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OPINIONS

Volume XXXVI

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

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Foreword

Accounting/ financial reporting is an important medium of communicating critical and important financial information to various users of financial information. It is through accounting all the pertinent facts and figures reach the relevant users. With the continuous changes in the world of accounting and reporting practices, the veracious interpretation and appropriate implementation of accounting principles, often swoops as a challenge. These challenges in financial reporting frequently pose the need for an expert guidance in specific situations of implementation of relevant accounting/ auditing principles. Considering these aspects and needs of the members of the Institute, the Council of the Institute constituted Expert Advisory Committee (EAC) to assist the members posed with intricate and sensitive issues on accounting and/or auditing principles.

Since its constitution in the year 1975, the Expert Advisory Committee has been providing independent and objective opinions to the members in industry and practice. The Committee has also been giving opinions on various accounting issues to the Regulatory and Government authorities, such as, Ministry of Corporate Affairs (MCA), Security and Exchange Board of India (SEBI), C&AG, etc.

In order to help members of our profession and those interested in financial reporting, there is a need to disseminate the wealth of knowledge contained in the various opinions issued by EAC from time to time. To achieve this larger objective, the ICAI periodically publishes volumes to act as a library of opinions. It gives me immense pleasure to congratulate CA. Tarun Ghia, Chairman, CA. M.P. Vijay Kumar, Vice-Chairman and all the other members of the Committee for bringing out this Volume.

I am highly optimist that this Volume will prove to be equally advantageous to the members of the profession in seeking answers to some of the accounting issues faced by them.

New Delhi
June 19, 2019

CA. Prafulla P. Chhajed
President

Preface

I feel deeply honoured to present to the members of the Institute of Chartered Accountants of India another splendid volume of the Compendium of Opinions, viz., thirty-sixth volume. This volume of the Compendium of Opinions contains opinions that were finalised by the Committee during the Council Year 2016-17.

The Expert Advisory Committee answers queries relating to accounting and/or auditing principles. With the introduction and implementation of new set of Accounting Standards viz., Indian Accounting Standards which although are quite detailed and extensive, but may pose certain implementation challenges at times requiring expert guidance on such matters. Therefore, the role of EAC has become all the more important in the present era.

I would like to bring to the kind attention of the readers that although the Council of the institute has constituted Expert Advisory Committee, an opinion or views expressed by the Expert Advisory Committee represents the opinion or view of the members of the Committee only and not the official opinion of the Council. I may further mention that the opinions are finalised by the Committee based on the facts and circumstances of the query as supplied by the querist, the relevant laws and statutes, and the applicable accounting/auditing principles prevailing on the date on which a particular opinion is finalised. The date of finalisation of each opinion is indicated along with the respective opinion. The opinions must, therefore, be read in the light of any amendments and /or developments in the applicable laws/statutes and accounting/auditing principles subsequent to the date of finalisation of the opinions.

I would also like to apprise the readers that the Expert Advisory Committee answers the queries in accordance with the Advisory Service Rules framed by the Council of the Institute in this regard. These Rules are available on the website of the Institute and have also been published in all the volumes of the Compendium of Opinions.

In this era of drive towards paperless working environment, we are also providing with this volume, a comprehensive compact disk (CD), incorporating all the opinions published in all the volumes (viz., Volume I to Volume XXXVI) of the Compendium of Opinions. The CD is very user friendly and contains advanced search facilities to locate the opinions on desired subject(s) in a jiffy. I hope that this CD would prove to be very useful for the accounting professionals.

I wish to place on record my sincere gratitude to all the other members and special invitees of the Expert Advisory Committee during the Council Year 2016-17, for their sincere efforts and valuable contribution in finalisation of opinions contained in this volume. I am also thankful to the members and Special Invitees of the Committee for this Council Year (2019-20) for their whole-hearted support in the activities of the Committee.

I would also like to acknowledge the consistent efforts and support of CA. Vidhyadhar Kulkarni, Head, Technical Directorate, CA. Parul Gupta, Secretary, Expert Advisory Committee and CA. Khushboo Bansal, Sr. Executive Officer in the process of formulating the drafts for the consideration of the Committee and thereafter in finalising them as per the decisions of the Committee.

I am very optimist that like all other previous volumes, this volume will be of great significance and value to the members and other accounting professionals.

New Delhi
June 19, 2019

CA. Tarun Jamnadas Ghia
C*hairman*
Expert Advisory Committee

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PART I:
Opinions on Indian Accounting Standards

Query No. 1

Subject: Accounting treatment and disclosure requirement for contribution to exempt provident fund.[1]

A. Facts of the Case

1. The querist is a Government company (hereinafter referred to as the 'company or corporation') within the meaning of section 2(45) of the Companies Act, 2013. The shares of the company are listed with recognised stock exchanges. The company is engaged in the business of refining of crude oil and marketing of petroleum products. It has two refineries and lube blending/filling plants. The company also has depots, installation and LPG plants across India, besides having administrative offices at Delhi, Chennai, Kolkata, Mumbai and other major cities.

2. The querist has stated that the company has an independent exempt provident fund (PF) trust (hereinafter referred to as the 'trust') to manage the PF contributions of its members which are made to the trust as per the Rules of the Provident Fund Scheme. The trust invests the contributions in securities as prescribed by the Employee Provident Fund Organisation (EPFO). The investments of the trust were held to maturity up to 29th May, 2015, when the new investment pattern was made applicable to the trusts. As per the new investment pattern, trusts are required to invest a minimum of 5% of accretions in 'Equity & Related Investments'. The pattern also allows that the turnover ratio (the value of securities traded in the year to the average of the portfolio at the beginning and end of the year) shall not exceed 'two', implying that the securities are allowed to be traded subject to conditions.

3. The querist has further stated that all exempt provident fund trusts have to mandatorily declare interest rate not below the rate announced by the EPFO. If the trust is not able to meet such interest rates, the employer has to make good the shortfall. Currently, the corporation treats the contributions to the trust as 'defined contribution' making necessary disclosures required for defined contribution plan as per Accounting Standard (AS) 15, 'Employee Benefits'.

4. During the audit of financial year 2014-15, statutory auditors have questioned the treatment of PF scheme as a 'defined contribution scheme'

[1]Opinion finalised by the Committee on 7.7.2016.

and recommended that the entire scheme be treated as 'defined benefit scheme' as cited in an earlier opinion (published as Query No. 19 of Volume XXXIII of the Compendium of Opinions) of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI). According to the querist, the opinion reads that as the interest portion is in the category of a defined benefit, the entire scheme tantamount to be a 'defined benefit scheme'. Actuarial valuation of the liability vis-a-vis assets of the fund should be done (assets to be at fair value instead of book value) and the accounting treatment and the disclosures should be made as per defined benefit scheme as per the provisions of AS 15.

5. *The corporation's point of view:*

Accounting Standard (AS) 15, 'Employee Benefits', does not have any specific guideline on the valuation and disclosure of liability towards an Exempt Provident Fund Trust wherein the interest portion is a 'defined benefit' and the contribution made has the characteristic of 'defined contribution'. The provisions for disclosure and valuation significantly differ for 'defined benefit plans' and 'defined contribution plans' under AS 15. The corporation has disclosed the following in its notes forming part of its financial statements for the year 2014-15:

> "The Corporation's contribution to the Provident Fund is remitted to a separate trust established for this purpose based on a fixed percentage of the eligible employee's salary and charged to Statement of Profit and Loss. Shortfall, if any, in the fund assets, based on the Government specified minimum rate of return, will be made good by the Corporation and charged to Statement of Profit and Loss".

Although the corporation has treated the scheme as 'Defined Contribution Scheme', it has obtained the interest service sufficiency/coverage certificate from the actuary which indicated sufficient interest coverage of the fund in line with the declared interest rates by the Employee Provident Fund Organisation.

6. The querist has also stated that the following points should be considered in favour of treating this scheme as 'Defined Contribution Scheme':

(i) The liability of the corporation is limited to the extent of employer's contribution and any shortfall in the interest obligation, if any. There is no further obligation on the part of the corporation as

the PF Act does not allow recognition/assumption of any liability/ surplus on account of any changes in the fair value of plan assets/actuarial valuation. Any change in the liability/fund status upon actuarial valuation/fair valuation of assets would only be a notional shortfall/surplus. The corporation is neither allowed to contribute beyond the statutory contribution nor withdraw from the fund.

(ii) The fund assets are mostly held to maturity and can be sold subject to the provisions laid down in the new investment pattern. Hence, fair valuation of the fund assets would only result in notional surplus/deficit based on actuarial assumptions.

(iii) The rules governing exempt trusts allow PF trusts to transfer the corpus to the PF authorities in which case it becomes an 'Un-exempt Trust'.

(iv) There is no reasonable basis to estimate the interest rate that will be announced by EPFO from time to time. It cannot be predicted in a scientific manner like expected yield on assets, rate of growth of compensation or attrition / mortality rate, etc. The current interest rate as well as the Government securities (G-Sec) rates cannot be taken as the benchmark for prediction of the future interest rate.

(v) The maximum liability for the corporation at any point of time is the discontinuance liability. In case of PF, the discontinuance liability is the corpus of the fund which is represented by its investments. There shall be no additional liability on account of interest shortfall in future as it is a future liability and not discontinuance liability.

(vi) AS 15 mandates use of projected unit credit method of valuation. However, in case of guarantee of interest shortfall, it would be difficult to allocate the same as the unit credit which has to be considered for each year of extra service. As a result, it would not be possible to assign a figure as service cost, which is nothing but an increase in liability due to additional years of service. The liability does not change with each year of service as it is related to current corpus payable in future with the differential rate of earning for the future period.

(vii) AS 15 requires the disclosure tables to be made for long term employee benefits. As the liability is a provisional figure, it will be difficult to allocate the liability to each year so as to disclose the requirement under AS 15 of interest cost, service cost and actuarial gain or loss.

B. Query

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

(i) Whether the accounting treatment followed by the corporation as defined contribution plan is proper or it should be treated as defined benefit plan.

(ii) If the fund is to be treated as defined benefit plan, whether the plan assets are required to be fair valued and the liability to be actuarially valued and what will be the accounting treatment of the resultant surplus/deficit in the plan?

(iii) Is it correct to recognise in corporation's books of account in respect of resultant deficit/surplus based on the fair valuation of fund assets though there is no obligation on the corporation to contribute for the deficit or adjust the surplus in the subsequent contribution to the extent of surplus in any financial year?

(iv) What disclosure needs to be made by the corporation?

The above position may be clarified from the perspective of AS 15 as well as Indian Accounting Standard (Ind AS) 19, 'Employee Benefits'.

C. Points considered by the Committee

8. The Committee restricts itself to the issues raised by the querist in paragraph 7 above from the perspective of AS 15 and Ind AS 19 and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment in the financial statements of the Trust, etc.

Views of the Committee considering the requirements of AS 15:

9. The Committee notes the definitions of the terms 'defined contribution plans' and 'defined benefit plans' as contained in paragraphs 7.5 and 7.6 of Accounting Standard (AS) 15, 'Employee Benefits', notified under the Companies (Accounting Standards) Rules, 2006, reproduced as below:

> ***"7.5 Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods."***
>
> ***"7.6 Defined benefit plans are post-employment benefit plans other than defined contribution plans."***

The Committee further notes paragraphs 26 and 50 of AS 15 and paragraph 9 of 'ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)', issued by the Accounting Standards Board of the ICAI, which provide as follows:

> *AS 15*
>
> "26. Examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:
>
> ...
>
> (b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; ...".
>
> "50. Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an enterprise, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting enterprise and from which the employee benefits are paid. The payment of funded benefits when they fall due depends not only on the financial position and the investment performance of the fund but also on an enterprise's ability to make good any shortfall in the fund's assets. Therefore, the enterprise is, in substance, underwriting the actuarial and investment risks associated with the plan. Consequently, the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period."

ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)

"9. Whether a provident fund which guarantees a specified rate of return is a defined benefit plan or a defined contribution plan.

Section 17 of the Employees Provident Funds (EPF) Act, 1952 empowers the Government to exempt any establishment from the provisions of the Employees' Provident Scheme, 1952 provided that the rules of the provident fund set up by the establishment are not less favourable than those specified in section 6 of the EPF Act and the employees are also in enjoyment of other provident fund benefits which on the whole are not less favourable to the employees than the benefits provided under the Act. The rules of the provident funds set up by such establishments (referred to as exempt provident funds) generally provide for the deficiency in the rate of interest on the contributions based on its return on investment as compared to the rate declared for Employees' Provident Fund by the Government under paragraph 60 of the Employees' Provident Fund Scheme, 1952 to be met by the employer. Such provision in the rules of the provident fund would tantamount to a guarantee of a specified rate of return. As per AS 15, where in terms of any plan the enterprise's obligation is to provide the agreed benefits to current and former employees and the actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise, the plan would be a defined benefit plan. Accordingly, provident funds set up by employers which require interest shortfall to be met by the employer would be in effect defined benefit plans in accordance with the requirements of paragraph 26(b) of AS 15."

From the definition of defined contribution plan, the Committee notes that in a defined contribution plan, the liability of an enterprise is restricted only to the amount it contributes to a separate fund for the benefit of its employees and has no further obligation whatsoever beyond its contribution. The Committee notes from the Facts of the Case that the company in the extant case has an independent Exempt Provident Fund Trust which manages its provident fund obligation towards its employees. The Committee further notes that the querist has stated that all Exempt Provident Fund Trusts have to mandatorily declare interest rate not below the rate announced by the

Employee Provident Fund Organisation (EPFO) and if the Trust is not able to meet such interest rates, the employer has to make good the shortfall. Thus, the employer (company) guarantees a specified rate of return on the contributions made and the liability of the enterprise is not restricted to the contribution it makes to the separate fund but also extends to any deficiency in the rate of interest earned by the separate fund as compared to the rate declared by the EPFO. Accordingly, the Committee is of the view that, in the extant case, actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance on the company and that the provident fund obligation in the extant case falls within the definition given in paragraph 26(b) of AS 15. Therefore, the Exempt Provident Fund set up by the company is a defined benefit plan under AS 15.

10. The Committee is further of the view that once an employee benefit scheme is treated as defined benefit scheme, all the requirements relating to recognition, measurement and disclosures of the defined benefit expense, obligation and plan assets, etc. as contained in AS 15 shall follow. Accordingly, in terms of the explicit requirements of AS 15 at the reporting date, all plan assets should be fair valued and the present value of the defined benefit obligation should be determined using actuarial valuation technique (viz., the Projected Unit Credit Method) and defined benefit liability would be recognised at net of these two amounts (assuming that there is no impact of any past service cost as the same is not referred to in the facts of the extant case). Further, any actuarial gains and losses resulting from the actuarial valuation and changes in fair value of plan assets should be included while determining the expense for the current year in respect of defined benefit obligation to be recognised in the statement of profit and loss. Thus, any surplus/deficit based on the fair valuation of plan (fund) assets and actuarial valuation would automatically be reflected as a part of defined benefit obligation for provident fund in the financial statements. Further, the company is required to make the disclosures in terms of paragraphs 119 to 125 of AS 15.

11. With regard to the difficulties mentioned by the querist in determination of current service cost, etc. and various estimates related to expected yield on assets, rate of growth of compensation or attrition/mortality rate, the Committee notes that paragraph 64 of AS 15 specifically requires actuarial valuation for determining defined benefit obligation and current service cost

due to uncertainties inherent in the process of estimation and due to long-term nature of employment benefit plan. Accordingly, the services of an expert, such as, an actuary, may be used, as also suggested in paragraph 49 of AS 15. In this regard, the Committee also wishes to point out that the Institute of Actuaries of India has also issued guidance note 29 (GN 29) on valuation of interest rate guarantees on exempt provident funds under AS 15, which provides relevant guidance on the issue of actuarial valuation.

Views of the Committee considering the requirements of Ind AS 19:

12. As far as determination of post-employment benefit plan (provident fund plan) as defined contribution or defined benefit plan is concerned, the Committee notes that under Ind AS 19, similar requirements corresponding to AS 15 requirements have been provided and therefore, there would be no change in the views of the Committee. Accordingly, under Ind AS 19 also, the provident fund plan should be treated as defined benefit plan and disclosures are required to be made considering it as defined benefit plan as per paragraphs 135 to 152 of Ind AS 19. Further, under Ind AS 19 also, the plan asset is to measured at fair value and defined benefit obligation is to be measured at its present value using actuarial technique, projected unit credit method and the difference between the two is to be recognised as net defined benefit liability (asset) in the balance sheet. However, gains and losses resulting from the remeasurement of net defined liability (asset) including actuarial gains and losses are to be recognised in other comprehensive income instead of the statement of profit and loss as under AS 15. In this regard, the Committee notes paragraph 57 of Ind AS 19 as follows:

> "57. Accounting by an entity for defined benefit plans involves the following steps:
>
> (a) determining the deficit or surplus. This involves:
>
> (i) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods (see paragraphs 67–69). This requires an entity to determine how much benefit is attributable to the current and prior periods (see paragraphs 70–74) and to make estimates (actuarial assumptions) about

demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit (see paragraphs 75–98).

