards regularising renewal from 1998 to 2018 on the even date. Subsequent to it, the State Govt. raised demands towards stamp duty and registration charges in the month of April, 2018 and May, 2018 respectively. The demanded amount consists of two periods i.e. from 1998 to 2018 and from 2018 to 2038. The total demand for both the periods amounted to Rs. 12.84 crore. It is to note that while raising the demand for both the periods, Govt. of Jharkhand has considered the latest royalty rate available as on that date.

b) In case of lease (Ajitaburu), the lease was initially granted on

07.12.1947 for an area of 323.887 Hectare. Considering first grant of lease for fifty years, the extension was due on 6.12.1997 and further extension was due on 7.12.2017 for twenty years. The applications towards extension for two periods were pending with the Govt. The Company has amortised the estimated amount of stamp duty and registration charges for the first 20 years period upto 6.12.2017 and considered a further estimate for stamp duty for the period from 7.12.2017 upto 7.12.2037. In 2018-19, the Company has amortised the total estimated gross carrying amount considering remaining useful life upto 7.12.2037.

c) In case of lease (Budhaburu), the lease was initially granted on 8.12.1945 for an area of land 823.617 Hectare. Considering the first grant of lease for fifty years, the extension was due on 7.12.1995 and further extension was due on 8.12.2015. The applications towards extension for two periods were pending with the Govt. The Company amortised the estimated amount of stamp duty and registration charges for the first period upto 8.12.2015 and considered a further estimate for stamp duty for the period from 8.12.2015 to 7.12.2035. In 2018-19, the Company has amortised the total estimated gross carrying amount considering remaining useful life upto 7.12.2035.

13. In the financial year 2017-18, for Lease (Dhobil) – Government of Jharkhand passed the Order of extension upto 8th March, 2038. On receipt of Order for extension and further to its demand for stamp duty and registration charges for two periods (i.e. from 08.03.1998 to 07.03.2018 and 08.03.2018 to 08.03.2038), the Company further capitalised the total differential amount under 'Leasehold Land' and the revised gross carrying amount (i.e. Rs. 12.84 crore minus already amortised amount Rs. 3 crore) was considered for amortisation over the remaining useful life i.e. upto 08.03.2038.

14. On receipt of demand of stamp duty and registration charges towards mining leasehold land (Dhobil), the present estimate of lease (Ajitaburu) and lease (Budhaburu) have been revised in line with the methodology adopted for Dhobil lease. While revising the estimate, the Company has revised the estimate for the entire forty year period including the previous period as well, i.e. for lease (Ajitaburu) total estimate for the period 1997-2017 and period from 2017 to 2037 have been revised. Similarly, for lease (Budhaburu) total estimate was revised including the previous estimate made for the period

1995 to 2015 and 2015 to 2035. Accordingly, the respective revised gross carrying amount for forty year period as on 31st March, 2018 minus amortisation already done, have been amortised over the remaining useful life i.e. upto year 2037 for lease (Ajitaburu) and upto 2035 for lease (Budhaburu).

15. It may also be noted that while the leases are extended and corresponding demand is raised for the future period, Government has to regularise for past lease period as well and by paying the demand for past as well as future periods, the Company is entitled to the economic benefit accruing over the remaining future useful life i.e. till the future remaining period of lease. It is also to note that these leases are perpetual in nature and the period of lease is extended as per law for 20 years at a time.

16. It is to state that the above accounting treatment is being consistently followed as per the Accounting Policy of the Company as stated below and as per applicable Accounting Standards, viz., Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' and Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', the relevant clauses of which are as under:

Accounting Policy of the Company states:

"Use of Estimates and Management Judgement

In preparing the financial statements in conformity with Company's Accounting Policies, management is required to make estimates and assumptions that affect reported amounts of assets and liabilities and the disclosure of contingent liabilities as at the date of the financial statements. ... Actual results could differ from those estimates. Any revision to such estimates is recognised in the period in which the same is determined." (Para 2.4 on page 39 of the Annual Report)

3.1.2 Depreciation

"... The estimated useful lives and residual values of depreciable/ amortisable assets are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

Where the historical cost of a depreciable asset undergoes a change, the depreciation on the revised unamortised depreciable amount is provided over the residual useful life of the asset. ..." (Para 3.1.3 on page 39 of the Annual Report)

Relevant excerpts of Ind AS referred to are as under:

Ind AS 16 – Property, Plant and Equipment

"Depreciation **is the systematic allocation of the depreciable amount of an asset over its useful life*."***

"Depreciable amount and depreciation period

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*."

"56 The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. …

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases."

Ind AS 8 - Accounting Policies, Changes in Accounting Estimates and Errors

"32 As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information. For example, estimates may be required of:

(a) bad debts;

(b) inventory obsolescence;

(c) the fair value of financial assets or financial liabilities;

(d) the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and

(e) warranty obligations.