(ii) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost (see paragraphs 67–69 and 83–86).

(iii) deducting the fair value of any plan assets (see paragraphs 113–115) from the present value of the defined benefit obligation.

(b) determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling (see paragraph 64).

(c) determining amounts to be recognised in profit or loss:

(i) current service cost (see paragraphs 70–74).

(ii) any past service cost and gain or loss on settlement (see paragraphs 99–112).

(iii) net interest on the net defined benefit liability (asset) (see paragraphs 123–126).

(d) determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:

(i) actuarial gains and losses (see paragraphs 128 and 129);

(ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset) (see paragraph 130); and

(iii) any change in the effect of the asset ceiling (see paragraph 64), excluding amounts included in net interest on the net defined benefit liability (asset).

Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately."

D. Opinion

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

(i) The accounting treatment followed by the corporation in respect of exempt provident fund plan as defined contribution plan is not proper; instead it should be treated as defined benefit plan under AS 15 and Ind AS 19, as discussed in paragraphs 9 and 12 above.

(ii) and (iii) Since the exempt provident fund plan is to be treated as defined benefit plan, as per the requirements of AS 15 and Ind AS 19, the plan assets are required to be fair valued and the liability to be actuarially valued and difference between the two is to be recognised as defined benefit liability/net defined benefit liability (asset) in the balance sheet and accordingly, the resultant surplus/deficit in the plan would be automatically reflected in the financial statements of the company, considering the requirements of AS 15 and Ind AS 19, as discussed in paragraphs 10 and 12 above.

(iv) Disclosure needs to be made by the company as per paragraphs 119 to 125 of AS 15 and paragraphs 135 to 152 of Ind AS 19.

Query No. 2

Subject: ***Discounting of deferred debts (retention money).***[1]

A. Facts of the Case

1. ABC Ltd. is a listed central public sector company and its net worth as on 31.03.2015 was Rs. 34085 crore. Hence, Indian Accounting Standards (Ind ASs) are applicable from 1st April 2016 onwards. The company is an integrated power plant equipment manufacturer engaged in design, engineering, manufacture, construction, testing, commissioning of power projects and also in servicing of a wide range of products and services for the core sectors of the economy, viz., power, transmission, industry, transportation (Railways), renewable energy, oil & gas and defence. In power project business, the contracts received by the company are either Engineering, Procurement & Construction (EPC) contracts or Boiler, Turbine and Generator (BTG) packages. In case of BTG contracts, civil works and balance of plant (BOP) package items are not in its scope. Power projects are long gestation period projects where the normal execution period of a contract ranges between 3 to 5 years. The scope of the project includes supply of equipment, erection, commissioning, synchronizing the plant to the grid, completing the trial operation and proving the guaranteed parameters. For revenue recognition in respect of long term construction contracts, percentage of completion method is used.

2. The querist has stated that although the taking over of the project takes place after all the activities under the scope are complete, payments are released on progressive basis and achievement of specified milestones over the execution period of contract ranging between 3 to 5 years. For these type of contracts, generally, the payment terms are as follows:

a) Advances (generally 5% or 10% of contract value) received from customer before start of execution of contract and adjusted against progressive billing based on milestone achievements over the period of contact execution.

[1] Opinion finalised by the Committee on 2.9.2016.

b) Payment against progressive billing linked with the completion of milestone activities defined in the contract concurrently over the execution period of the contract. This progressive billing contains minor percentage normally 5% to 10% which will become contractually due for payment by customer on the happening of another event, such as trial operation, PG test etc. This is accounted for as deferred debtors till completion of the specific performance activities of the contract.

3. The querist has referred to the following technical guidance from Indian Accounting Standards (Ind AS):

Ind AS 11, Construction Contracts

According to the querist, the objective as stated in Ind AS 11 in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. Further, the querist has reproduced the following paragraphs of Ind AS 11:

"11. **Contract revenue shall comprise:**

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

(b) variations in contract work, claims and incentive payments:

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured.

12. Contract revenue is measured at the fair value of the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. ..."

"29. An entity is generally able to make reliable estimates after it has agreed to a contract which establishes:

(a) each party's enforceable rights regarding the asset to be constructed;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

…

30. … Progress payments and advances received from customers often do not reflect the work performed."

"41. Retentions are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed."

To identify the fair value, the querist has reproduced the relevant paragraphs from Ind AS 113, 'Fair Value Measurement' are as below:

"9. This Ind AS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

"58 In many cases the transaction price will equal the fair value (eg that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold).

59 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. Paragraph B4 describes situations in which the transaction price might not represent the fair value of an asset or a liability at initial recognition."

Paragraph B4 of Appendix B, Application Guidance of Ind AS 113 provides that, "When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

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

(b) The transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (eg in a business combination), the transaction includes unstated rights and privileges that are measured separately in accordance with another Ind AS, or the transaction price includes transaction costs.

(d) The market in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market."

Further, relevant paragraphs of Ind AS 109, 'Financial Instruments', Ind AS 32 'Financial Instruments: Presentation' and Ind AS 115, 'Revenue from Contracts with Customers' (which was subsequently omitted by Companies (Indian Accounting Standards) (Amendments) Rules, 2016, vide notification dated March 30, 2016 by the Ministry of Corporate Affairs) have been reproduced by the querist as follows:

Ind AS 109

"2.1 This Standard shall be applied by all entities to all types of financial instruments except:

...

(j) rights and obligations within the scope of Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue*, that are financial instruments, except for those that Ind AS 11 and Ind AS 18 specify are accounted for in accordance with this Standard."

"4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

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

Ind AS 32

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

...

(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;..."

Ind AS 115

"60 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties of the contract (either explicitly or implicitly*) provides the customer*

or the entity with a significant benefit of financing the transfer of goods or services to the customer. … A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract. (Emphasis supplied by the querist)

61 *The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (i.e. the cash selling price).* An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

(b) the combined effect of both of the following:

(i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and

(ii) the prevailing interest rates in the relevant market.

62 Notwithstanding the assessment in paragraph 61, a contract with a customer would not have significant financing component if any of the following factors exist:

…

(c) the difference between the promised consideration and the cash selling price of the goods or service (as described in paragraph 61) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the

reason for the difference. For example, *the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract."*

(Emphasis supplied by the querist)

The querist has also referred to paragraph 5.1.3 of Ind AS 109 (before consequential amendments due to withdrawal of Ind AS 115), which provides that, "Despite the requirement in paragraph 5.1.1, at initial recognition, an entity shall measure trade receivables at their transaction price (as defined in Ind AS 115) if the trade receivables do not contain a significant financing component in accordance with Ind AS 115 (or when the entity applies the practical expedient in accordance with paragraph 63 of Ind AS 115).

Practice of the company

4. The querist has further stated that the company, as stated, is into long-term contract execution with a normal contract period ranging from 3-5 years. The long-term construction contracts are received by the marketing wing of the company, which allocates the scope and value to various manufacturing units and region/sites for execution. The units/ regions bill the customer based on the Billing Break up (BBU) agreed with the customer. *The billing is basically to ensure cash flows and may not represent the true value of the despatches or the project progress at the site.* Thus, the billing schedule is customary industry practice and contracts are structured in similar fashion across the sector by all the customers as well as contractors. A typical contract includes retention of fixed % (generally 5% to 10%) on successful completion of trial run/PG test. These activities (Trial run/PG test) are the core activities and completion of these activities signify fulfillment of the company's contractual obligation and customer's objective. Presently, the company recognises revenue as per percentage of completion method in accordance with the requirements contained in Accounting Standard (AS) 7 'Construction Contracts'. The amount of retention money is not presently due for payment by customer and is reflected in the balance sheet as deferred debtors at transaction value. As per the querist, this is nothing but activity linked payments and is not resulting from any specific financing arrangement.

Analysis by the company

5. Based on the background of the company and other paragraphs referred

above, the transaction value is fair value for revenue recognition and deferred debt (retention money) need not be discounted on the following grounds on both initial recognition as well as subsequent measurement:

a. The price charged by the company for construction of power plant represents the fair value of the transaction as the price charged from the customer remains same irrespective of the retention money agreed with the customer. Further, none of the conditions mentioned in Para B4 of Appendix to Ind AS 113 are applicable.

b. Payment terms as being followed by the company are generally followed by most of the companies (customers as well as contractors) in the same segment of construction contracts in power sector. Customer also pays advance before start of the project and also retains a specified % of the contract value as retention money to ensure successful completion of core milestone activities. This is the generally accepted industry practice. Moreover, these contracts are generally based on competitive bidding and are awarded based on the lowest evaluated price.

c. The payment schedule as per the agreed billing schedule is basically to ensure cash flows and is independent of the revenue recognition which is guided by the method as prescribed in applicable Ind AS 11. Revenue will be continued to be recognized on POC method at transaction value in case of construction contracts as there is no financing arrangement. Thus, transaction value is fair value.

d. These deferred debtors are contractually due for payment by customer on completion of a specific core activity (generally PG test/Trial Operation) which is a must to fulfil the customer's ultimate objective, satisfaction of conditions specified and adequate protection to meet obligations in the contract. Similarly, customer also pays advances before start of the execution of the project which reflects commitment from the customer.

e. The objective of Ind AS 11 as stated in the Standard for accounting for construction contracts is the allocation of contract revenue and cost over the execution period. Discounting of deferred debtors and accounting for interest income instead of contract

revenue is applicable in case of specific financing arrangement only. Hence, deferred debts are to be recognised initially at transaction value only.

f. As per the exception given in paragraph 2.1 of Ind AS 109, it is understood that, Ind AS 109 (except for impairment and derecognition requirements) is not applicable on trade receivables which are governed by Ind AS 11 and 18. Therefore, even though deferred debtors meet the definition of financial instruments but they are specifically excluded from the scope of Ind AS 109 and accordingly need not be discounted at the time of subsequent measurement also.

g. The billing schedule representing the cash flows is fixed after the price is finalized with the customer. Since the billing schedule is decided only post the price is finalized, the billing schedule representing cash flows does not have any bearing on price/ consideration.

Accordingly, the company has concluded that the fair value of the transaction is equal to the transaction value.

6. The querist has also separately clarified that the amount of deferred debtors (retention money) is paid by customer on satisfactory completion of performance activities linked to completion of various milestones to ensure completion of the project. In case of any shortcomings, the same has to be rectified by the company to the satisfaction of customer before release of deferred debtors. The amount of deferred debtors and contract revenue remain same irrespective of delay in release of payment by customer even if delay is on account of customer due to their fund constraint. The company is a leading manufacturer in this field since long and if any technical issue arises, the same is resolved for successful running of the project to the satisfaction of customer before release of deferred debtors is ensured. Till that time, the customer has the right to hold the release of payment of deferred debtors.

7. The querist has also separately supplied the following information for the perusal of the Committee:

1. The revenue in respect of construction contracts is recognised based on percentage of completion method over the period of

contract based on cost incurred to total estimated cost of contract on performance of various activities at various stages of execution of project as per Ind AS 11 (earlier AS 7).

2. Trial operation (TO) and performance guarantee (PG) test are main activities to be done for successful completion of project and handing over the plant to customer, which is the core essence of the contract from the customer angle, and revenue pertaining to that activity based on percentage completion method is recognised at that point of time.

3. After finalisation of contract value as per contracts terms and conditions only, billing break up is agreed with customer which is not linked with revenue recognition and it is to ensure cash flow over the tenure of the contract. Since the contract value is determined first and thereafter only billing break up is agreed with customer, the contract value clearly reflects fair value of consideration. For example, revenue recognition may be at Rs. 100 and billing may be at Rs. 120. This difference is accounted as part of valuation adjustment liability. However, total billing and revenue recognition at the end of the contract will remain same. Accounting entries with respect to one such construction contract, as an example/sample basis, have been separately supplied by the querist for the perusal of the Committee.

4. Generally, the terms of payment of such construction contracts are 10% advance, 80% on dispatch and 10% deferred payment on PG test/ TO. Considering advance and deferred billing payable on milestone within the contractual period, the contract value represents fair value in such construction contracts as the intent behind deferred billing is to secure the execution and performance of the contract and hence, there is no time value of money involved in such contracts.

5. Financing of such contracts is being done by international/ domestic funding agencies and the company is not financing any part of such project. The role of the company is to manufacture the items, supply, erection and commissioning of the project. Further, customer shall also not be willing to have financing arrangement with the company as their cost of funding from

international/domestic agencies is much lower than the company's incremental borrowing rate.

6. Based on the audited annual accounts and published results for 1st Quarter of financial year (Q1 F.Y.) 2016-17 of similar companies of international repute who are also the competitor of the company and executing the same type of contract with similar terms, the contract value has been accounted as the fair value of consideration and no discounting has been done (Extracts from annual accounts of two such similar companies have been provided by the querist for the perusal of the Committee).

7. The querist has also confirmed that considering the contract value awarded through competitive bidding route / negotiated route, the contract value is fair value of consideration since intent behind advance and deferred billing /debtors are to protect the interest of respective parties such as to secure the execution and performance of the contract and hence, there cannot be in-built interest/time value of money.

B. Query

8. Based on the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the company's accounting practice of not discounting deferred debts both at:

(a) initial recognition and;

(b) subsequent measurement

is in line with the requirements contained in Ind ASs.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to whether the company's accounting practice of not discounting deferred debts both at initial recognition and subsequent measurement is in line with the requirements contained in Ind ASs. 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 advance payments and progress payments received during the contract period, recognition of contracts costs and revenue recognition policy of the company, etc. Further,

the Committee presumes that the deferred debts, as referred to by the querist, in the extant case, are only in respect of retention money. Further, it is presumed that there are no performance obligations remaining unfulfilled in respect of retention money and conditions for revenue recognition as per Ind AS 11 in respect of deferred debts have been met. In other words, no contractual performance obligations remain unfulfilled in respect of the revenue recognized for deferred debts as in that case to the extent of unfulfilled performance obligations, revenue would not be recognised.

10. The Committee notes the following paragraphs of Ind AS 11:

"12. Contract revenue is measured at the fair value of the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) a contractor and a customer may agree variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased."

"22. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36."

From the above, the Committee notes that as per the requirements of paragraph 12 of Ind AS 11, contract revenue should be measured at fair value. The Committee also notes that the Standard does not specifically require to discount or determine the present value of various payments made over the contract period. It only requires to recognize the contract revenue, measured at fair value by reference to the stage of completion of the contract activity at the end of the reporting period. However, the Committee is of the view that when a contract payment would be received at a later date, viz., there is a deferment of payments, for example, in case of deferred debtors/payments, such that the effect of the time value of money is material, the nominal amount of consideration receivable from the contract activity would not represent its fair value. Further, the Committee is of the view that whether the effect of the time value of money is material or not should be determined on a overall consideration of total cash flows including advance payments, etc. Accordingly, the Committee is of the view that where the effect of time value of money is material, the deferred debts/ receivables to the extent revenue is recognised in respect of them as per Ind AS 11 should be discounted in order to arrive at the fair value of the consideration from the contract activity and the difference between the nominal value and fair value should be recognised as interest element over the contract period.

11. In this regard, the Committee also wishes to point out that if the company expects that significant rectification work will have to be carried out in order to claim retention money from the customers, it should be examined as to whether the retention money represents the cost of rectification work normally undertaken. If this is the case, the Committee is of the view that rectification work becomes a performance obligation and the retention money in such cases accrues to the company only after satisfaction of such performance obligation. Therefore, in such cases, retention money should not be recognised as revenue unless such performance obligation is satisfied. Further, this should also be considered while determining the stage of completion of the contract activity as per the requirements of the Standard.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that where the effect of the time value of the money is material, deferred debtors due to retention money to the extent revenue has been recognised in respect of

them should be discounted in order to arrive at the fair value of the consideration receivable from the contract, as discussed in paragraph 10 above. Further, whether the time value of money is material or not, should be determined on a overall consideration of total cash flows including advance payments, etc.

PART II:
Opinions on Accounting Standards

Query No. 3

Subject: Accounting treatment of exchange variation arising on loan taken by foreign operations of the company held through a wholly owned foreign subsidiary company for the purposes of consolidated financial statements as per AS 11.[1]

A. Facts of the Case

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

2. The querist has stated that overseas oil and gas operations are generally conducted in joint ventures with other partners. The company has PI in these joint ventures either directly or through acquisition of a company holding PI in the assets or through its overseas subsidiaries. The PI of joint venture is held through subsidiaries due to tax/ host country's regulations, risk management perspective, etc.

3. The company compiles its financial statements both on standalone and consolidated basis including the overseas subsidiaries in INR, following the requirements of the Companies Act, 2013, Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI). *For the purpose of consolidation, all the subsidiaries prepare special purpose accounts, in accordance with Indian GAAP, converting to INR from their respective reporting currency.* (Emphasis supplied by the querist.)

4. The company has an overseas subsidiary (subsidiary A) for holding PI in some of its joint ventures. This subsidiary A has a step-down subsidiary (subsidiary B) in another country. Subsidiary B holds certain PI in an oil and gas joint venture (Joint Venture) in the country of domicile. The functional currency of subsidiary A is united states dollars (USD). According to local regulatory requirements of the country wherein subsidiary B is registered and operating, the functional currency of subsidiary B is mandatorily the

[1] Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

local currency (local currency) and for the purpose of consolidation of group accounts at subsidiary A level, the reporting currency is USD. The major part of the sales revenue of subsidiary B is received in USD and is kept in an offshore bank account in USD.

5. There is a major transaction between subsidiary A and subsidiary B as follows:

> Subsidiary A has advanced significant amount of loans in USD *under various loan agreements* to subsidiary B. The main part of a loan was towards purchase of an additional PI in the existing Joint Venture. As per the terms of this loan agreement, the principal amount along with interest was required to be repaid within one year, subject to the availability of the funds with subsidiary B. Since, the utilisation of the said loan was to acquire oil fields, which take normally longer period for commercial operations, subsidiary B was not able to repay its dues on time and tenure of the loan has been extended time and again. Considering the liquidity position of subsidiary B and because the repayment of principal was not foreseeable to be paid in near future, part of the loan was converted into equity and the balance loan was extended for another period of 350 days thereby the total repayment period was about two years. Further, the loan agreements in respect of other loans which were due and payable were also extended time and again considering liquidity position of subsidiary B. As of now, the significant amount of loans is also not likely to be settled in the foreseeable future. (Emphasis supplied by the querist.)

6. The querist has stated that subsidiary B operates with a substantial degree of autonomy and its day to day operations do not impact subsidiary A. The management and control of subsidiary B is located in respective overseas jurisdiction. Further, the operations of subsidiary B are substantially managed from its own resources. The list of indicators as per paragraph 20 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', to test whether a foreign operation is an integral foreign operation or a non-integral foreign operation has been supplied by the querist for the perusal of the Committee as Annexure 1. Considering these, subsidiary B is considered as non-integral foreign operation of subsidiary A.

7. While compiling the consolidated financial statements of subsidiary A, the balance sheet items of subsidiary B are converted at the period-end exchange rate and the profit and loss items of subsidiary B are converted at

the average exchange rate for the period. The resulting exchange difference is transferred to the Foreign Currency Translation Reserve, which is part of 'Reserves & Surplus'.

8. According to the querist, as subsidiary B is a non-integral foreign operation for subsidiary A, paragraphs 15 and 16 of AS 11 would apply, which are reproduced as follows:

> ***"15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.***
>
> 16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables."

9. In case of outstanding loans due from subsidiary B to subsidiary A, though the repayment dates have been specified as per local regulatory requirements, the tenure has been extended time and again by subsidiary A. *As of now, the remaining loans are not likely to be settled in the foreseeable future and, therefore, the company is of the view that such loans are, in substance, an extension of the subsidiary A's net investment in subsidiary B as per paragraph 16 of AS 11. Further, recently a resolution has been passed wherein a major part of a loan has been extended by 1095 days with a clause for repayment on or after 5th April, 2016 based on the liquidity and cash flow position of subsidiary B.* (Emphasis supplied by the querist.)

10. The querist has also stated that sales revenue of subsidiary B is received in USD and kept in an offshore USD account. Whenever there is a requirement to meet payment obligations of subsidiary B in local currency, the requisite funds kept in the offshore USD account are converted into local currency and actual exchange loss/gain does not arise. Accordingly,

exchange differences arising on outstanding loan (from local currency to USD) as on the balance sheet date are notional and do not have direct effect on the present and future cash flows of both subsidiaries A and B and, therefore, according to the querist, should be accumulated in a foreign currency translation reserve in the consolidated financial statements of subsidiary A until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31 of AS 11.

11. The company, in the consolidated financial statements, has adopted paragraph 46 A of AS 11, wherein exchange differences arising on long-term foreign currency monetary items, in sofaras they relate to the acquisition of depreciable capital assets, can be capitalised. The text of paragraph 46A is reproduced as follows:

> "46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.
>
> (2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:
>
> Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the

financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

B. Query

12. In view of the above facts, the opinion of the Expert Advisory Committee of the ICAI is sought on the following as to whether:

(i) paragraph 46A can be applied in the particular case by subsidiary B, since the company has already opted the same for long-term foreign currency monetary items since 2012-13, and if yes, whether there will be any prior period implication or not;

(ii) the accounting treatment of exchange differences arising on loan as per paragraphs 8 to 10 above is appropriate;

(iii) there is any other appropriate accounting treatment/disclosure in respect of exchange differences arising on loan.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to the accounting treatment of the exchange differences arising on outstanding loan taken by company B in question (which is subsidiary of company A) from company A for the purpose of incorporation of the same in the consolidated financial statements of the company in question (which is the parent company of company A and B) as per the principles of AS 11. 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 in the books of company A and company B as per the local GAAPs prevailing in the countries in which these companies are domiciled, accounting for the loans converted into equity and exchange differences arising on such part of loans, etc. At the outset, the Committee wishes to point out that the determination of appropriate classification of foreign operations into integral and non-integral is a matter of judgement considering the application of paragraphs 17 to 20 of AS 11 in the facts and circumstances of the company and since considering these paragraphs, company B has been considered as non-integral foreign operation in the books of company A, the Committee has not examined this issue and presumes that company B is a non-integral foreign operation for company A.

14. The Committee notes that the querist has referred to 'functional currency' at various places in the query. In this regard, the Committee wishes to point out that AS 11 does not follow the 'functional currency' concept and prescribes that the reporting currency should be used in recording foreign currency transactions and for presenting financial statements.

15. With regard to accounting treatment of the exchange differences arising on outstanding loan taken by company B (which is subsidiary of company A) from company A for incorporating the same in the consolidated financial statements of the parent company, the Committee notes paragraphs 15 and 16 of AS 11 as reproduced in paragraph 8 above and other requirements of AS 11, notified under the Companies (Accounting Standards) Rules, 2006, as follows:

> ***"11. At each balance sheet date:***
>
> ***(a) foreign currency monetary items should be reported using the closing rate. ...***
>
> ***(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and***
>
> ***(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined."***
>
> ***"13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15."***
>
> ***"24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:***

(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment."

"29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment."

From the above, the Committee notes that in case of non-integral foreign operations, for determining the accounting for the exchange differences on the loan amounts, there is a need to determine whether the loans to that foreign operation, in substance, form part of the company's net investment in that non-integral foreign operation or not. The Committee further notes from paragraphs 15 and 16 of AS 11 reproduced in paragraph 8 above that a monetary item that is receivable from a non-integral foreign operation is, in substance, an extension to the enterprise's net investment in that non-integral foreign operation if for such item, settlement is neither planned nor likely to occur in the foreseeable future. In this regard, the Committee notes

that in the extant case, initially, company A had given dollar denominated loans to subsidiary B which were to be repaid within one year. Further, recently their tenure has been extended by 1095 days. From the above, the Committee is of the view that although the tenure of such loans has been extended from time to time and although settlement of such loans is not expected in the foreseeable future, the repayment of such loans was always planned and, therefore, such loans/advances to subsidiary B cannot be treated as the company's net investment in non-integral foreign operation. Accordingly, the question of adjustment of foreign exchange differences on such loans to foreign currency translation reserve as per paragraphs 15 and 16 of AS 11 does not arise in the consolidated financial statements of subsidiary A or the Indian parent company. Further, in the financial statements of company B, the loan in USD, viz., foreign currency monetary item shall be reported at the closing exchange rate and the resultant exchange difference shall be recognised as expense or income in the statement of profit and loss (except in situations where paragraphs 46/46A of AS 11 are applied). While incorporating the financial statements of company B in the consolidated financial statements of the Parent company also, although the intra-group monetary items, viz., advances receivable in the financial statements of company A and advances payable in the financial statements of company B shall be eliminated, but considering the requirements of paragraph 29 of AS 11, as reproduced above, since monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations, exchange difference arising on an intra-group monetary item cannot be eliminated against a corresponding amount arising on other intra-group balances and has to be recognized as income or expense in the consolidated financial statements of the reporting enterprise.

16. With regard to the issue whether subsidiary B can apply paragraph 46A of AS 11, the Committee notes that the situation of application of paragraph 46A of AS 11 would arise in the extant case only in the context of consolidated financial statements of the company. The Committee further notes that paragraph 46A is applicable only in relation to long-term monetary items. Therefore, the issue to be determined is whether the loans payable in the extant case can be considered as long-term loans for the purpose of accounting for exchange differences arising on monetary item translation as

per paragraph 46A of AS 11. In this regard, the Committee notes paragraph 46A (2) of AS 11 as follows:

> "(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:
>
> ..."

From the above, the Committee notes that an asset or liability shall be designated as long term, if the asset or liability has a term of twelve months or more at the date of origination of the asset or liability. Since in the extant case, initially, from the date of origination of loan to the date when it falls due, the term is less than a year, though that term has been extended time and again considering the liquidity position of company B, the liability in the financial statements of company B cannot be designated as long-term liability and, therefore, the option available under paragraph 46A of AS 11 is not applicable to the company.

D. Opinion

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

(i) Paragraph 46A of AS 11 cannot be applied in the particular case by subsidiary B, as discussed in paragraph 16 above.

(ii) and (iii) The accounting for exchange difference arising on the outstanding loan to be accumulated in foreign currency translation reserve in the consolidated financial statements of company A for incorporating the same in the financial statements of the parent company is not correct. Same should be recognised as expense or income in the financial statements, as discussed in paragraph 15 above.

Annexure 1

Particulars	Subsidiary B
(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;	Yes
(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;	Yes
(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;	No
(d) costs of labour, material and other components of the operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;	Yes
(e) the foreign operation's sales are mainly in currencies other than the reporting currency;	No
(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;	Yes
(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and	Yes
(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.	Yes

Query No. 4

Subject : Accounting treatment of exchange variation arising in respect of foreign operations of the company held through a wholly owned foreign subsidiary company as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.[1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as the 'company'), which is a wholly owned subsidiary of a listed Government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. The company acquires oil and gas properties/ blocks by way of acquisition of Participating Interest (PI) either directly or through acquisition of shares of the legal entity owning the right in the oil and gas properties/ blocks. The overseas oil and gas operations are generally conducted in joint ventures with other partners. The company has PI in these joint ventures either directly or through acquisition of a company holding PI in the asset or through its overseas subsidiary. The PI of joint venture is held through subsidiary due to tax/ host country's regulations, risk management perspective, etc.

2. The querist has stated that the company compiles its financial statements both on standalone and consolidated basis including the overseas subsidiaries in INR, following the requirements of the Companies Act, 2013, Accounting Standards and Guidance Notes, issued by the Institute of Chartered Accountants of India (ICAI). For the purpose of consolidation, all the subsidiaries prepare special purpose accounts, in accordance with Indian Generally Accepted Accounting Principles (GAAPs), converting to INR from their respective reporting currency.

3. As per the querist, the company has an overseas subsidiary (subsidiary A) for holding PI in some of its joint ventures. The functional currency of the subsidiary A is United States Dollars (USD). This subsidiary has a step-down subsidiary (subsidiary B) in another country. Subsidiary B holds certain PI in an oil and gas joint venture (joint venture) in the country of domicile. According to local regulatory requirements of the country wherein subsidiary B is registered and operating, the functional currency of subsidiary B is

[1] Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

mandatorily the local currency, but for the purpose for consolidation of group accounts at subsidiary A level, the reporting currency is USD. The major part of the sales revenue of subsidiary B is received in USD and is kept in an offshore bank account in USD. The querist has informed that the joint venture in which subsidiary B has PI is a jointly controlled operation within the meaning of Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures' and the operations of joint venture are carried out in local currency only.

4. The querist has further stated that subsidiary A also holds equity in a joint venture company (JVC). The purpose of the JVC is to acquire, charter or lease equipment on one part and sell, charter or lease these assets on another part to facilitate the development and production of hydrocarbons in the joint venture. The JVC is incorporated in the country of domicile of subsidiary A. The functional and reporting currency of JVC is USD.

5. As informed by the querist, there is a major transaction between JVC and the joint venture as follows:

> The JVC (lessor) has entered into a long term lease agreement (viz., fifteen years) with the joint venture (lessee) for major oil field equipments like floating production storage and off-loading vessel (FPSO) and other sub-sea assets. These assets have been capitalised and recognised in the books of joint venture at lower of the fair value of the asset and the discounted value of the minimum lease instalments. The lease instalments are payable in USD and broken down into repayment of principal and interest components, based on a fixed interest rate and instalments derived from the underlying agreement. The lease commitments are carried and shown under long-term liabilities exclusive of interest in the books of joint venture. As informed by the querist, the lease payments are planned to be settled through periodic payments in USD by the joint venture to JVC. The structure of the relevant companies and joint ventures and transactions between them have been explained by the querist in Annexure 1.
>
> The proportionate value of assets and liabilities of the joint venture is taken in the books of subsidiary B as per the principles laid down in AS 27 and recorded in the local currency, being the functional currency as per local regulatory requirements.

The querist has also informed that while compiling the consolidated financial statements of subsidiary A, the balance sheet items of subsidiary B are converted at the period end exchange rate and the profit and loss items of subsidiary B are converted at the average exchange rate for the period. The resulting exchange difference is transferred to the foreign currency translation reserve (FCTR), which is a part of 'Reserves & Surplus'.

6. As per the querist, subsidiary B operates with a substantial degree of autonomy and its day to day operations do not impact the cash flows of subsidiary A. The management and control of the subsidiary B are located in respective overseas jurisdiction. Further, the operations of subsidiary B are substantially managed from its own resources. The list of indicators as per paragraph 20 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', to test whether a foreign operation is an integral foreign operation or a non-integral foreign operation has been supplied by the querist for the perusal of the Committee as Annexure 2. Considering these, subsidiary B is considered as a non-integral foreign operation of the subsidiary A.

7. As per the querist, since subsidiary B is a non-integral foreign operation for subsidiary A, paragraphs 15 and 16 of AS 11 would apply, which are reproduced as follows:

"15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables."

8. The querist has also stated that the lease payables are recorded in local currency in the standalone accounts of joint venture which is then consolidated with the local currency accounts of subsidiary B. Being a monetary item, these lease payables are translated at the period end using a closing exchange rate between USD and the local currency. The resultant exchange difference is charged off to the statement of profit and loss. However, for the purpose of consolidation of subsidiary B accounts with subsidiary A, the same lease payables are restated in USD thereby generating exchange difference which is being taken to foreign currency translation reserve (FCTR). On the other hand, lease receivables in the form of FPSO and subsea assets in the JVC are also appearing in the subsidiary A's consolidated accounts. As per the querist, lease receivables and payables get knocked off with each other in subsidiary A's consolidated accounts, however, the exchange variation arising from the books of joint venture still exist in the consolidated statement of profit and loss.

9. The querist is of the view that these exchange differences arising on long-term lease payables (from local currency to USD) as on the balance sheet date are notional and do not have direct effect on the present and future cash flows of both subsidiaries A and B. The querist is also of the view that these long-term lease receivables in the form of FPSO and subsea assets in the JVC are, in substance, subsidiary A's net investment in subsidiary B. Accordingly, these exchange differences should be accumulated in a foreign currency translation reserve in the consolidated financial statements of subsidiary A until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraphs 15, 16 and 31 of AS 11. However, subsequently, the querist has also informed that since the finance lease is planned to be settled by periodic lease payments in USD by the JV to JVC, the provisions of AS 11 relating to 'net investment in non-integral foreign operation' are not applicable on long-term lease receivables.

10. The querist has also stated that the company, in the consolidated financial statements, has adopted paragraph 46A of AS 11, wherein exchange differences arising on long-term foreign currency monetary items, so far as they relate to the acquisition of a depreciable capital asset, can be capitalised. The text of paragraph 46A is reproduced as follows:

> "46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option

under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

The querist has also stated that subsidiary B has not been applying provisions of paragraph 46A of AS 11, while the same was followed in the books of the parent company since 2011.

B. Query

11. The querist has sought the opinion of the Committee in respect of the following matters:

(i) Whether the accounting treatment of exchange differences arising on long-term lease obligations as per paragraphs 7 to 9 above is appropriate;

(ii) Whether paragraph 46A can be applied in the particular case by subsidiary B, since the company has already opted the same for long- term foreign currency monetary items since 2012-13, and if yes, whether there will be any prior period implication;

(iii) Whether there is any other appropriate accounting treatment/ disclosure in respect of exchange differences arising on long-term lease obligations.