33 The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

34 An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error."

"**36 The effect of change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in:**

(a) the period of the change, if the change affects that period only; or

(b) the period of the change and future periods, if the change affects both.

37 To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item

in the period of the change.

38 Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate. A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods."

B. Query

17. On the basis of above facts, the Company seeks the opinion of the Expert Advisory Committee on the following issues:

(a) Whether the total payment including differential amount (i.e. actual payment minus estimated amount) for past period can be amortised over the future remaining useful life of lease period. or

(b) Where the gross block is estimated and amortised, whether the differential gross carrying amount for the past period based on revised estimate, is to be charged fully in the year of revision(s).

C. Points considered by the Committee

18. The Committee notes that the basic issue raised in the query relates to amortisation of the differential amount (i.e. actual payment minus estimated amount) of stamp duty and registration charges for past period, viz., whether the same can be amortised over the future remaining useful life of lease period. The Committee has, therefore, considered only this issue and has not

considered any other issue that may arise from the Facts of the Case, such as, accounting treatment of mining rights and various expenditure incurred for and during the mining activities, accounting for any other cost incurred in relation to renewal including any recurring cost, depreciation method to be followed in case of iron ore reserves, etc. Further, the opinion issued is purely from accounting perspective and not from the perspective of legal interpretation of Mines and Minerals (Development & Regulation) Act, 1957 (MMDR Act, 1957), MMDR Amendment Act, 2015, Mineral (Mining by Government Company) Rules, 2015 etc. At the outset, the Committee wishes to clarify that situations of three different mines have been discussed in the facts, however, the Committee has examined the issue from the broad perspective of accounting principles to be followed and not with respect to each situation separately. Further, the Committee wishes to point out that the Indian Accounting Standards referred to in the Opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

19. At the outset, from the perspective of the applicable Accounting Standard for mining leases, the Committee notes that the erstwhile Ind AS 17, 'Leases' and Ind AS 116, 'Leases' (which supersedes Ind AS 17 and is applicable from the accounting periods beginning on or after April 1, 2019) state as follows:

Ind AS 17

"2 This Standard shall be applied in accounting for all leases other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and

..."

Ind AS 116

"3 An entity shall apply this Standard to all leases, including leases of *right-of-use* assets in a *sublease*, except for:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

..."

The Committee notes from the above that Ind AS 17/116 does not apply to leases to explore for or use minerals and therefore these standards are not applicable in the extant case. The Committee further notes the following paragraphs of Ind AS 106, 'Exploration for and Evaluation of Mineral Reserves':

Ind AS 106

"3 An entity shall apply this Ind AS to exploration and evaluation expenditures that it incurs."

"5 An entity shall not apply this Ind AS to expenditures incurred:

(a) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area.

(b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable."

"9 An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources. The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):

(a) acquisition of rights to explore;

(b) topographical, geological, geochemical and geophysical studies;

(c) exploratory drilling;

(d) trenching;

(e) sampling; and

(f) activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource."

"12 After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets. If the revaluation model is applied (either the model in Ind AS

16, *Property, Plant and Equipment* or the model in Ind AS 38) it shall be consistent with the classification of the assets (see paragraph 15)."

"15 An entity shall classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired and apply the classification consistently.

16 Some exploration and evaluation assets are treated as intangible (eg drilling rights), whereas others are tangible (eg vehicles and drilling rigs). To the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset."

The Committee notes from the above-reproduced requirements of Ind AS 106 that mining lease in the extant case is an exploration and evaluation asset under Ind AS 106, which should be initially recognised at cost and subsequently in accordance with Ind AS 38, considering that the mining lease is intangible in nature.

20. The Committee further notes the following paragraphs of Ind AS 38, 'Intangible Assets':

"**88 An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.**

89 The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised (see paragraphs 97–106), and an intangible asset with an indefinite useful life is not (see paragraphs 107–110)."

"94 The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period

of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. The useful life of a reacquired right recognised as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.”

“96 Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

(a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;

(b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and

(c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.

If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the ‘renewal’ cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.”

The Committee also notes the Basis of Conclusions on International Accounting Standard (IAS 38), ‘Intangible Assets’, issued by the International Accounting Standards Board, which state as follows:

“BC 66 The Board noted that the useful life of an intangible asset that arises from contractual or other legal rights is constrained by the duration of those rights. The useful life of such an asset cannot extend beyond the duration of those rights, and may be shorter. Accordingly, the Board concluded that in determining the useful life of an intangible asset, consideration should be given to the period that the entity expects to use the intangible asset, which is subject to the expiration of the contractual or other legal rights.