C. Points considered by the Committee

12. The Committee has examined the queries in paragraph 11 above, purely from accounting point of view and, accordingly, has not evaluated the compliance or otherwise of the applicable laws and regulations since as per Rule 2 of the Advisory Service Rules of the Committee, the Committee does not answer issues that involve only interpretation of enactments. Similarly, the Committee has not evaluated any tax implications of the matters under consideration.

13. The Committee has examined the matter from the perspective of Indian Generally Accepted Accounting Principles (Indian GAAP). The Committee notes that the querist has referred to 'functional currency' at various places in the query. The Committee notes that AS 11 does not have the concept of 'functional currency', but is based on the concept of 'reporting currency'. AS 11 defines 'reporting currency' as "the currency used in presenting the financial statements". Based on the facts of the query, the Committee's understanding of the reporting currency of relevant entities is as below:

Sl.No.	Entity	Reporting currency
1.	Indian parent company	INR
2.	Subsidiary A	USD
3.	Subsidiary B	Local currency of the country of domicile (other than USD and INR)
4.	JVC (lessor)	USD
5.	Joint venture (lessee)	Local currency of the country of domicile (same as subsidiary B)

The Committee has assumed that the determination of reporting currencies by the company, as above, is in accordance with the requirements of AS 11. The Committee also notes that the company has considered subsidiary B as non-integral foreign operation. The Committee has not examined this aspect as the querist has not raised this issue and, accordingly, assumes that the same is in accordance with the relevant requirements of AS 11.

14. The Committee notes that the joint venture has considered the asset acquired on lease from JVC as 'finance lease' and, accordingly, reognised a finance lease payable in its books of account. The Committee assumes that the said determination is in accordance with the requirements of Accounting Standard (AS) 19, 'Leases'.

15. The Committee notes that the finance lease payable is denominated in foreign currency (USD) since the reporting currency of joint venture is other than USD. The Committee also notes that the finance lease payable is in the nature of monetary item and is required to be translated to reporting currency by using the closing rate as at the reporting date in the books of joint venture. With regard to accounting treatment of resultant exchange difference, the Committee notes paragraphs 15 and 16 of AS 11 as reproduced in paragraph 7 above and paragraph 13 of AS 11, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), as follows:

> "***13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15."***

Considering the above, the Committee is of the view that the exchange differences should be recognised in the statement of profit and loss of joint venture and subsidiary B (to the extent of its share in the joint venture) in accordance with the requirements of paragraph 13 of AS 11 (as reproduced above). Further, in the financial statements of subsidiary A, since in the extant case, the finance lease receivables are planned to be settled on a periodic basis, the question of consideration of the finance lease receivables in the nature of a monetary item that, in substance, forms part of company A's net investment in subsidiary B does not arise.

16. The Committee further notes that the exchange differences on finance lease payable recognised in the stand-alone financial statements of joint venture continue to reflect in the consolidated statement of profit and loss of subsidiary A (to the extent of subsidiary B's share in joint venture). The issue under consideration is how to deal with this exchange difference considering the fact that the underlying finance lease receivable (to the extent of subsidiary A's proportionate share in joint venture company) and finance lease payable (to the extent of subsidiary B's share in joint venture) are eliminated on consolidation. In this regard, the Committee notes paragraph 29 of AS 11, as below:

> "29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). *However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated* against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, *such an exchange difference continues to be recognised as income or an expense* or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment." (Emphasis supplied by the Committee.)

In view of the above, the Committee is of the view that the exchange differences arising on finance lease payable in the stand-alone books of joint venture would continue to be recognised in the consolidated statement of profit and loss of subsidiary A (to the extent of subsidiary B's share in joint venture), even though the underlying finance lease payable (to the extent of subsidiary B's share in joint venture) is eliminated against the finance lease receivable.

17. With regard to applicability of paragraph 46A to the present case, based on the facts of the query, the Committee is of the view that the finance lease installments that are scheduled to be paid on or after one year from the date the finance lease qualifies for recognition in the books of

account are in the nature of long-term monetary item and, hence, paragraph 46A is applicable to the said item. In this regard, the Committee also notes the following guidance issued by Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI), in the form of Frequently Asked Questions on AS 11 notification - Companies (Accounting Standards) Amendment Rules, 2009 (G.S.R. 225 (E) dt. 31.3.09) issued by Ministry of Corporate Affairs:

> ***"(13) If the long term foreign currency monetary item is received in instalments whether the installment received within a period of 12 months should be treated as short term in nature?***
>
> **Response**
>
> Yes, each loan installment should be treated as a separate monetary item. The principle should be to amortise the exchange difference proportionately over the period of the monetary item and not to carry forward any unamortised amount beyond the settlement of the monetary item to which the exchange difference relates. Treating the entire loan as a single monetary item would result in the exchange difference relating to the loan instalment which is settled being amortised in accounting periods even after such settlement."

In view of the above, paragraph 46A should be applied to the long-term portion of finance lease payable by the joint venture.

18. The Committee also notes that as per the querist, paragraph 46A is being applied by the Indian parent company but not by subsidiary B. In this regard the Committee notes the following paragraph of Accounting Standard (AS) 21, 'Consolidated Financial Statements', notified under the Rules:

> ***"20. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied."***

In view of the above, the Committee is of the view that the company should have applied paragraph 46A to subsidiary B as well while preparing its

consolidated financial statements. In view of this, the impact of not applying paragraph 46A by subsidiary B in past in the context of consolidated financial statements, should be considered as prior period item and should be dealt with in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

D. Opinion

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

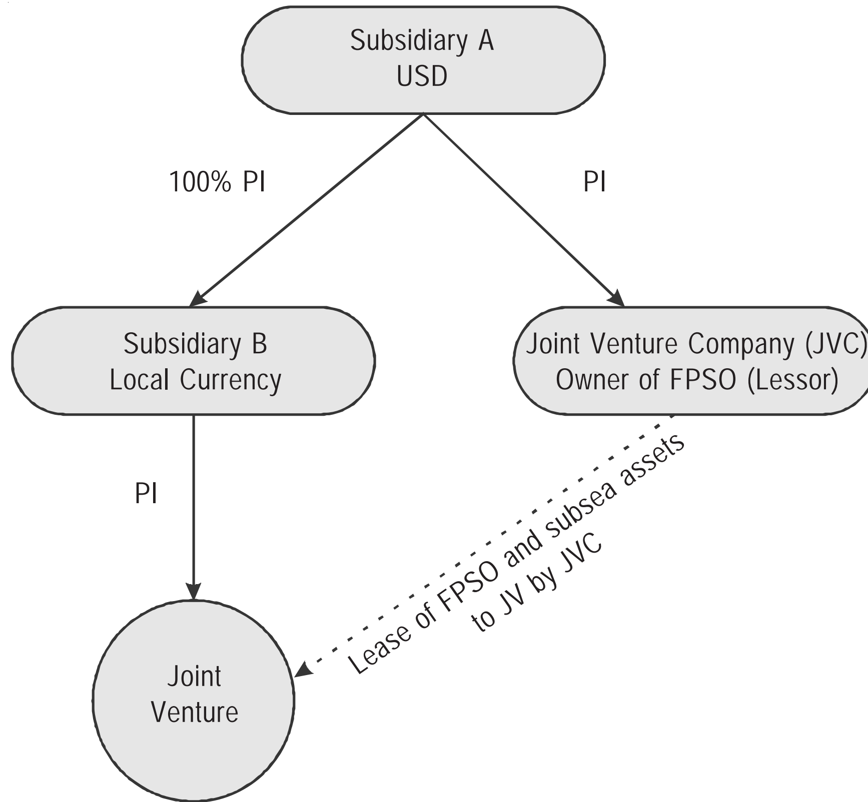
(i) The accounting treatment of exchange differences on long-term lease obligations, as referred to in paragraphs 7 to 9 above, is not appropriate. In the financial statements of subsidiary A, since the finance lease receivables are planned to be settled on a periodic basis, the question of consideration of the finance lease receivables in the nature of a monetary item that, in substance, forms part of company A's net investment in subsidiary B does not arise, as discussed in paragraph 15 above. Further, the exchange differences arising on finance lease payable in the stand-alone books of joint venture would continue to be recognised in the consolidated statement of profit and loss of subsidiary A (to the extent of subsidiary B's share in joint venture), even though the underlying finance lease payable (to the extent of subsidiary B's share in joint venture) is eliminated against the finance lease receivable, as discussed in paragraph 16 above.

(ii) The company should apply paragraph 46A to subsidiary B as well while preparing its consolidated financial statements as discussed in paragraph 18 above. Further, the impact of not applying paragraph 46A by subsidiary B in past in the context of consolidated financial statements, should be considered as prior period item and should be dealt with in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', as discussed in paragraphs 17 and 18 above.

(iii) The accounting treatment for exchange differences arising on long-term lease obligation should be in accordance in paragraphs 15 to 18 above. Further, the disclosures should be in accordance with the requirements of AS 11.

Annexure 1

Structure



Annexure 2

Particulars	Subsidiary B
(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;	Yes
(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;	Yes
(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;	No
(d) costs of labour, material and other components of the operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;	Yes
(e) the foreign operation's sales are mainly in currencies other than the reporting currency;	No
(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;	Yes
(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and	Yes
(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.	Yes

Query No. 5

Subject: ***Accounting treatment of unutilised spare parts to be used on renovation and modernisation (R&M) of Power Plant.***[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a subsidiary company of another company (100% Government of Gujarat undertaking) having installed capacity of 5894 Mega Watt (MW). The company is having 2 units of 120 MW thermal power plants at Gandhinagar commissioned on 13-03-1977 for Unit-I and 10-04-1977 for Unit-II. [Both units have completed 38 years of life, which is normally 25 years (as per life prescribed by Central Electricity Regulatory Commission) and with R&M it will be 35 years of life]. As per the directives of Central Electricity Authority (CEA), the company has carried out renovation and modernisation (R&M) work during the financial year (F.Y.) 2007-08 to 2009-10. The company has given an Engineering, Procurement and Construction (EPC) contract to M/s XYZ to complete R & M work for the said units. As per this, M/s XYZ, an EPC contractor, has supplied materials and carried out some work in coal handling plant and ID fan etc. However, the company has a bitter experience of other power plants for not achieving the targeted efficiency. Therefore, the company has cancelled the order placed on M/s XYZ for R&M of 2 units of 120 MW each at Gandhinagar thermal power station (TPS). M/s XYZ has completed some work upto the date of cancellation of order. The company is seeking guidance for the above subject matter in context to the following information:

(i) As per Accounting Standard (AS) 10, 'Accounting for Fixed Assets'[2], fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

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[1] Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

[2] The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

(ii) Stand-by equipment and servicing equipments are normally capitalised. If the machinery spares can be used only in connection with an item of fixed asset and their use is expected to be not frequent, it may be appropriate to allocate total cost on a systematic basis over a period not exceeding useful life of principal item.

(iii) Improvement of assets: According to the querist, the R & M (improvement) subsequent expenditure related to very old fixed asset is to be capitalised because the expenditure that increases future benefit from the existing assets beyond its previously assessed standard of performance is included in the gross book value, i.e., an increase in the capital.

2. The querist has stated that during this period, the company has carried out following entries in the books of account:

(i) Whatever work completed and shown in capital work in progress has been transferred to fixed assets of 'Plant & Machinery' during the F.Y. 2009-10 and F.Y. 2011-12.

A) Purchase (Capital) A/c. Dr.

To M/s XYZ (Party) A/c

(Being entry passed for purchase of capital nature material from M/s XYZ to carry out R & M.)

B) Capital work in progress A/c. Dr.

To Purchase (Capital) A/c

(Being entry passed to transfer capital nature material and work to work in progress.)

C) Plant and Machinery A/c Dr.

Capital Spares A/c. Dr

To Capital work in progress A/c

(Being entry passed for transfer of work in progress to fixed assets and capital spares on work completion.)

Gandhinagar Thermal Power Station Unit 1 & 2
Renovation and Modernisation (R&M)

Year	Addition in capital work in progress-WIP (Rs. in lacs)	Transferred to fixed asset (Rs. In lacs)	Statutory auditors' qualification	C&AG qualifications
2007-08	125.08	0		
2008-09	10176.86	0		
2009-10	8031.08	18333.01	NIL	NIL
2010-11	3321.18	0	NIL	NIL
2011-12	1161.52	4482.70	NIL	NIL
2012-13	0.00	0.00	NIL	NIL
2013-14	0.00	0.00	Yes	NIL
2014-15	0.00	0.00	Yes	NIL
Total	22815.71	22815.71		

The company depreciates plant and machinery as per Central Electricity Regulatory Commission (CERC) rate and capital spares on the basis of useful life of plant as per AS 10.

(ii) Unutilised material/spares of plant and machinery not installed are shown separately under the head of 'Capital Spares' and charged depreciation as per AS 10 i.e., depreciation to be charged during the useful life of plant and machinery.

(iii) The Gujarat Electricity Regulatory Commission (GERC) has approved the expenditure and allowed the addition of fixed assets and depreciation thereon as per CERC norms. The company, being a power generating company, is governed under the Electricity Act, 2003.

- The company has considered material purchased under above contract as capital nature spares with an intention to use in plants. So it was capitalised from the beginning.

- The statutory auditors have considered the fixed assets as per AS 10 for F.Y. 2010-11, 2011-12 and 2012-13 and given clear (unqualified) report to the company.

- The competent authority of GERC has considered the addition of fixed assets and capital spares and allowed depreciation, loan, return on equity etc. Further, the commission has approved tariff upto F.Y. 2015-16 only and hence, the company has re-assessed the life of plant. The company has charged the additional depreciation to achieve 90% depreciation up to life of plant, i.e., upto financial year 2015-16 as per CERC norms. And also for the capital spares, depreciation is charged to amortise capital spares 100% upto life of plant.

- During the F.Y. 2013-14 and 2014-15, the statutory auditors have taken a different view for CWIP and capitalization done (F.Y. 2007-08 to F.Y. 2011-12) and qualified their report considering this as current assets and not of the nature of capital spares.

- Further, C&AG has carried out supplementary audit and given Nil audit comments. According to the querist, the qualification of statutory auditors has not been considered by C&AG Office because the nature is, as such, the capital nature and treatment is as per generally accepted accounting principles. As narrated above, the company's statutory auditors for the year 2011-12 and 2012-13 and internal auditors, Commission and C&AG have considered it as capital nature.

3. The querist has separately explained with regard to the nature of the spares that as these spares were purchased for renovation and modernisation, (for the plant whose life is over) its nature is capital. However, due to non-achieving the parameters by the original equipment manufacturers, the company has carried out bare minimum renovation and modernisation work for the purchase materials and balance material will be used in other similar unit of the company as and when required. Hence, it is inter-changeable with similar capacity unit and can also be used with other similar plant and machinery of other units of the company.

B. Query

4. The company has treated these spares as capital nature and shown under the head 'fixed assets' due to above reasons and hence, the querist has sought the opinion of the Committee as to whether this accounting treatment is in conformity with Accounting Standards and GAAPs.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to treatment of unutilised (not installed) spares and material (assumed to be of the nature of spares) of plant and machinery as capital spares. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, depreciation on plant and machinery and capital spares, accounting treatment of expenditure on renovation and modernisation, accounting entries passed in respect of transfer of work completed and shown in capital work in progress to fixed assets of plant and machinery (as provided in paragraph 2 above), etc. At the outset, it is presumed that spares kept for future use are ready for their intended use. The opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 and without considering the application of Accounting Standards amended by MCA vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification. Further, the Committee wishes to point out that opinion expressed hereinafter is purely from accounting perspective and not from the perspective of determination of tariff as per CERC/GERC.

6. With regard to the issue raised, the Committee notes the requirements of Accounting Standard (AS) 2, 'Valuation of Inventories'[3] and AS 10, as follows:

> *AS 2*
>
> "4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale,

[3] The opinion should be read in the context of pre-revised Accounting Standard (AS) 2, 'Valuation of Inventories'. However, it may be noted that certain requirements of the Standard have been amended by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

computer software 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 enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets."

AS 10

"8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item."

From the above, the Committee notes that the accounting treatment of machinery spares depends upon their nature, viz., whether these spares can be used only in connection with an item of fixed asset and their use is expected to be irregular. The Committee is of the view that machinery spares which are specific to a particular item of fixed asset, i.e., they can be used only in connection with a particular item of the fixed asset and their use is expected to be irregular can only be considered and capitalised as capital spares. In other words, machinery spares which are not specific to a particular item of fixed asset but can be used generally for various items of fixed assets should be treated as inventories for the purpose of AS 2. The Committee is further of the view that the capital spares as per AS 10 can be used only in relation to a specific item of fixed asset, and, accordingly, they are to be discarded in case that specific fixed asset is disposed of. In other words, such spares are integral parts of the fixed asset.

7. In the light of above discussion, the Committee notes from the Facts of the Case that the material/spares in the extant case were purchased originally for renovation and modernisation of a plant whose life is over. However, due to some reasons, those could not be used for that purpose and, therefore, the material/spares unutilised were kept to be used in other similar unit of the company as and when required. Further, the querist has also stated that

these are inter-changeable with similar capacity unit of the company and can also be used with other similar plant and machinery of other units. From the above, the Committee is of the view that since these are inter-changeable with similar units and similar plant and machineries, these cannot be considered as specific to a particular item of fixed asset and, therefore, these cannot be treated as capital spares to be shown under 'fixed assets'. Accordingly, these spares should be treated as inventories.

D. Opinion

8. On the basis of the above, the Committee is of the view that for the reasons mentioned in paragraphs 6 and 7 above, the unutilised material/ spares cannot be treated as capital spares and, therefore, the accounting treatment accorded by the company is not in conformity with Accounting Standards and GAAPs.

Query No. 6

Subject: Accounting treatment of machinery/capital spares on replacement of worn out parts.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a subsidiary company of another company (100% Govt. of Gujarat undertaking) having installed capacity of 5894 Mega Watt (MW). The company is registered under the Companies Act, 1956 and governed by the Electricity (Rules & Regulations) Act, 2013. The nature of the business of the company is to generate power for the State. The company is installing the power plants on Engineering, Procurement, Construction (EPC) basis on turnkey job. As per this, the company gets the power plant ready in all respects, starting from design and drawing to generation of the power. For this, the company is

[1] Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

issuing order to the L-1 bidder in one consolidated amount. Generally, M/s. XYZ and other integrated power plant equipment manufacturers are taking the EPC contract and complete the power plant. The major components of the power plants are engineering drawing and design, civil work, boiler turbine generator and switchyard etc. On the basis of this broad back up, the company is maintaining fixed asset registers plant-wise with major components of the plant and machinery, such as, hydraulic work, plant and machinery, lines & cables and capital spare parts. At the time of purchase, the detailed parts assembled in the boiler and turbine generator etc. cannot be determined. Therefore, the costs of these specific parts are not available. During the continuous operation of the plant, the company is required to maintain annual overhauling (AOH), major overhauling and capital overhauling (COH). As per the requirements of demand and supply of power, shut down of the plant for the AOH and COH is carried out as per the planning of the State requirement and Grid position. During this maintenance period, some parts are replaced by newly purchased spares.

2. The querist has stated that as per the standard practice adopted by all the power generating companies for machineries, whatever be the cost of the capital spare purchased either with plant and machinery or separately, it has to depreciate over balance useful life of plant. In case of replacement of old/worn out parts, the costs of original parts are not available and it is very difficult to ascertain the value of the replaced parts or old parts and depreciation thereon separately. When the parts are removed, these are sold as scrap and shown as other income. Under this situation, deduction from gross block is not possible and therefore, as per the querist, all large scale industries are not deducting cost of worn out parts from the gross block and charge depreciation as it is. This is a globally adopted practice since beginning.

3. The querist has also stated that the learned statutory auditors of the company have qualified the report for the financial year 2014-15, by stating that old capital parts are not charged to revenue in the year in which such parts are replaced. The company is of the view that this is disposable scrap and has no market or negligible value because the part is an asset having a specific machine design. To be more specific, in the ordinary course of life also, suppose the company had purchased a building or computer. Then, in case of replacement of window or key board, it is not possible to ascertain the carrying amount of this window or key board and, hence, its value is not

deducted from the original asset. If in ordinary course of activity it is not possible, then in the plant and machinery, boiler turbine etc. is a complex part and it is impossible to determine specific value/carrying amount of installed parts which is worn out.

B. Query

4. In view of above, the querist has sought the opinion of the Expert Advisory Committee as to whether the practice of non-removing carrying value of worn out parts is appropriate as there is no possibility of determining carrying value of worn out/old parts to be replaced.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to the appropriateness of the practice followed by the company of non-removal of carrying value of worn-out part of a fixed asset replaced by spares. Therefore, the Committee restricts itself to the specific issue raised by the querist and has not examined any other issue that may be contained in the Facts of the Case, such as, appropriateness of rest of the accounting policy of the company related to spares as mentioned in the facts of the case, recognition of the income realised from the sale of old/damaged part that has been replaced as 'other income', etc.

6. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by MCA vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

7. In the context of Accounting Standard (AS) 10, 'Accounting for Fixed Assets'[2], notified under the 'Rules', the Committee notes from the Facts of the Case that the querist has stated that as per the standard practice adopted by all the power generating companies for machineries, whatever be the

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[2] The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

cost of the capital spare purchased either with plant and machinery or separately, it has to depreciate over balance useful life of plant. Therefore, the Committee has presumed that the spares in the extant case can be used only in connection with an item of fixed asset and their use is expected to be irregular in accordance with the requirements of paragraph 8.2 of AS 10 and has not examined whether the spares fulfil the aforesaid requirements of AS 10 or not.

8. Further, in the context of the part/component that is being replaced, the Committee notes from the Facts of the Case that for the financial year 2014-15, the company has considered such part/component as an integral part of the plant which has been capitalised alongwith the cost of the plant itself. In this regard, the Committee also notes the requirements of Note 4 of Schedule II to the Companies Act, 2013, which provide as follows:

> "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."

Further, as per the MCA Notification dated August 29, 2014, the said requirement shall be voluntary in respect of the financial year commencing on or after April 1, 2014 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015. Thus, from the financial year 2015-16, component accounting needs to be followed mandatorily in respect of a part/component of an asset whose cost is significant to the total cost of the asset and where useful life of that part is different from the useful life of the remaining asset. In this regard, the Committee notes from the facts of the case that although it appears that useful life of the part or component that is being replaced is different from the useful life of the concerned plant and machinery, it is not clear as to whether or not cost of such part or component is significant to the total cost of the plant and machinery to which the requirements of 'component accounting' as per the Companies Act, 2013 are required to be applied. Accordingly, the Committee, while expressing its views has considered both the situations, viz., where the component accounting is followed (either voluntarily or otherwise considering the requirements of the Companies Act) and where component accounting is not required to be followed considering the requirements of the Companies Act.

9. In a situation, where component accounting is followed (either voluntarily or otherwise considering the requirements of the Companies Act), the Committee notes the recommendations contained in the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013, issued by the Institute of Chartered Accountants of India, in respect of component accounting, as reproduced below:

> "48. As per note 4 of Schedule II -"Useful life specified in Part C of the Schedule is for whole of the asset. 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." As per the amendment dated August 29, 2014 notified by the MCA, the said requirement shall be voluntary in respect for the financial year commencing on or after the April 1, 2014 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015.
>
> 49. The above requirement is commonly known as 'component accounting'. Companies will need to identify and depreciate significant components with different useful lives separately. The component approach is already allowed in paragraph 8.3 of the current AS 10. Under AS 10, there seems to be a choice in this matter; however, Schedule II requires application of component accounting mandatorily. The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This assessment would include at a minimum:
>
> - ➢ Determine the threshold value to determine which asset requires componentisation.
> - ➢ Threshold value in percentage of cost of component to the total cost of the asset
> - ➢ Proportion of useful life of that part as compared to the useful life of the asset
> - ➢ Potential impact on the total depreciation expenditure
>
> 50. Component accounting requires a company to identify and depreciate significant components with different useful lives separately. The application of component accounting is likely to cause significant change in the measurement of depreciation and accounting for

replacement costs. Currently, companies need to expense replacement costs in the year of incurrence. Under component accounting, companies will capitalise these costs as a separate component of the asset and decapitalise the carrying amount of previously recognised component. When it is not practicable to determine the carrying amount of the replaced part, the cost of the replacement may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed."

"52. A company is required to apply component accounting (if appropriate) for all depreciable fixed assets (existing or newly acquired) as at 1 April 2014 if a company opts to follow it voluntarily and as at 1 April, 2015 mandatorily. However, if the carrying amount of any asset is lower than or equal to the estimated residual value of the asset(s), company is not required to apply component accounting for such asset(s)."

"54. Further, under component accounting, an issue arises whether the transitional provision under Note 7 of Schedule II will be available to company on April 1, 2015, with respect to componentisation, though it adopted the other provisions (useful life) of Schedule II as on April 1, 2014. This Guidance Note clarifies that if a company determines the life of a component which is different from the remaining asset and such useful life happens to be nil as on the date of transition to Schedule II either on voluntary basis or on mandatory basis as the case may be, the carrying amount of such component may be transferred directly to the retained earnings. In other words, the transitional provisions of Schedule II may be applied *mutatis mutandis* w.r.t. component accounting. Further, if the company opts to adjust the carrying amount of the components to the retained earnings in accordance with the transitional provisions of Schedule II, the tax effect of the same has also to be adjusted directly against the retained earnings in accordance with the Announcement issued by the Institute of Chartered Accountants of India, *"Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account"."*

From the above, the Committee is of the view that when the component accounting is applied, in the context of the replacement of worn-out/old part or component, the cost of new replaced part shall be capitalised as a separate component of the concerned plant and machinery and the carrying amount

of the replaced worn-out part/component shall be decapitalised. As far as the issue of determining the carrying amount of the replaced part is concerned, the cost of the new replaced part may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed. Further, the company needs to apply transitional provisions under Note 7 of Schedule II to the Companies Act, 2013 from the date it applies component accounting, viz., 1.4.2014 or 1.4.2015 as the case may be. Accordingly, under transitional provisions, the carrying amount of the component whose useful life is nil as on the date of transition, may be transferred directly to retained earnings.

10. In a situation, where component accounting is not required to be followed considering the requirements of the Companies Act, the Committee notes paragraphs 8.2 and 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the 'Rules', which state as below:

> "8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item."
>
> ***"23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."***

The Committee notes from the above that at the time of subsequent expenditure, it should be evaluated as to whether the subsequent expenditure increases the future benefits arising from the asset beyond its previously assessed standard of performance in terms of its useful life, or its production capacity, or in terms of decreased operational costs, etc. Applying the above principles, the Committee notes that since the replacement of worn out parts of the fixed asset with new spares, normally does not increase the future benefits arising from the fixed asset beyond its previously assessed standard of performance, the cost of replacement should be charged to the statement of profit and loss and should not be added in the value of fixed asset.

11. With regard to reducing the written down value of the old/ worn-out part that is being replaced from the value of the fixed asset, the Committee is of the view that ordinarily, when a part of the fixed asset gets worn out and is physically replaced by its capital spare, the part taken out from the fixed asset is of no further use and is discarded. The capital spare, which now replaces the original part in the fixed asset loses its separate identity and becomes a part of the fixed asset. Accordingly, on replacement, it is the written down value of the spare (that had been separately capitalised earlier) which replaces the worn-out part that should be written off in the profit and loss account and not the written down value of the worn-out part itself.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that in a situation, where 'component accounting' is not required to be followed considering the requirements of the Companies Act, 2013, the practice of not derecognising written down/carrying value of worn-out part in the fixed asset that is being replaced with a spare is appropriate as per the requirements of AS 10, notified under the Rules, as discussed in paragraphs 10 and 11 above. In such a case, the cost of replaced part is charged to the statement of profit and loss (unless it results in increase in future benefits). However, in a situation, where 'component accounting' is followed (either voluntarily or otherwise considering the requirements of the Companies Act), the cost of the replaced part shall be capitalised as a separate component of the concerned plant and machinery and the carrying amount of the replaced worn-out part/component shall be decapitalised. As far as the issue of determining the carrying amount of the replaced part is concerned, the cost of the new replaced part may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed. Further, the company needs to apply transitional provisions under Note 7 of Schedule II to the Companies Act, 2013 from the date it applies component accounting, viz., 1.4.2014 or 1.4.2015 as the case may be. Accordingly, under transitional provisions, the carrying amount of the component whose useful life is nil as on the date of transition, may be transferred directly to retained earnings, as discussed in paragraph 9 above.

Query No. 7

Subject: ***Accounting policy on depreciation of dredgers and accounting treatment of repair costs during drydock of a dredger after completion of estimated useful life.***[1]

A. Facts of the Case

1. A public sector undertaking under the Ministry of Shipping commenced its commercial operations in April, 1977 and since then it has been earning profits. The company is a listed company in the stock exchanges of NSE, BSE, CSE and DSE. The turnover of the company for the financial year (F.Y.) 2014-15 was Rs. 744 crore with an after tax profit of Rs. 62 crore. The company was incorporated with the objective of providing dredging services to major ports, minor ports and other maritime organisations covering both maintenance and capital dredging requirements. As on date, the company possesses 12 trailer suction hopper dredgers, 3 cutter suction dredgers and 1 backhoe dredger.

2. Depreciation was charged on 'dredgers' at the rates specified under Schedule XIV to the Companies Act, 1956 which stipulated minimum rates at which the depreciation is to be charged. The rates fixed for dredgers, tugs, barges, survey launches and other similar ships used mainly for dredging purposes was 7% under straight line method. The company has been charging for depreciation on 'dredgers' at the rate of 7% p.a. upto F.Y. 2013-14. This means that the life of the vessel was considered as 14 years. The remaining 2% {100% - 98% (7% x 14)} was being considered as residual value.

3. The particulars of existing dredgers, month and year of acquisition, original cost of acquisition, and their age are given below:

[1] Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

S. No.	Particulars of Dredger	Date of Commissioning of Dredger	Original cost of Acquisition (Rs. Lakhs)	Present Age as on 31/03/ 2015 (Years)
1	Dredger-VI	01/01/1976	710.63	39
2	Dredger-VII	07/09/1977	884.38	38
3	Dredger-VIII	10/05/1976	1693.21	39
4	Dredger-IX	01/01/1984	2469.52	31
5	Dredger-XI	01/01/1986	2732.56	29
6	Dredger-XII	05/10/1990	8872.37	25
7	Dredger-XIV	10/01/1991	8911.48	24
8	Dredger-XV	24/04/1999	9455.19	16
9	Dredger-XVI	01/04/2000	20729.89	15
10	Dredger-XVII	01/08/2001	18200.62	14
11	Dredger-XVIII	21/01/2011	27373.51	4
12	Dredger-XIX	21/12/2012	64058.17	2
13	Dredger-XX	24/07/2013	60508.50	2
14	Dredger-XXI	10/03/2014	63662.75	1
15	Back-hoe-BH 1	22/11/2011	12954.16	3
16	Dredger Aquarius	1977	6306.52	38

4. As may be observed from the above table, dredgers are available for use by the company for even after 30 years of age and thus have a useful life of more than 30 years. Dredgers VI, VIII, IX, XI, XII, XIV, XV, and Aquarius have been fully depreciated (leaving a residual value of 2% of the

cost of the asset) as on date as per the Companies Act, 1956 considering the rate of depreciation as 7% p.a. under straight line method. The dredgers are being economically deployed at various places.

5. The querist has stated that ABC Ltd., Netherlands, the builder of dredgers, issued a certificate dated 14/01/2014 stating that the newly built dredgers, viz., dredger XIX, XX and XXI should have an expected life of over 25 years.

6. The existing accounting policy on depreciation in respect of 'dredgers' has been reviewed/examined keeping in view the changes in the new Companies Act, 2013 read with the Notification of the Ministry of Corporate Affairs dated 31/03/2015, Accounting Standards, certificate issued by ABC Ltd., Netherlands, the builder of dredgers to the effect that the dredgers built by them have a useful life of 25 years and a certificate given by a technical expert. According to the querist, internationally also, dredgers were found to have an average useful life of 30-40 years.

7. It was noted by the company that depreciation charge taking useful life of 14 years can no longer be considered as fair charge when dredgers in fact have a useful life of more than 30 years which is evident from the table shown above. As per the experience of the company, the dredgers are available for use for more than 30 years, whereas the depreciation is getting charged only for initial 14 years and in the later 16 years, there is no charge of depreciation even though the dredger is available for use. In fact, as per accepted practices, the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

8. Keeping in view the above position of dredgers, the changes in Companies Act, 2013 and other factors as stated in paragraph 6 above, the company revised its accounting policy on depreciation w.e.f. F.Y. 2014-15. The existing accounting policy has been supplied by the querist for the perusal of the Committee.

9. Revised accounting policy on depreciation w.e.f. F.Y. 2014-15 is as under:

> "Depreciation is provided considering the useful lives, as prescribed under Schedule II of the Companies Act, 2013, other than the following class of assets, whose useful lives are different from that of the lives

prescribed in the Schedule, which are determined based on the technical evaluation.

i. Dredgers –

(a) the useful life of dredgers will be 25 years.

(b) Expenditure incurred on dry-docking of dredgers, which have completed the useful life of 25 years already, is capitalised to the said dredger and depreciated over the extended useful life determined by technical evaluation

Note:

Residual value of the dredgers will be considered at 2% of the original cost of the dredger, including capitalisation of exchange variance in accordance with Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'.