BC 67 However, the Board also observed that such rights are often conveyed for limited terms that may be renewed. It therefore considered whether renewals should be assumed in determining the useful life of such an intangible asset. The Board noted that some types of licences are initially issued for finite periods but renewals are routinely granted at little cost, provided that licensees have complied with the applicable rules and regulations. Such licences are traded at prices that reflect more than the remaining term, thereby indicating that renewal at minimal cost is the general expectation. However, renewals are not assured for other types of licences and, even if they are renewed, substantial costs may be incurred to secure their renewal.

BC 68 The Board concluded that because the useful lives of some intangible assets depend, in economic terms, on renewal and on the associated costs of renewal, the useful lives assigned to those assets should reflect renewal when there is evidence to support renewal without significant cost."

From the above, the Committee notes that an intangible asset with finite useful life is to be allocated on a systematic basis over its useful life. The term 'useful life' is defined as: (a) the period over which an asset is expected to be available for use by an entity; or (b) the number of production or similar units expected to be obtained from the asset by an entity. The Standard further states that if the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

The Committee also notes from the above that in case the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date. Thus, the Committee is of the view that the accounting for cost of renewal in the extant case would depend upon whether the same is significant when compared with the future economic benefits expected to flow to the entity from renewal. In case it is so, the cost of renewal shall represent the cost to acquire a new intangible asset (mining lease) at the renewal date and accordingly, it should be amortised over its useful life, viz., the renewal period, however, it may be shorter depending on the period over which the entity expects to use the asset. In this context, the Committee notes from the illustrative example provided by the querist in the Annexure I that the Company is considering the estimated cost of renewal of a lease as a new separate asset, which is being amortised over the period of renewal of that lease. From this, it is assumed that the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal. Therefore, the Committee is of the view that each cost of renewal should be amortised over its useful life, viz., each renewal period (which is normally 20 years in the extant case) or any shorter period depending on the period over which the entity expects to use the asset. Further, as far as difference in the estimated cost and actual cost is concerned, the Committee is of the view that since there was uncertainty with regard to amount of cost to be incurred at the time of renewal of lease, the Company should make a provision for the present obligation in respect of renewal cost at the renewal date, viz., when such leases are renewed (which in the extant case may be assumed to be renewed on the expiry of the initial or earlier renewed period) on the basis of best estimate of the expenditure required to settle the present obligation of renewal cost, viz., stamp duty and registration charges, as per the requirements of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets'; and the same should also be reviewed at each reporting date and adjusted to reflect the current best estimate. Further, the provision being in respect of the intangible asset (mining lease), it should be capitalised as a new intangible asset. If the provision amount is different from the actual expenditure incurred, same should be considered as change in estimates as per the requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', which being related to the new intangible asset (mining lease), should be amortised over its remaining useful life, viz., the remaining period of renewal for which such costs were estimated (and not including the period of next renewal period) or the remaining shorter period if expected period of use is shorter.

In case the useful life has already expired, the change in estimates of the amount of stamp duty and registration charges should be recognised as an expense forthwith in the period of such change. In this regard, the Committee also notes that Ind AS 8 provides as follows:

"34 An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error."

"**36 The effect of change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in:**

(a) the period of the change, if the change affects that period only; or

(b) the period of the change and future periods, if the change affects both.

37 To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

38 Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate. A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods."

From the above, the Committee notes that Ind AS 8 states that a change in accounting estimate is recognised prospectively by including it in profit or loss in the period of change, if the change affects that period only or the period of the change and future periods, if the change affects both. It further states that the effect of a change in an estimate is applied from the date of the change in the estimate and the effect, if any, on future periods is recognised as income or expense in those future periods e.g. change in estimated useful life or the expected pattern of consumption of the future economic benefits. The Committee notes that in the extant case, if at the time of change in estimates, it is determined that the useful life (determined as per the afore-mentioned discussion) has already expired, the change affects only the current period and should be recognised in the period of change only. However, if there is any remaining useful life of the intangible asset at the time of change in estimates, the change in estimates affects both the current and future periods, and accordingly, the intangible asset (mining lease) should be amortised over the remaining useful life of the mining lease.

D. Opinion

21. As discussed in paragraph 20 above, the Committee is of the opinion that since in the extant case, the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, each cost of renewal should be amortised over its useful life, viz., each renewal period (which is normally 20 years in the extant case) or any shorter period depending on the period over which the entity expects to use the asset.

The differential amount between the amount provided for in respect of past renewal cost (viz., estimated stamp duty and registration charges) and the actual cost should be considered as a change in estimates as per the requirements of Ind AS 8, ‘Accounting Policies, Changes in Accounting Estimates and Errors’; and should be amortised over the remaining useful life of the intangible asset (mining lease), viz., the remaining period of renewal for which such costs were estimated (and not including the period of next renewal period) or the remaining shorter period if expected period of use is shorter, as discussed in paragraph 20 above. In case the useful life has already expired, the change in estimates of the amount of stamp duty and registration charges should be recognised as an expense forthwith in the period of such change.