In respect of the following assets, depreciation is provided on straight line method based on technical estimation of useful lives of such assets:

ii. Pipeline equipment: 25% for mild steel pipeline equipment and 12.5% for high density polyethylene pipeline equipment.

iii. Second hand assets: As per the estimate of balance service life.

iv. Buildings on lease: Cost of buildings constructed on lease hold land is amortised over the lease period.

v. Items of fixed assets whose cost does not exceed Rs. 5000/- each are capitalised and 100% depreciated during the year.

vi. Cost of Library: Cost of library is considered as other establishment expenditure.

vii. The exchange differences on long term foreign currency monetary liabilities used for acquisition of specific fixed assets, adjusted to the cost of fixed assets, are amortised over the remaining useful life of the said asset."

10. During F.Y. 2014-15, the company incurred drydock repair expenses amounting to Rs. 9.74 crores (on dredger-IX – Rs. 8.74 crore and on dredger-XI – Rs. 1 crore), which have completed their originally determined

useful life (25 years). As per Indian Register of Shipping (IRS) Rules, all ships classed with IRS are to undergo special surveys at five yearly intervals and at least one intermediate survey has to be carried out between 2nd and 3rd year from the date of completion of special survey. Dredger-IX underwent special survey during this drydock repairs. Accordingly, after the completion of drydock repairs, IRS extended the full term International loadline certificate/ full term cargo ship safety certificate, etc. with validity upto 31/03/2019. As per the technical certificate signed by General Manager (Technical), after completion of the said repairs, Dredger-IX will have an extended useful life of two years. Dredger-IX completed its drydock repairs and the cost of the said repairs amounting to Rs. 8.74 crores has been added to the cost of the Dredger-IX and the amount for the proportionate period after completion of the said drydock repairs i.e., 1/08/2014 to 31/03/2015 amounting to Rs. 2.91 crores was charged to depreciation. In the case of Dredger-XI, an amount of Rs. 1 crore spent was shown as work-in-progress pending completion of drydock repairs which is expected to extend the life beyond the originally stated life by a minimum of another two years.

11. CAG audit has commented on the above accounting treatment as under:

"Repairs and Maintenance (Vessels) – Rs. 69.35 crore

13) This includes Rs. 9.74 crore towards the dry dock of dredgers IX and XI. While furnishing reply to Audit Note – 6, the management stated that based on the Technical Certificate, after completion of above said repairs, the life of Dredger IX stood extended for two years from the date of completion of its repairs. So, the cost of repairs amounting to Rs. 8.74 crore will be added to the cost of the asset and proportionate amount attributable to 1-8-2015 to 31-03-2015 i.e., Rs. 2.91 crore will be charged to depreciation for F.Y. 2014-15. Likewise in the case of Dredger XI, since the dredger is still to complete its repairs, the amount spent i.e., Rs. 1 crore during the F.Y. 2014-15 will be shown under capital work-in-progress. Thus, the management intended to withdraw the repair expenditure of Rs. 9.74 crore and debited to assets.

The reply of the management is not tenable in view of the following:

A. The dry-dock expenditure is a regular maintenance expenditure to restore the dredger to normal conditions and it is purely a revenue expenditure. The dry dock expenses and cost of replacement of spares etc. during the dry dock are against the

wear and tear suffered by the dredger and to bring the vessel into normal working condition. Hence, treating the dry dock expenses as capital expenditure for short period and that too for two years is not correct.

B. As per paragraph 12.1 of AS 10[2], only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. The dry dock repairs will not increase original capacity of the dredgers except to optimally restore the dredger to its original capacity.

C. As per corporate policy, retrofit of dredgers is of capital nature and the management intended to capitalise the expenditure under deferred revenue expenditure. Thus, treating the ordinary routine dry dock as capital expenditure is not correct.

D. As per the accounting policy of another company, XYZ, in the industry, the dry dock expenses are charged to profit and loss account and not to capital.

Reversing the entries by the company, resulted in understatement of repairs and maintenance (Vessels) by Rs. 9.74 crore, overstatement of fixed assets by Rs. 8.74 crore, capital work in progress by Rs. 1.00 crore and depreciation for the year by Rs. 2.91 crore. Consequently, the profit for the year is overstated by Rs. 6.83 crore."

12. The company replied as under:

"As per the accounting policy approved by the Audit Committee and the Board:

"Expenditure incurred on drydocking of dredgers which have completed the useful life of 25 years already is capitalized to the said dredger and depreciated over the extended life determined by technical evaluation."

Dredgers IX and XI have completed their life of 25 years. In accordance

[2] Accounting Standard (AS) 10, 'Accounting for Fixed Assets' has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

with the above policy and based on the technical certificate, after completion of above said repairs, the life of Dr. IX stood extended for two years from date of completion of its repairs. So, the cost of repairs amounting to Rs. 8.74 crore was added to the cost of the asset and proportionate amount attributable to 1-8-2015 to 31-03-2015, i.e., Rs. 2,91,29,927 was charged to depreciation for F.Y. 2014-15.

In the case of Dredger XI, the dredger is still to complete its repairs and therefore, the amount spent, i.e., Rs. 1 crore for F.Y. 2014-15 was shown under capital work-in-progress.

(A & B) In the cases of Dredger IX and XI, both have completed their originally stated life. So the present expenditure is to enhance its originally estimated life and make use of vessel for two more years. In other words, originally estimated 25 years has been enhanced to two more years. Hence, this meets the requirement of AS 10.

(C) The expenditure incurred for making use of the asset beyond its originally stated life (i.e., 25 years) is to be capitalised and is to be depreciated over its estimated extended life. This treatment is as per AS 10. The expenditure incurred would result in the asset becoming useful for two years.

(D) Any expenditure incurred resulting in increase of originally estimated life or standard of performance etc. is capital expenditure. All other drydock repair expenses which did not meet this criterion were charged to revenue.

There is no overstatement of profit/fixed assets etc. as stated by Audit. In view of above clarifications and that since the treatment is in line with the Accounting Policy No. 5 of the company and also in accordance with AS 10, the Audit is requested to drop the observation."

13. Statutory auditors agreed with the company's reply. During the course of subsequent discussions with CAG audit, the CAG audit dropped their comments subject to an assurance that the company shall refer the matter to the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on the issue as to whether the accounting treatment made by the company with regard to dry dock expenses incurred in respect of Dredger-IX and Dredger-XI is in order.

B. Query

14. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the accounting treatment made by the company with regard to repair expenses incurred during dry dock, as referred to by the CAG audit, incurred in respect of Dredger-IX and Dredger-XI is in order.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to accounting treatment made by the company with regard to repair expenses during dry dock, as referred to by the CAG audit, incurred in respect of Dredgers IX and XI, which have already completed their originally estimated useful life of 25 years. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, depreciation policy in respect of other dredgers and various equipments/fixed assets of the company, accounting for exchange variation on long term foreign currency monetary liabilities used for acquisition of specific fixed assets, accounting for cost of special survey and intermediate survey as a separate component, etc. The Opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 and without considering the application of Accounting Standards amended by MCA vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

16. The Committee notes from the facts of the case that the company incurred dry dock repair expenses on dredger IX and XI during F.Y. 2014-15, by which these dredgers have already been used for 30 and 28 years respectively. Further, the costs of these assets (less residual value) have already been depreciated in full over 14 years as per the rates prescribed in the Companies Act, 1956. Accordingly, as on 1.4.2014, when Schedule II of the Companies Act, 2013 came into effect, only the residual value of these dredgers was appearing as the carrying amount in the books of account. In this regard, the Committee further notes the requirements of Note 7 to Schedule II to the Companies Act, 2013 as follows:

> "7. From the date this Schedule comes into effect, the carrying amount of the asset as on that date—

(a) shall be depreciated over the remaining useful life of the asset as per this Schedule;

(b) after retaining the residual value, may be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil."

From the above, the Committee notes that Schedule II requires companies to re-estimate the remaining useful life of the existing assets as per the requirements of Schedule II and give effect to the revision in the useful life of the assets in accordance with the above requirements. With regard to the revision in useful life, the Committee further notes paragraph 23 of Accounting Standard (AS) 6, 'Depreciation Accounting'[3], notified under the Companies (Accounting Standards) Rules, 2006 as follows:

> ***"23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life."***

From the above, the Committee notes that AS 6 requires that in case of revision in the useful life of a depreciable asset, it is the unamortised depreciable amount that should be charged over the revised remaining useful life. From this it implies that on the date of revision in the useful life of the asset, the depreciable amount (which is historical cost/revalued amount less residual value) should be in existence. Since in the extant case, costs of Dredgers IX and XI (less residual value) have already been depreciated in full, no unamortised amount is left as on the date of Schedule II coming into effect. Accordingly, the Committee is of the view that the question of allocating the unamortised depreciable amount over the revised remaining useful life as per the requirements of the Schedule II and AS 6 does not arise.

17. The Committee further notes from the Facts of the Case that as per Indian Register of Shipping (IRS) Rules, all ships classed with IRS are to

[3] The opinion should be read in the context of Accounting Standard (AS) 6, 'Depreciation Accounting'. However, it may be noted that the Standard has been withdrawn by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

undergo special surveys at five yearly intervals and at least one intermediate survey has to be carried out between 2nd and 3rd year from the date of completion of special survey. Thus, dry dock expense is a periodical and regular maintenance expenditure which has to be incurred on regular intervals over the life of the dredgers. The Committee is of the view that the fact that the dredgers have to undergo such kind of regular maintenance is known to the company from the very beginning when the dredgers are put to use and when their useful life is determined. Therefore, the useful life of the dredgers should be estimated after taking into consideration such periodical and regular maintenance. Thus, once the useful life is determined considering the periodical maintenance, the question of increase in the useful life due to regular and periodical maintenance, such as, dry docking does not arise. For example, a plant and machinery may have different useful life depending upon whether the regular maintenance expenditure required on regular intervals for the smooth functioning of such plant and machinery is carried out or not and if an entity intends to carry out such regular maintenance, the useful life of the plant and machinery should be estimated taking into consideration such regular maintenance.

D. Opinion

18. On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 14 above that the accounting treatment followed by the company of (i) capitalising the repair expenses, as referred to by the CAG audit, incurred during dry dock in respect of Dredgers IX and XI, whose depreciable amounts have already been written off in full to the value of such assets and (ii) depreciating the same over the revised remaining useful life is not appropriate for the reasons discussed in paragraphs 16 and 17 above.

Query No. 8

Subject: Revenue recognition in case of mortgage guarantee company.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is incorporated under the provisions of the Companies Act, 1956 and registered as a non-banking financial company (NBFC) with the Reserve Bank of India ('the RBI'). The company is engaged in the business of providing mortgage guarantees (MGs). In addition to being regulated as an NBFC, the company is also governed by the 'Mortgage Guarantee Companies (Reserve Bank of India) Guidelines, 2008', issued by the RBI. The shareholders of the company include National Housing Bank, Genworth Financial Mauritius Holdings Limited, International Finance Corporation and Asian Development Bank.

2. The company was set up with the objective of conducting the business of issuing mortgage guarantees. Mortgage guarantee (also known as mortgage insurance in some parts of the world) is a financial product which compensates lending institutions/ banks/ housing finance companies for losses, to an agreed extent, that may arise when a home owner defaults on a mortgage. In return for issuing mortgage guarantees, the company charges a fee. This fee can be received up-front at the time of issuance of the guarantee or spread over a number of installments and is non-refundable. The pricing of the mortgage guarantee is based on the mix of the portfolio characteristics and historic loan performance. The querist has separately clarified that the company calculates the fee as a percentage of the principal outstanding of the mortgage loan (in respect of which a mortgage guarantee is being issued) on the date from which the mortgage guarantee is applicable to the loan. The company till date has only issued mortgage guarantees where the fee has been received upfront (i.e., single premium). In case the fee is to be received in installments, it is proposed that the fee will be received in equal installments over the first 3 years and will be advised to the lender upfront. Since the fee (that is received in installments) relates to the entire life of the mortgage guarantee, it is intended that the fee would be amortized over the life of the guarantee, in the same manner as the fee that is received upfront. In this regard, the querist has supplied a copy of MG contract for a single upfront fee for the perusal of the Committee.

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[1] Opinion finalised by the Committee on 7.7.2016.

3. The querist has stated that key concepts, relating to mortgage guarantee business, as defined in the RBI Mortgage Guarantee Guidelines are:

> "Mortgage guarantee" means a guarantee provided by a mortgage guarantee company for the repayment of an outstanding housing loan and interest accrued thereon up to the guaranteed amount to a creditor institution, on the occurrence of a trigger event;
>
> "Borrower" means any person or any entity who has been granted a housing loan by any creditor institution or any other entity which may be specified by Reserve Bank of India from time to time;
>
> "Creditor institution" means a bank or housing finance company; and
>
> "Mortgage guarantee contract" means a tri-partite contract among the borrower, the creditor institution and the mortgage guarantee company, which provides the mortgage guarantee.

4. As per Consultative Document issued by Basel Committee on Banking Supervision in August 2013, "*Mortgage Insurance* (*MI) is also called mortgage default insurance, mortgage credit insurance, mortgage guaranty insurance, mortgage indemnity insurance, and lenders' mortgage insurance. MI protects lenders against losses when loans default – i.e. when outstanding debt exceeds the foreclosure proceeds. The borrower pays the insurance premium, but the lender is the policy beneficiary, and the amount of loss coverage is usually capped as a proportion of lost loan principal.*"

(Emphasis supplied by the querist.)

5. The querist has stated that the company is obliged to make good credit losses (up to the guarantee cover issued) when the guarantee is invoked by the lending institution (creditor) on the loan being classified as non-performing in the books of the creditor institution. For practical purposes, the loss emergence pattern is built by the company by applying forecasting techniques to historical data of actual loss sustained. The forecasting techniques, inter alia, incorporate economic assumptions, which impact the loss development, such as, unemployment rates, interest rates and expected changes in house prices. These techniques provide a scientific approach to estimate the pattern in which the guarantee loss would materialise and devolve upon the company.

6. The querist has also stated that it is also important to distinguish mortgage guarantees from a more commonly known guarantee product generally issued by banks. Bank guarantees are most often issued by banks to provide assurance that certain financial or commercial obligations of their customer will be met by the customer. Bank guarantees typically have a shorter tenor (as compared with Mortgage Guarantee) of anywhere between 6 months to 36 months. A bank guarantee is issued primarily to protect against risk of non-performance of contractual obligations. The risk cover provided under a bank guarantee is uniform and the assumption is that if the guarantee is invoked, the same becomes a crystallised liability, of the bank's customer who will repay the same to the bank in the same manner as a funded loan obligation. On the other hand, mortgage guarantee is a financial product intended to be used as a credit risk mitigation tool. The tenor of a mortgage guarantee matches the tenor of the underlying loans and could extend beyond 15 – 20 years. Losses are estimated using stochastic models and based on data of delinquencies in mortgage loans historically.

7. The RBI guidelines also specify that 'guarantee' means a contract of guarantee as defined in the Indian Contract Act, 1872 (9 of 1872). However, as per the RBI Notification dated 8th August 2014, mortgage guarantees issued by a mortgage guarantee company may be taken as contingent liabilities for the purpose of calculating the risk weights, and not as financial and other guarantees. The querist has also separately clarified that as per the RBI Guidelines, the mortgage guarantee is considered as an off balance sheet exposure and is recognised as a contingent liability in the financial statements. The same is measured depending on the underlying exposure of the MG firm to the housing loans forming part of the guarantee. For e.g., if on a loan of Rs.100, a mortgage guarantee of 20% cover is issued then the exposure of the MG Firm will be Rs. 20 (i.e. 20% x Rs.100).

Current accounting guidance on revenue recognition:

8. Recognition of guarantee fee income is one of the key accounting considerations for a mortgage guarantee company which requires addressing of questions as to when and how much of the fee should be recognised as income by the company in an accounting period. The following paragraphs describe the relevant regulatory and statutory guidance on accounting in this regard.

9. Being a mortgage guarantee company (MGC), the company is required to follow the prudential norms issued by the RBI for such companies. As per paragraph 3 (ii) of the Mortgage Guarantee Companies Prudential Norms (Reserve Bank) Directions, 2008 ('the Prudential Norms'), "A mortgage guarantee company shall account the premium or fee on the mortgage guarantee contracts as an *income in the profit and loss account in accordance with the Accounting Standards* issued by the Institute of Chartered Accountants of India. The amount of unearned premium shall be shown as a separate line on the liability side of the balance sheet." (Emphasis supplied by the querist.)

10. Since the prudential norms do not specify any particular basis/method of revenue recognition for premium (or fee) on mortgage guarantee contracts and leave this to be determined as per accounting standards, reference is made to Accounting Standard (AS) 9, 'Revenue Recognition'. According to the querist, as the concept of mortgage guarantee has been newly introduced in India, there is no authoritative guidance or established industry practice on application of the requirements of AS 9 to mortgage guarantee contracts. Hence as is the practice, references may be drawn to acceptable GAAPs and practices in other jurisdictions, to take help on how AS 9 can be evaluated with reference to above.