Annexure I

			Extension granted in Mar 18 for two periods		
	Year of Grant				
		1st extension			
	30 Yrs		2nd Extension		
	March 1948	20 Yrs		3rd extension	Next expiry
		March 1978	20 Yrs		
			March 1998	20 Yrs	
Lease I				March 2018	March 2038
Stamp duty & Registration charges estimated	Paid & amortised	Paid & amortised	Rs 100	Rs 100	
Amortisation /Yr			100/20 = 5	100/20 = 5	
Amortised upto March 2017				95	
Demand receipt in Mar 18 for two periods			Two periods = Rs 150 + Rs 150		
Amortisation in Accounting Year **2017-18** and onwards adopted				{(150 +150) - 95} /21 Yrs	
Amortisation in Accounting Year **2017-18** and onwards as suggested by Audit				(50 +5)	(150) /20 Yrs = 7.5

			Extension pending for two periods		
	Year of Grant				
		1st extension			
	30 Yrs		2nd Extension		
	March 1945	20 Yrs		3rd extension	Next expiry
		March 1975	20 Yrs		
			March 1995	20 Yrs	
Lease II				March 2015	March 2035
Stamp duty & Registration charges estimated	Paid & amortised	Paid & amortised	Rs 100	Rs 100	
Amortisation /Yr			100/20 = 5	100/20 = 5	
Amortised upto March 2017			100 + 5 + 5		
Revision of estimates			Two periods = Rs 150 + Rs 150		
Amortisation in Accounting Year **2017-18** and onwards adopted			{(150 +150) - 110} /18 Yrs		
Amortisation in Accounting Year **2017-18** and onwards as suggested by Audit				{(50 + (7.5-5) +(7.5-5)}	{(150 - 15)} /18 Yrs

(The above is an Illustration provided by the querist)

Query No. 11

Subject: Non-recognition of deferred tax assets on provision for warranty, replacement, inventory and doubtful debts & claims.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is an Indian state owned aerospace and defence Company. The Company is engaged in the design, development, manufacture, repair, overhaul, upgrade and servicing of a wide range of products including aircrafts, helicopters, aero engines, avionics, accessories and aerospace structures. Manufacture of the Company's products involve a substantial period of time and are subject to high precision and stringent quality control measures and Inspection procedures.

Accounting treatment in the books of account of the Company:

2. The querist has stated that in terms of the contracts entered into with Defence customers, the contracts typically provide for:

(a) Product warranties

(b) Liquidated damages for supply beyond the contractual delivery date

The Company in compliance of Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets', recognises provision for liabilities in respect of replacement or future charges, onerous contracts, wage revision due to revision in salary, raw materials to take care of redundancy, doubtful debts / claims in respect of dues from parties other than Government in addition to warranties and liquidated damages. The nature and method of provision in respect of each item is detailed below:

a) Warranty Provision

- The Company offers warranty for the supplies of various platforms and services given to Defence services as per the terms and conditions of the warranty governed by the Government of India (GOI) policy letter.
- The warranty obligation depends on the nature of activities like

[1] Opinion finalised by the Committee on 4.6.2020.

manufacturing, overhaul, repair and spares and is for specific period or flying hours.

- The approved price for supply of the Company's products/services to defence customers includes warranty as a separate element of cost.
- As on date, the warranty percentage applicable for various products is as tabulated:
    - Aircraft & Helicopters - 1.75%
    - Engine - 4%
    - Accessories - 3.5%
- The warranty liability is recognised in the books based on actuarial valuation by independent actuary. The basis of the ascertainment of the warranty liability is done after considering the date from which warranty starts, period of warranty outstanding, warranty percentage, warranty expenditure incurred etc.
- The provision is created/withdrawn for the reporting period based on the actuarial valuation. When the closing liability (after adjustment of actual expenditure) assessed as per actuarial valuation is more than available liability, provision is made towards warranty. In case closing liability as per actuarial valuation is less than available liability, unutilised liability is withdrawn and accounted for as operating revenue.

b) *Provision for Liquidated Damages (LD)*

- Provision for liquidated damages is recognised for the period of delay between due date of supply of goods/services as per contractual delivery and the actual date of delivery in respect of the contracts, repair & overhaul task and spares supplies.
- Liquidated damages are payable upto 5% (maximum) for supplies under various manufacturing contracts and upto 10% (maximum) for repair & overhaul and supply of services.
- The provision created/withdrawn for the reporting period is arrived at as follows :

  - The opening liability at the beginning of the year is reduced by actual LD paid during the reporting period.
  - Closing balance of liability required at the end of reporting period is determined considering the delay between due date and actual date of delivery.

- When the closing liability is more than available liability, provision is made towards LD. In case closing liability is less than available liability, unutilised liability is withdrawn and accounted as operating revenue.

c) *Provision for Replacement & Future Charges*

- Provision for replacement and future charges outstanding at the close of each financial year is made towards:
  - Material taken on loan from customer, which needs to be replaced subsequently.
  - Maintenance expenditure from acceptance of products by customer till physical delivery.
- The provision to be created/withdrawn for the reporting period is arrived at as follows:
  - The opening liability at the beginning of the year is reduced by the expenditure incurred during the reporting period and net liability is arrived at the end of reporting period.
  - When the closing liability is more than available liability, provision is made towards replacement or future charges. In case closing liability is less than available liability, unutilised liability is to be withdrawn and accounted for as other Operating Revenues.

d) *Onerous Contract*

- A provision for onerous contract is recognised when the expected benefits to be derived by the Company are less than the unavoidable cost of meeting its obligations under the contract.

- Prior to the creation of provision, the Company recognises any impairment loss on the assets associated with that contract.

e) Wage Revision

Pending settlement of negotiations with workmen, based on the past settlement, provision is made for wage revision.

f) Provision for Redundancy of Materials

Redundancy provision is recognised in the books of account based on the available balance of inventories @ 1.5% of the total inventories and 100% of the shelf-life expired items, non-moving items for more than 5 years, closed projects etc.

Provision is assessed at the close of accounting period and required provision is created and excess, if any, is reversed in the books of account.

g) Provision for Doubtful Debts

In respect of dues from customers other than Government, provision is made if the debts are due for more than three years on case to case basis.

h) Provision for Doubtful Claims

Claims on suppliers / underwriters / carriers towards loss / damages, claim for export subsidy, duty drawback and claims on Customs Department for refunds are accounted for when claims are preferred and are carried forward till such time the Company has a legal right to recover such amounts.

3. The querist has referred to the following requirements of Ind AS 12, 'Income Taxes':

"*Deferred tax liabilities* are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

***Deferred tax assets* are the amounts of income taxes recoverable in future periods in respect of:**

(a) deductible temporary differences;

(b) the carryforward of unused tax losses; and

(c) the carryforward of unused tax credits.

***Temporary differences* are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:**

(a) *taxable temporary differences*, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) *deductible temporary differences*, which are temporary differences that will results in amounts <u>that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.</u>"

"24 A deferred tax asset shall be recognised for all <u>deductible temporary differences</u> to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized. ..."

(Emphasis supplied by the querist.)

4 The querist has given the reasons for not accounting for deferred tax assets (DTA) by the Company in respect of the following provisions as follows:

S. No.	**Description**	**Certainty/Uncertainty**	**Treatment in deferred tax computation**
1	***Provision for Warranty:*** Provision for warranty is created by the Company for an estimated amount that may have to be spent to repair or replace a product during its warranty period. The Company recognises the provision on the basis of actuarial valuation in respect of warranty for	It is uncertain that the provision created for warranty by the Company will be utilized fully or the utilization of the provision will be at the amount of provision	Even though it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, DTA was not created for provision for warranty,

<table>
<tr><td></td><td>manufacturing, repair and overhaul of aircraft/helicopter/engine/ rotables and spares.</td><td>created.</td><td rowspan="3">redundancy, replacement and other charges, doubtful debts and claims since the following was not certain:
(1) amount of provision and
(2) whether the provision will be settled fully in future (i.e. there will be no reversal)
(Emphasis supplied by the querist.)</td></tr>
<tr><td>2</td><td>Provision for redundancy:
Provision for redundancy is assessed by the Company on ageing at a suitable percentage / level of the value of closing inventory of raw material and components, stores and spare parts and construction material. Besides, wherever necessary, the Company provides adequate provision for the redundancy of such materials in respect of completed / specific projects and other surplus / redundant material pending transfer to salvage stores.</td><td>The provision for redundancy will never be recovered or settled by the Company in full.</td></tr>
<tr><td>3</td><td>Provision for replacement and other charges:
It represents provision created by the Company for expenditure which may be incurred from the date of acceptance of products by customer till physical delivery and loan items taken from the customer which need to be replaced, etc.</td><td>It is uncertain that whether the provision by the Company will be required or if required, whether it will be sufficient or deficient for the expense to be incurred between the date of acceptance of products by customer till physical delivery.</td></tr>
</table>

4	***Provision for doubtful debts:*** Debts from the Government departments are generally treated as fully recoverable by the Company and hence the Company does not recognise credit risk of such financial assets. Impairment on account of expected credit loss is being assessed by the Company on a case to case basis in respect of dues outstanding for a significant period of time.	As per the recent past history of the Company, there was no trade receivable which was written off as bad debts for receivable from Government. Therefore, it is highly uncertain that the provision created will be treated as bad debts.	
5	***Provision for Doubtful claims:*** *Claims which are not likely to realise are provided as doubtful claims.*	There is no certainty that the doubtful claims would be reversed.	