11. *Accounting for fee from mortgage guarantee insurance (similar product) in other jurisdictions*

a. The general standard governing revenue is International Accounting Standard (IAS) 18 'Revenue' (Existing standard)/ International Financial Reporting Standard (IFRS) 15 'Revenue from Contracts with Customers' (proposed effective from 1 January, 2018).

b. IAS18 scopes out insurance contracts within the scope of IFRS 4 'Insurance Contracts'. In Canada and Australia, mortgage insurance is treated as an insurance contract, and hence, the revenue accounting for this product is scoped out of IAS 18. Similarly, IFRS 15 (effective from 1 January, 2018) has a scope exclusion for insurance contracts, i.e. contracts within the scope of IFRS 4 'Insurance Contracts' are excluded from IFRS 15.

c. Even though mortgage insurance is considered as an insurance contract under IFRS, there is no specific guidance for revenue recognition for such contracts under IFRS 4.

d. An overview of internationally prevalent revenue recognition practices has been provided by the querist as below:

   - ***Accounting for mortgage insurance in Canada*** **–**As mentioned earlier, there is no specific revenue recognition guidance in IFRS 4. Hence, at the time when many entities were adopting IFRS, they continued with prior accounting practices, which are typically based on local/regulatory accounting practices that were previously being followed. In Canada, the Office of the Superintendent of Financial Institutions (OSFI) is the primary regulator and as part of their capital standards, denote how the Unearned Premium Revenue (UPR) should be recognised for mortgage insurance contracts. As per OSFI *"Unless an entity can demonstrate sufficient industry experience to develop their own recognition curve the Company is required to follow the revenue pattern as set-out by OSFI".* The table provided by OSFI has been attached as Appendix 1 at the end of this document. Some companies like Genworth, Canada have a customized curve today (based on the experience in Canada) that is similar to the curve provided by OSFI.

   - ***Accounting for mortgage insurance in Australia*** **-** As compared to Canada, the Australian regulator (the Australian Prudential Regulation Authority) has not issued any specific guidance on revenue recognition. However, the Australian Accounting Standard Board has issued AASB 1023 which addresses the accounting for 'General Insurance Contracts'. This standard supplements the lack of guidance in IFRS 4 (adopted as AASB 4) with specific requirements for accounting (in Australia) for these insurance contracts. AASB 1023 states that *"Premium Revenue shall be recognized, over the life of the general insurance contract, in accordance with the pattern of the incidence of risk expected under the general insurance contract".*

- ***Accounting for mortgage insurance in UK -*** Insurance contracts in UK are governed by FRS 103 (Insurance contracts - Consolidated accounting and reporting requirements for entities in the UK and Republic of Ireland issuing insurance contracts) with effect from 1st January, 2015. Like IFRS 4, FRS 103 does not give any guidance on revenue recognition. Hence, guidance on the insurance contracts premium recognition is provided in the Statement of Recommended Practices (SORP) on accounting for insurance business.

  As per SORP (Guidance note issued by the Association of British Insurers), written premiums are recognised as earned premiums over the period of the policy having regard to the incidence of risk. Time apportionment of the premium is normally appropriate if the incidence of risk is the same throughout the period of cover. If there is a marked unevenness in the incidence of risk over the period of cover, a basis which reflects the profile of risk should be used. The proportion of the written premiums relating to the unexpired period of these policies will be carried forward as an unearned premiums provision at the balance sheet date. Accordingly, Genworth in UK recognises premium on the basis of incidence of risk.

- ***Accounting for mortgage insurance in USA -*** There is no authoritative regulatory guidance governing such Mortgage Insurance contracts under US GAAP. Since, there was no specific guidance, industry convention has developed over a period of time, i.e. recognising revenue in relation to incidence of risk/losses incurred.

  The approach followed by the industry *is generally consistent (and not the only basis)* with the revenue recognition guidance contained within U.S. GAAP for warranty contracts contained in Accounting Standards Codification (ASC) 605-20-25-3, which states: "Sellers of extended warranty or product maintenance contracts have an obligation to the buyer to perform services throughout the period of the contract and, therefore, revenue shall be recognized in income over the period in which the seller is

obligated to perform. That is, revenue from separately priced extended warranty and product maintenance contracts shall be deferred and recognized in income on a straight-line basis over the contract period *except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue shall be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract."*

(Emphasis supplied by the querist.)

12. *Revenue Recognition under Indian context:*

a. AS 9 states the following with regard to recognition of revenue from services:

"7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) ***Proportionate completion method*** —Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period *unless there is evidence that some other method better represents the pattern of performance*.

(ii) ***Completed service contract method***—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is

relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable."

(Emphasis supplied by the querist.)

Further, as per an illustration to AS 9:

"*3. Financial service commissions*

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

(a) whether the service has been provided "once and for all" or is on a "continuing" basis;

(b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. *Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan* or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto."

(Emphasis supplied by the querist.)

b. Paragraph 20 of IAS 18, inter alia, states that "**when the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to stage of completion** ...". Paragraph 24 of IAS 18, inter alia, states, "The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services

performed. Depending on the nature of the transaction, the methods may include:

(a) surveys of work performed;

(b) services performed to date as a percentage of total services to be performed; or

(c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction." (Emphasis supplied by the querist.)

c. While applying the above referred principles of AS 9, a key accounting consideration is the determination of the pattern in which revenue should be recognised. The performance obligations associated with a mortgage guarantee contract continue during the lifetime of the guarantee and do not cease at any particular point of time unless the guarantee is exhausted or cancelled. As such, the revenue arising on account of mortgage guarantee fee should be amortized over the life of the guarantee using proportionate completion method, rather than at a point in time (whether upfront or under completed service contract method).

With respect to proportionate completion method, the standard provides that "The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognized on a straight line basis over the specific period *unless there is evidence that some other method better represents the pattern of performance."*

(Emphasis supplied by the querist.)

There can be a view that under Indian GAAP, the period of guarantee and the net amount guaranteed should form the basis of revenue recognition. In other words, the revenue should be recognised either on a straight-line basis (if the amount of

exposure on account of amount guaranteed remains uniform over the guarantee period) or based on proportion of outstanding guarantee obligation at the end of each year. Thus, if in a contract, the repayment terms are uniform and hence the guaranteed amount reduces uniformly, the guarantee fee will be recognised in the proportion of guarantee outstanding at the end of each reporting period, i.e., in a declining proportion basis.

However, it is important to consider that *in a mortgage guarantee contract, the risk cover provided is not uniform*. Though the company is obliged to make good credit losses when the guarantee is invoked, the risk of loss (i.e. the loss emergence pattern) does not mirror a uniform and straight line pattern but instead arises in an unequal pattern.* Hence, the revenue should be amortised based on the loss emergence curve. In other words, the measure of performance can be considered to be the pattern of expected loss rather than period of guarantee or the net amount guaranteed.

(Emphasis supplied by the querist.)

(*Loss emergence typically peaks between the third year and the fifth year of origination of a loan. This is in contrast to the guarantee obligation which reduces as per the terms of the Mortgage Guarantee (MG) Contract and the behavioral characteristics of individual home loans backed by MG.)

It may be noted that in following the loss emergence approach, the company would take into account the impact of external factors such as unemployment rates, interest rate changes and volatility in the housing prices in order to provide for a scientific and systematic approach for revenue recognition. In order to ensure that this accounting treatment is consistent with the changes in economic circumstances over time, the loss emergence assumptions, as well as the pattern in which expenses are incurred would need to be reviewed and adjusted periodically, based on the company's experience and updated loan credit history (of mortgage loans).

d. Thus, on an overall consideration of the above, the company believes that revenue can be recognised with reference to pattern

of estimates of losses incurred. This is also consistent with the approach followed internationally (as summarised earlier).

13. *Overall analysis:*

    a. Mortgage guarantee as a product in India is new. The business is regulated by the RBI as a NBFC, which also requires the company to follow Accounting Standards issued by the ICAI. AS 9 does not have any explicit guidance for accounting for mortgage guarantee. However, it requires commissions charged for arranging loans/other facilities to be recognised over the period of the loan, having regard to obligations outstanding, nature of services provided and timing of costs related thereto.

    b. As per the RBI, mortgage guarantee is a guarantee under the Indian Contract Act.

    c. Both under US GAAP and IFRS, various jurisdictions are amortising revenue using loss emergence pattern over the period of the mortgage insurance contract. Such accounting is primarily driven *either due to requirement of the respective insurance regulator and/ or industry practices* (including guidance for accounting for warranty contracts).

    d. Since mortgage guarantee is a similar product to mortgage insurance, and given the guidance in AS 9 (in relation to timing of costs, etc.), guidance can be borrowed from international practices.

    e. The performance obligations associated with a mortgage guarantee contract continue during the lifetime of the guarantee and do not cease at any particular point of time unless the guarantee is exhausted or cancelled. As such, the revenue arising on account mortgage guarantee fee should be amortized over the life of the guarantee (and not recognised upfront).

    f. Since the loss emergence** in connection with the guarantee do not mirror a uniform and straight line pattern and they arise in an unequal pattern; revenue should not be amortised on a straight line basis. The amortisation should be based on the loss emergence curve/pattern.

       (**Estimation of loss emergence is explained in Appendix 2)

g. In case the fee can be amortised as per loss emergence curve, the method of amortisation should take into account the impact of external factors such as unemployment rates, interest rate changes and volatility in the housing prices in order to provide for a scientific and systematic approach for revenue recognition. In order to ensure that this accounting treatment is consistent with the changes in economic circumstances over time, the loss emergence assumptions would need to be reviewed and adjusted periodically, based on the companies' experience and updated loan credit history (of mortgage loans).

B. Query

14. In light of the analysis mentioned above and in accordance with prevalent international revenue recognition practices (as mentioned in paragraph 11), the company believes that revenue should be recognised as per the pattern of loss emergence. This, in the opinion of the querist, is the most appropriate approach for the MG business in India. Hence, the querist has requested the concurrence of the Expert Advisory Committee in this regard.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to timing of recognition of mortgage guarantee fee. The Committee has therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, recognition of liability in respect of the mortgage guarantees issued at the reporting date, etc.

16. At the outset, the Committee notes that internationally, mortgage guarantee contracts are considered as insurance contracts. The Committee further notes that for revenue recognition under mortgage guarantee contracts, international practices do not follow any specific accounting literature, primarily due to such transactions being scoped out of International standard on revenue (i.e., IAS 18) and that the International practices/ conventions of revenue recognition have largely developed over a period of time with a sufficient and reliable data related to incidence of risks in relation to guarantee business being available over a period. However, the Committee notes that since the issue under consideration has been raised from the perspective of GAAPs prevailing in India and since the issue is in respect of

revenue recognition, the principles enunciated in this regard under AS 9, 'Revenue Recognition', should be applied to the mortgage guarantee contract undertaken by the company in the extant case. In this regard, the Committee notes that AS 9 does not have a scope exclusion similar to IAS 18. Since the company in the extant case is an NBFC registered with the RBI, the Committee is of the view that revenue recognition of mortgage guarantee fee from mortgage insurance contracts should be governed by AS 9 only. Accordingly, the Committee notes the requirements of Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006, which provide as follows:

> "7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.
>
> (i) ***Proportionate completion method—***Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.
>
> (ii) ***Completed service contract method—***Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable."
>
> *"3. Financial service commissions*
>
> A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be

made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

(a) whether the service has been provided "once and for all" or is on a "continuing" basis;

(b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto."

From the above, the Committee notes that when a number of activities are performed over a period of time revenue needs to be recognised over a period proportionately by reference to performance of each act considering the contract value, associated costs, number of acts, etc. However, for practical purposes revenue is recognised on a straight line basis over the specified period of time unless there is evidence that some other method better represents the pattern of performance. Further, with regard to financial service commissions, for example, in respect of loan management fee, AS 9 provides that revenue should be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto. With regard to the pattern of performance in the extant case, the Committee notes that the performance is the assurance or guarantee provided by the company to compensate for losses incurred on outstanding housing loan obligations over the period of loan obligations. Thus, as the loan obligations reduce over the period of the guarantee, guarantee obligations of the company also reduce and that reflects the pattern of performance of the company in the extant case. Therefore, the Committee is of the view that pattern of performance in the extant case is directly linked with outstanding obligations amount over the guarantee period. Further, the Committee also

notes that mortgage guarantee fee received is calculated with reference to the principal outstanding of the mortgage loan and is being received upfront without any linkage to the period in which the losses or costs are expected to be incurred. Thus, the receipt of fee is also not linked with the period in which the associated costs/losses are incurred over a period. Hence, the Committee is of the view that the revenue in the extant case should be recognised over the period of guarantee in proportion to the outstanding guarantee obligations.

D. Opinion

17. On the basis of the above, the Committee is of the opinion that revenue in the extant case should be recognised over the period of guarantee in proportion to the outstanding guarantee obligations, as discussed in paragraph 16 above and therefore, the Committee does not concur with the view of the querist to recognise revenue as per the pattern of loss emergence.

4. **Unearned premiums**

a) An insurer shall maintain unearned premiums on the scales prescribed below, unless OSFI is satisfied that there is sufficient historical loss emergence data to reliably identify the loss emergence pattern. For business insured prior to January 1, 2009, the difference between the two amounts, on an after-tax basis, is to be deducted from capital available.

	Unearned Premium Reserve as Percent of Single Premium Policy Reserve in Years					
Completed Policy Duration in Years	5 or less	over 5 and less than 10	over 10 and less than 15	over 15 up to 25	over 25 up to 30	over 30 up to 40
0	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
1	75.00%	80.00%	85.00%	88.00%	88.50%	89.00%
2	50.00%	60.00%	65.00%	70.00%	70.50%	71.00%
3	25.00%	40.00%	45.00%	52.00%	52.50%	53.00%
4	12.50%	20.00%	30.00%	35.00%	35.50%	36.00%
5	0.00%	10.00%	18.00%	23.00%	23.50%	24.00%
6		5.00%	10.00%	14.00%	16.00%	16.50%
7		3.00%	6.00%	8.00%	12.00%	12.25%
8		2.00%	4.00%	6.00%	8.00%	8.25%
9		1.00%	2.00%	3.00%	5.00%	5.50%
10		0.00%	1.50%	2.50%	3.00%	3.50%
11			1.00%	2.00%	2.50%	2.75%
12			0.50%	1.50%	2.00%	2.10%
13			0.25%	1.00%	1.50%	1.70%
14			0.125%	0.50%	1.00%	1.30%
15			0.000%	0.40%	0.50%	0.90%
16				0.35%	0.45%	0.70%
17				0.30%	0.40%	0.65%
18				0.25%	0.35%	0.50%
19				0.20%	0.30%	0.40%
20				0.15%	0.25%	0.35%
21				0.12%	0.22%	0.32%
22				0.09%	0.19%	0.29%
23				0.06%	0.16%	0.26%
24				0.03%	0.13%	0.23%
25				0.00%	0.10%	0.20%
26					0.08%	0.18%

Appendix 2

<u>Loss emergence curve</u>

Globally, revenue is recognised on the basis of pattern in which losses are incurred.

a. India does not have any loss distribution data for various vintages for one or more lenders across life of loan pools of various origination years in its public domain information. The Company intends to follow either one of the following two options for determining the loss emergence pattern/ loss curve.

b. As a first option, since, no such data is available for the India Mortgage Industry, the Company proposes to follow **the 180+ DPD** (loans crossing 180 delinquency bracket), as a surrogate for arriving at the loss emergence curve. The company has engaged with Indian credit bureau CIBIL, for tracking the delinquency pattern of mortgage portfolio in last 7 years and plans to leverage the trend of 180+ derived from CIBIL data as a proxy for estimating the Indian loss emergence pattern. *The company also intends to get this evaluated with the help of an actuary.*

c. As a second option, the Company intends to use a 10-yr loss emergence curve being used by Genworth, UK. Per the Company, this is so because, standard mortgage term and interest rate structure in U.K is similar in India (Standard mortgage term is 20 years and interest rate structure is Variable). Also, the UK loss emergence curve is conservative and peaks earlier than other economies (U.S; Mexico, Canada, Japan & Australia)

d. Also, the general experience on borrower behavior is that while the loan tenor is 15-20 years, most prepay within 10-12 years, since the pre-payment penalties outweigh the interest costs. The loss emergence curve for the business considers the aspect of pre-payment of loans in a portfolio, determined considering an average life of the loan of 10 years.

e. Residential Mortgage Backed Securities (RMBS, or mortgage loans) pool data observed in India. Based on analysis of RMBS pools rated by ICRA, the company observed that almost 83% of pool is amortised in 7-8 years leading to the conclusion that average life of pools in India is 10 years.

Query No. 9

Subject: ***Accounting for unspent CSR spending as per Revised DPE Guidelines on Corporate Social Responsibility and Sustainability for Central Public Sector Enterprises.***[1]

A. Facts of the Case

1. The querist is a Government company within the meaning of section 2(45) of the Companies Act, 2013. The shares of the company are listed with recognised stock exchanges. The company is engaged in the business of refining of crude oil and marketing of petroleum products. It has two refineries and lube blending/filling plants. The company also has depots, installation and LPG plants across India, besides having administrative offices at Delhi, Chennai, Kolkata, Mumbai and other major cities.