5. In view of the above, the Company has not recognised deferred tax assets (DTAs) of Rs.1,14,360 lakhs as on 31.03.2019. The break-up of which is given below:

Rs. in lakhs

Sl. No.	Description	As on 01.04.2018	For the year 2018-2019	Utilisation/ Reversal during the year	As on 31.03.2019
1	Provisions for Replacement and Other Charges	101577	51323	8245	144655
2	Provision for warranty	43056	22186	8779	56463
3	Provision for Raw Materials and	77314	9638	8698	78254

	Components, Stores and Spares, Construction Material and Loose Tools				
4	Provision for Doubtful Debts	18122	719	2108	16733
5	Provision for Doubtful Claims	29831	2153	822	31162
	Total	**269900**	**86019**	**28652**	**327267**
	Tax @34.944%				**114360**

6. *Issue raised by the Auditors:*

The querist has informed that during the audit of the financial statements for the year ended 31.03.2019, the statutory auditors appointed by the Comptroller and Auditor General of India (C&AG) have raised an issue that in terms of Ind AS 12, 'Income Taxes', deferred tax shall be recognised as these are all deductible temporary differences. The relevant paragraphs have been referred as follows:

"**24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:**

(a) is not a business combination; and

(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

25 It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When

resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to deferred tax asset in respect of the income taxes that will be recoverable in future periods."

"26 The following are examples of deductible temporary differences that result in deferred tax assets:

(a) retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity. A temporary difference exists between the carrying amount of the liability and its tax base; the tax base of the liability is usually nil. Such a deductible temporary difference results in a deferred tax asset as economic benefits will flow to the entity in the form of a deduction from taxable profits when contributions or retirement benefits are paid;

(b) preliminary expenses are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period(s). The difference between the tax base of the preliminary expenses, being the amount permitted as a deduction in future periods under taxation laws, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset;

(c) with limited exceptions, an entity recognises the identifiable assets acquired and liabilities assumed in a business combination at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill (see paragraph 66); and

(d) certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes (see paragraph 20). A deductible temporary difference arises if the tax base of the asset exceeds its carrying amount."

"27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reduction in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised."

The statutory auditors are of the view that all these provisions, when made, affect the accounting profit but are not allowed for income tax purposes (paragraph 24 (b)). The tax base and accounting base are different. The actual expenditure on warranty gets debited to the respective heads of expenditure and there is outflow of economic resources embodying economic benefits and further gets allowed in income tax. The incremental provisions are based on actuarial report which is based on the warranty expenditure incurred and the warranties expired. Therefore, it cannot be said that provision for warranty does not get allowed or not capable of reversal. Further, provision in respect of warranties though disallowed for the purpose of computation of income tax will get allowed in the year in which the liability gets crystallized and therefore, they partake the character of deductible temporary differences and it is probable that taxable profit will be available against which the deductible temporary differences can be utilised. No doubt, the period over which the reversal takes place may be longer which is true in the case of depreciation (paragraph 26 of Ind AS 12) also. Further, provisions for employee benefits like gratuity made based on actuarial valuation in books gets allowed only in tax assessments when the same is paid and deferred tax assets are recognised. The Company is a profit-making Company and paying income tax under normal computation; and therefore, does not get covered under paragraph 27 of Ind AS 12 also. The basis of provision and accounting for replacements are identical to provision for warranties and therefore, deferred tax assets are to be recognised.

In respect of provision for doubtful debts, the provision gets reversed when the actual write off takes place leading to deduction under income tax assessments. When provisions are reversed when no longer required, the reversal is not subject to tax and the provision as well as reversal affects both accounting and tax profits and the base is also different requiring recognition of deferred tax. However, the statutory auditors are in agreement with the Company in respect of provision for raw materials redundancy as the same is a mere provision and the deduction will be available only when the inventories are sold.

B. Query

7. In view of the above facts, the opinion of the Expert Advisory Committee (EAC) has been sought by the querist on the following:

(i) Whether the stand taken by the Company is in order that deferred tax assets are not to be recognised on provision for warranties, replacements, redundancy, doubtful debts and doubtful claims as they are mere provisions and are not likely to be available for set off against future taxable profits.

(ii) If the answer to the above is in the negative, i.e. deferred tax assets ought to be recognised on the above items, whether the recognition of the same would be a change in an accounting estimate in terms of paragraph 32 of Indian Accounting Standard (Ind AS) 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'; or would it be an error/omission and therefore, a prior period item and the Company has to comply with paragraphs 42 to 49 of Ind AS 8 and accordingly, restate the financial statements, i.e. recognising the deferred tax asset for the financial year 2018-

2019 by restatement of the financial statement for the year 2018-2019 or adjusting the deferred tax assets as on 01.04.2019 to the opening equity and give suitable disclosures.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to creation/recognition of DTA in respect of provision for warranties, replacements, redundancy, doubtful debts and doubtful claims. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, appropriateness of creation, measurement and write-back of the above-mentioned provisions; recognition of DTA in respect of other provisions, such as, provisions for wage revision, other employee benefits, onerous contract, etc.; computation of deferred tax asset; interpretation of Companies Act, 2013 with regard to restatement/revision of financial statements in respect of prior period items/errors (if any); etc. Further, the opinion expressed is purely from accounting perspective and not from the perspective of Income-tax Act. The Committee also wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended/revised from time to time. At the outset, the Committee notes from the Facts of the Case that the provisions referred by the querist are not deductible for income tax purposes in the year when these are recognised in the books of account but in subsequent years and therefore, the opinion expressed hereinafter, is on the said premise.

9. The Committee notes from the Facts of the Case that the Company is recognising provision in respect of warranties, replacements, future charges, etc.; however, at the same time, it is also stated that the liabilities in respect of such provisions are uncertain and may or may not settle to the extent of the provision created. In this regard, the Committee wishes to point out that a provision is always created for such liabilities whose timing or amounts are uncertain and therefore, a judgement would necessarily need to be exercised with regard to the probability/possibility of the events giving rise to the obligation/liability and the amount of cash flows required to settle that obligation.

The Committee is of the view that certainty or uncertainty of an event/contingency in respect of a provision should be taken into consideration while recognising or measuring the provision rather than while creating/recognising deferred taxes in respect of them.

Hence, once a provision is recognised considering the due requirements of various standards dealing with such provisions, the Committee is of the view that the application of another standard, for example, Ind AS 12 in the extant case should not be questioned due to the uncertain nature or amount of the provision. The Committee, therefore, without going into the correctness of the judgement of the Company with regard to the above-mentioned provisions, has presumed that the same have been made in accordance with the requirements of the relevant standards, viz., Ind AS 37, Ind AS 115, etc.

10. With regard to the creation of the deferred tax asset, the Committee notes the following requirements of Ind AS 12:

> "***Deferred tax assets*** **are the amounts of income taxes recoverable in future periods in respect of:**
>
> **(a) deductible temporary differences;**
>
> **(b) the carry forward of unused tax losses; and**
>
> **(c) the carry forward of unused tax credits.**
>
> ***Temporary differences*** **are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:**
>
> **(a) *taxable temporary differences*, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or**
>
> **(b) *deductible temporary differences*, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.**
>
> **The *tax base* of an asset or liability is the amount attributed to that asset or liability for tax purposes."**
>
> **"Tax base**
>
> 7 The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow

to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.

Examples

1 A machine cost Rs. 100. For tax purposes, depreciation of Rs. 30 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes. *The tax base of the machine is Rs. 70*.

2 Interest receivable has a carrying amount of Rs. 100. The related interest revenue will be taxed on a cash basis. *The tax base of the interest receivable is nil*.

3 Trade receivables have a carrying amount of Rs. 100. The related revenue has already been included in taxable profit (tax loss). *The tax base of the trade receivables is Rs. 100*.

…"

"8 The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

Examples

1 Current liabilities include accrued expenses with a carrying amount of Rs. 100. The related expense will be deducted for tax purposes on a cash basis. *The tax base of the accrued expenses is nil.*

2 Current liabilities include interest revenue received in advance, with a carrying amount of Rs. 100. The related interest revenue was taxed on a cash basis. *The tax base of the interest received in advance is nil*.

3 Current liabilities include accrued expenses with a carrying amount of Rs. 100. The related expense has already been deducted for tax purposes. *The tax base of the accrued expenses is Rs. 100.*

…"

"9 Some items have a tax base but are not recognised as assets and liabilities in the balance sheet. For example, preliminary expenses are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period(s). The difference between the tax base of the preliminary expenses, being the amount permitted as a deduction in future periods under taxation laws, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.

10 Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an entity shall, with certain limited exceptions, recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences. Example C following paragraph 51A illustrates circumstances when it may be helpful to consider this fundamental principle, for example, when the tax base of an asset or liability depends on the expected manner of recovery or settlement."

"**24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, …**

25 It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be

deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. ...

Example

An entity recognises a liability of Rs. 100 for gratuity and leave encashment expenses by creating a provision for gratuity and leave encashment. For tax purposes, any amount with regard to gratuity and leave encashment will not be deductible until the entity pays the same. The tax rate is 25%.

The tax base of the liability is nil (carrying amount of Rs. 100, less the amount that will be deductible for tax purposes in respect of that liability in future periods). In settling the liability for its carrying amount, the entity will reduce its future taxable profit by an amount of Rs. 100 and, consequently, reduce its future tax payments by Rs. 25 (Rs. 100 at 25%). The difference between the carrying amount of Rs. 100 and the tax base of nil is a deductible temporary difference of Rs. 100. Therefore, the entity recognises a deferred tax asset of Rs. 25 (Rs. 100 at 25%), provided that it is probable that the entity will earn sufficient taxable profit in future periods to benefit from a reduction in tax payments.

26 The following are examples of deductible temporary differences that result in deferred tax assets:

(a) retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity. A temporary difference exists between the carrying amount of the liability and its tax base; the tax base of the liability is usually nil. Such a deductible temporary difference results in a deferred tax asset as economic benefits will flow to the entity in the form of a deduction from taxable profits when contributions or retirement benefits are paid;

(b) preliminary expenses are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period(s). The difference between the tax base of the preliminary expenses, being the amount permitted as a deduction in future periods under taxation laws, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset;

(c) with limited exceptions, an entity recognises the identifiable assets acquired and liabilities assumed in a business combination at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill (see paragraph 66); and

(d) certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes (see paragraph 20). A deductible temporary difference arises if the tax base of the asset exceeds its carrying amount."

From, the above, the Committee notes that as per the above-reproduced requirements of Ind AS 12, deferred tax asset is required to be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. Further, Ind AS 12, inter alia, provides that deductible temporary differences are the temporary differences (viz., differences between the carrying amount of an asset or liability in the balance sheet and its tax base), that will result in taxable amounts in determining taxable profit/loss of future periods when carrying amount of the asset or liability is recovered or settled.

The Committee notes that the provisions referred by the querist in the extant case, will either be reflected in the financial statements as an adjustment to the related existing asset (i.e., by measuring the related asset net of such provision), for example, provision for doubtful debts/ claims and provision for redundancy will be reflected in the financial statements as an adjustment to the value of the related receivables/debts/inventory; or as a separate liability, for example, provision for warranty or provision for replacements.

The Committee is of the view that where a provision is reflected in the financial statements as a separate liability, the tax base of such liability would be nil and therefore there would be a difference between the tax base and carrying amount for accounting purposes. However, when that liability would be settled in future for its carrying amount, the same shall reduce the future taxable profit by an equivalent amount and therefore the same is a deductible temporary difference. Accordingly, deferred tax asset in respect of the same should be recognised in the financial statements to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

Similarly, where the provision is reflected as an adjustment to the value of related asset (i.e., by measuring the related asset net of such provision), it will reduce the carrying amount of the related asset, whereas tax base of the related asset would be higher than the carrying amount of that asset as these adjustments or restatement of an asset does not affect taxable profit in the period of the adjustments or restatement and, consequently, the tax base of the asset is not adjusted. However, when in future the carrying amount of the asset would be recovered, to the extent of the difference in the carrying amount and tax base, there would be less taxable profit in future leading to deductible temporary difference. Accordingly, deferred tax asset in respect of the same should be recognised in the financial statements to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

11. With regard to the issue as to whether the recognition of DTA in a period later than when such provision is recognised in the financial statements, will be considered as a change in accounting estimate or would be considered as an error, the Committee notes the following requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors':

"A *change in accounting estimate* is an adjustment of the

carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors."

"*Prior period errors* are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were approved for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud."

From the above, the Committee notes that a change in accounting estimate is change in value of asset or liability due to the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities, whereas errors refer to omissions in financial statements due to failure to use or misuse any information that was available when financial statements were approved. Further, changes in accounting estimates result from new information or new developments. In the extant case, DTA is required to be created in respect of the above-mentioned provisions in the period in which these provisions are recognised as per the afore-mentioned requirements of Ind AS 12 and, therefore, non-recognition of the same results in an omission in the financial statements, which constitutes as a prior period error and not a change in estimate resulting from new information or new development. Accordingly, if these prior period errors are material, the Company should rectify the same by retrospective restatement as per paragraphs 42 to 49 of Ind AS 8 and accordingly, restate the financial statements. In this context, the Committee notes paragraphs 42 and 49 of Ind AS 8 as follows:

"42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their

discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."

"Disclosure of prior period errors

49 In applying paragraph 42, an entity shall disclose the following:

(a) the nature of the prior period error;

(b) for each prior period presented, to the extent practicable, the amount of the correction:

(i) for each financial statement line item affected; and

(ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(c) the amount of the correction at the beginning of the earliest prior period presented; and

(d) if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures."

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) Not recognising deferred tax asset on provisions for provision for warranties, replacements, redundancy, doubtful debts and doubtful claims is not correct and DTA should be recognised as discussed in paragraph 10 above.

(ii) Since DTA is required to be created in respect of the above-mentioned provisions in the period in which these provisions are recognised as per the requirements of Ind AS 12, non-recognition of the same results in an omission in the financial statements, which constitutes as a prior period error and not a change in estimate resulting from new information or new development. Therefore, if these prior period errors are material, the Company should rectify the same by retrospective restatement as per paragraphs 42 to 49 of Ind AS 8 and accordingly restate the financial statements, as discussed in paragraph 11 above.

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.

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