2. The querist has stated that as per the provisions of section 135 and relevant rules, etc. under the Companies Act, 2013, Board of Directors of a company has to ensure that the company spends, in each financial year, at least 2% of the average net profits of the company, made during the three immediately preceding financial years, in pursuance of its corporate social responsibility (CSR) policy. If the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of section 134 of the Companies Act, 2013, specify the reasons for not spending the amount. Further, paragraph 1.5.3 of the erstwhile DPE Guidelines[2] (effective till 31.3.2014), applicable to all the central public sector enterprises, inter alia, stated as follows:

> "The budget allocated for CSR and Sustainability activities/projects planned for each financial year is expected to be spent within that year. If due to some reason, the budget of a year remains unutilised, the same would not lapse. Instead, it would be carried forward to the next year for expenditure on CSR and Sustainability activities, which were planned for implementation in the previous year, but could not be completed due to some reason. However, the public sector enterprise shall have to disclose reasons for not being able to spend the entire

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[1] Opinion finalised by the Committee on 7.7.2016.

[2] These Guidelines were subsequently superseded by the Revised Guidelines on Corporate Social Responsibility and Sustainability for Central Public Sector Enterprises, which are effective from 1.4.2014.

budget on CSR and Sustainability activities as planned for that year, and shall make every endeavour to spend the unutilized budget of any year within the next two financial years. In case the CPSEs are unable to spend the unutilized budget within the next two financial years, the unspent amount would be transferred to a 'Sustainability Fund' to be used for CSR and Sustainability activities. This 'Sustainability Fund' would be created separately. Implementation mechanism in this context is also being formulated separately."

3. The querist has further stated that in the financial year 2014-15, Rs. 76.01 crore is required to be spent by the company towards CSR expenses. However, the company has spent Rs. 33.95 crore (including payables of Rs 7.28 crore as on 31st Mar 15). The company had made the provision of Rs. 42.06 crore for the unspent amount in line with an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), published as Query No. 8 of Volume XXXIV of the Compendium of Opinions, which provides guidance in a similar case. Further, the company made the following disclosures in line with the Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities, issued by the ICAI:

"Disclosure in respect of Expenditure on Corporate Social Responsibility Activities

(Rs. in crore)

a)	Amount required to be spent by the company during the year	76.01
b)	Amount spent during the year (on purpose other than construction/ acquisition of assets controlled by the company) #	33.95*
c)	Provision created for balance amount	42.06

the above expenditure includes contribution to funds, expenses through registered trusts / registered society or company established under section 8 of the Act and direct expenses by the company.

* including payables of Rs. 7.28 crore as on 31.03.2015."

4. Points raised by Government Auditor

During the audit of the financial year 2014-15, Government auditor has raised query stating that provision created for unspent amount on CSR expenditure is not in line with the interim guidance of the Corporate Laws and Corporate Governance Committee of the ICAI i.e., Frequently Asked Questions (FAQs) [3] on the provisions of Corporate Social Responsibility under Section 135 of the Companies Act 2013 and Rules thereon, which, inter alia, states (vide Issue no. 7) that "any such shortfall is not required to be provided for in the books of accounts".

5. The company's view

As per section 135 (5) of the Companies Act, 2013 and as mentioned in the Guidelines on Corporate Social Responsibility and Sustainability For Central Public Sector Enterprises, issued by the Department of Public Enterprises (DPE) on 21st October, 2014 (hereinafter referred to as the 'Revised DPE Guidelines'), which are effective from 1.4.2014, the Board of every company to which CSR provisions are applicable, shall ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy. Further, if the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of Section 134, specify the reasons for not spending the amount. The DPE guidelines in paragraph 2.4 (iv) also state that in case of CPSEs mere reporting and explaining the reasons for not spending this amount in a particular year would not suffice and the unspent CSR amount in a particular year would not lapse. It would instead be carried forward to the next year for utilization for the purpose for which it was allocated. There is an earlier opinion, issued by the Expert Advisory Committee (EAC) of the ICAI (published as Query No. 8 of Volume XXXIV of the Compendium of Opinions) on a similar query wherein EAC has opined that the company should provide for the unspent amount of CSR and sustainability development (SD) as provision in its accounts since the company is obligated to spend the remaining amount in subsequent periods. Accordingly, taking guidance from the subject opinion, the provision towards

[3] The FAQs on certain issues covered by the Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities were subsequently superseded by the said Guidance Note on its issuance on May 15, 2015.

unspent CSR amount for F.Y. 2014-15 was created in the accounts as there is an obligation on the company on the reporting date to spend the balance CSR amounts and the same will not lapse. Further, the company has made the necessary disclosures as per the guidance referred to in paragraph 4 above.

B. Query

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

(i) Whether the accounting treatment followed by the company, i.e., creating provision towards unspent CSR amount is correct.

(ii) If not, what will be the accounting treatment for the unspent amount in view of the fact that the unspent amount shall have to be carried forward and spent in subsequent years in line with the DPE Guidelines?

(iii) What are the disclosure requirements of the unspent amount by the company?

C. Points considered by the Committee

7. The Committee, while expressing the opinion, has restricted itself to the issues raised in paragraph 6 above and has not examined any other issue arising from the Facts of the Case, such as, determination of the amount to be earmarked for CSR activities, legal interpretation of DPE Guidelines, what qualifies as CSR expenditure, etc. At the outset, the Committee notes from the Revised DPE Guidelines that the Guidelines supplement the CSR requirements as envisaged in the Companies Act, 2013 and Companies (Corporate Social Responsibility Policy) Rules, 2014 (hereinafter referred to as CSR Rules) and, therefore, CPSEs have been advised to follow the CSR Rules together with the Guidelines. Accordingly, it is understood that these DPE guidelines are additionally required to be followed by the CPSEs. Further, since the company seems to be already following the requirements of DPE Guidelines as the querist has also referred to the DPE Guidelines while arguing for creation of provision by the company in the extant case, the Committee, without interpreting DPE Guidelines presumes that the company is required to follow these Guidelines. Accordingly, the Committee has examined the extant issue in the context of

DPE Guidelines. Further, the Committee notes that the querist has raised the issue for financial year 2014-15 and has also referred to the requirements of FAQs issued by the Corporate Laws and Corporate Governance Committee, which provided an interim guidance and on issuance of the Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities on May 15, 2015, by the ICAI, the FAQs related to areas covered by the Guidance Note stand withdrawn from that date. The Committee also notes that the Guidance Note as well as FAQs provide that considering the requirements of the Companies Act, no provision for the unspent amount is required to be made in the financial statements. However, the Committee notes that both the FAQs as well as the Guidance Note cover only the requirements of the Companies Act 2013 and CSR Rules, whereas in the extant case, the company is also required to follow DPE Guidelines in addition to the requirements of the Companies Act, 2013. Accordingly, the issue in the extant case is being examined in the context of DPE Guidelines.

8. The Committee further notes the following paragraphs of the revised DPE Guidelines:

> "2.4 (i) It is *mandatory* for all profit making CPSEs to undertake CSR activities as per the provisions of the Act and the CSR Rules. Even the CPSEs which are not covered under the eligibility criteria based on threshold limits of net-worth, turnover, or net profit as specified by Section 135 (1) of the Act, but which made profit in the preceding year, would also be required to take up CSR activities as specified in the Act and the CSR Rules, and such CPSEs would be expected to spend at least 2% of the profit made in the preceding year on CSR activities.
>
> …
>
> (iv) It would be *mandatory* for all CPSEs which meet the criteria as laid down in Section 135 (1) of the Act, to spend at least 2% of the average net profits of the three immediately preceding financial years in pursuance of their CSR activities as stipulated in the Act and the CSR Rules. This stipulated percentage of average net profits is to be spent every year in a manner specified in the Act and CSR Rules. *In case a company fails to spend such amount, it shall have to specify the reasons for not spending it. However, in case of CPSEs mere reporting and explaining the reasons for not spending this amount in a*

particular year would not suffice and the unspent CSR amount in a particular year would not lapse. It would instead be carried forward to the next year for utilization for the purpose for which it was allocated.

(Emphasis supplied by the Committee.)

From the above, the Committee notes that as per the above DPE Guidelines, all central public sector enterprises are mandatorily required to undertake CSR activities and spend the prescribed amount on such activities in a financial year. If a company fails to spend such amount, it shall have to specify the reasons for not spending it and further that unspent CSR amount in a particular year would not lapse. It would instead be carried forward to the next year for utilization for the purpose for which it was allocated, viz., CSR activities. Thus, the Committee is of the view that as per the revised DPE Guidelines, there is a mandate on the CPSEs to spend on CSR activities within a specified period as the prescribed amount, if not spent in a financial year, will be carried forward and shall not lapse.

9. The Committee notes the definitions of the terms, 'provision', 'liability', 'obligating event', 'present obligation' and paragraphs 11, 14 and 16 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, as follows:

"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

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

10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation."

"10.6 Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."

"11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence

of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

"14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised."

"16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event."

From the above, the Committee notes that as per the provisions of AS 29, a provision should be recognised when there is a present obligation, i.e., more likely than not, involving incurrence of expenditure, arising from a past event that leaves no realistic alternative apart from settling that obligation and that the obligation exists independently of an enterprise's future actions. In this context, Committee also notes that since DPE Guidelines are presumed to be followed by the company (in paragraph 7 above), which require the company to spend certain amount on CSR activities within a particular year and since as per the these Guidelines, the unspent amount would not lapse; rather the same would be carried forward only to next year to be used only for CSR activities, the Committee is of the view that as per DPE Guidelines, the company has no realistic alternative apart from spending that amount on the CSR activities. Thus, it creates a present obligation on the company to spend the specified amount on CSR activities. Accordingly, the company should make a provision for such an obligation as per the requirements of AS 29. On the basis of the above, the Committee is of the view that in the extant case, in the financial year 2014-15, the company is correct in recognising a provision in respect of unspent expenditure on CSR activities.

10. With regard to disclosure of unspent amount of CSR, the Committee is of the view that apart from complying with the disclosure requirements as prescribed in the Companies Act, 2013 (Schedule III and section 135), Companies (Corporate Social Responsibility) Rules, 2014 and DPE Guidelines, the company should make disclosures in accordance with the disclosure requirements with regard to the provisions, as contained in AS 29.

D. Opinion

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

(i) The accounting treatment followed by the company, i.e., creating provision towards unspent CSR amount in the financial year 2014-15 is correct.

(ii) Answer to this question does not arise in view of (i) above.

(iii) As regards the disclosure requirements of the unspent amount by the company, the company should, apart from complying with the disclosure requirements as prescribed in the Companies Act, 2013 (Schedule III and section 135), Companies (Corporate Social Responsibility) Rules, 2014 and DPE Guidelines, make disclosures in accordance with the disclosure requirements with regard to the provisions, as contained in AS 29.

Query No. 10

Subject: Capitalisation of cost incurred towards replacement of economizer coil in a boiler of a thermal power plant.[1]

A. Facts of the Case

1. A company is incorporated as a wholly owned Government company

[1] Opinion finalised by the Committee on 7.7.2016.

under the Companies Act, 1956 during the year 1984 and is engaged in construction and operation of thermal power plants in the State of Odisha. The company had set up two units of 2 x 210 MW (Units I and II, i.e., Stage-1) as its maiden venture in the district of Jharsuguda known as IB Thermal Power Station and the units commenced commercial operation during December 1994 and June 1996 respectively. Power generated from Units I & II is sold to G Ltd., a Govt. of Odisha undertaking at a tariff determined as per Bulk Power Purchase Agreement executed during 1996. During 1999, as a part of power sector reforms, the Government of Odisha divested 49% of the shares in favour of A Corporation, USA, the strategic investor. The company prepares its annual financial statements as per the provisions of the Companies Act, 2013 as amended from time to time. The financial statements are audited by the statutory auditors appointed by the Comptroller and Auditor General (C & AG) of India. The auditors of C & AG of India had also undertaken supplementary audit under section 143(6) of the Companies Act, 2013.

2. The querist has stated that economizer is one of the major component of the boiler in a power plant. The thermal power generating plant, as stated above (2* 210MW) is in operation for about 20 years. During the year 2014-15, the company replaced "economizer coils" which is a component of boiler in Unit -2 of the power plant which was rendered un-serviceable due to severe erosion as a result of firing of high ash content coal. The plant is getting coal from C Ltd. *Most of the months, Gross Calorific Value (GCV) of coal received was less than average 2700 kcal/kg (approx.) as against design coal GCV of 3000 kcal/kg (42% ash)* and the ash content was is in the range of 43%-47% majority of the time, which is more than designed range. Firing of such coal with high ash content into the boiler leads to accelerated erosion of the tubes of the coils and dislodging of support clits. (Emphasis supplied by the querist.)

3. The querist has stated that during the year 2014-15, the company incurred an amount of Rs. 4.31 crore for replacement of economizer upper bank coil of Unit-II boiler. While capitalising the replacement cost of economizer, the company also decapitalised the original cost incurred during the year 1995-96. Auditors of C&AG of India while conducting supplementary audit under section 143(6) of the Companies Act, 2013 for the financial year 2014-15, raised draft observations on accounting treatment of capitalisation of economizer coil which are as follows:

> *"Equity and Liabilities*
>
> *Assets: Fixed Assets*
>
> *Tangible Assets (Note No.12) - Rs. 212.89 crore (Net Block)*
>
> *The above includes Rs. 4.31 crore (net block) being the value of replacement of economizer upper bank coil (50 numbers) of Unit-II boiler and repair of the remaining coil. As the expenditure was of repair and maintenance nature, the same should have been charged to revenue instead of capitalizing the same as per AS 10. This has resulted in overstatement of Plant & Equipment (Net Block) and understatement of generation and other expenses to the extent of Rs. 4.31 crore. While confirming the facts and figures, the views of the Management on the fact stated above may be furnished."*

To above observation, the company submitted its replies. However, the replies submitted by the company were not accepted by the auditors and they retained the same as part of final observation which is as follows:

> *"Equity and Liabilities*
>
> *Assets: Fixed Assets*
>
> *Tangible Assets (Note No.12) - Rs. 212.89 crore (Net Block)*
>
> *The above includes Rs. 4.31 crore (net block) being the value of 50 nos. of economizer upper bank coil replaced in Unit-II boiler and repair of the remaining coil. As these expenses have not increased the future benefits from the existing assets beyond its previously assessed standard of performance as required under AS 10 for capitalization of the item, these should not have been capitalized. Rather, it should have been charged to revenue. Capitalizing the amount instead of charging to revenue has resulted in overstatement of Plant & Equipment (Net Block), understatement of generation and other expenses and overstatement of profit for the year by Rs. 4.31 crore each."*

4. *Reason for replacement of coil in economizer:*

According to the querist, the purpose of the economizer of a boiler in a power plant is to preheat the boiler feed water before it is introduced into the steam drum and to recover some of the heat from the flue gases leaving

the boiler. The economizer absorbs heat from the flue gas and adds it mainly as sensible heat to feed water.

The total number of coils present in the economizer is 145. The company has experienced number of economizer coil tube failure events. The findings are as follows:

Event Occurrence-Unit -2	Location	Outage Hrs.
09-4-1997	Eco upper bank coil no 34 & 35 from left	Not available
23-3-1999	Near ECO hanger tube above LTSH coil	45.45
06-1-2009	Eco upper bank 1st coil	38.27
10-11-2012	Eco intermediate header	84.65
07-4-2013	Eco near header EH2C	88.25
17-09-2013	Eco tube no.1 coil 145	27.52

The forced outage of boiler, which was quite frequent due to tube failure having financial loss in terms of generation loss is a concern for the company. To analyse the reason, a technical committee was formed to give suggestions for improving the boiler performance by minimising 'tube failure' incidents. After detailed analysis, the committee finds the following reasons for tube leakage:

(a) From the past records of failure data of tube leakages and failure analysis, it has been noticed that 50% of failures are caused due to flue gas induced accelerated erosion and another prominent reason is due to construction (site welding) weld joint failure. Most of the economizer failures have taken place in the narrow gap between corner tubes of coil and the side wall as the narrow area is affected due to high velocity flue gas containing excessive amount of fly ash leading to accelerated erosion.

(b) The committee recommended for replacement of thinned-out coils with 100% thickness measurement of all tubes of the coils after making access by removing the coils. The committee proposed replacement of economizer coils, which are located on either

sides (right and left) out of total 145 numbers of coils in the economiser. After removing the side coils, access can be made and inspection, checking and repair can be done on the other coils depending on the requirement. The tube thickness reduction has happened over a period of time (20 yrs) and has reached to the present stage of 25-30% reduction.

(c) Factors which influence high fly ash erosion are mainly due to:

- The velocity of flue gas
- The temperature of flue gas
- The mineral content in coal
- The arrangement of pressure parts
- Deviation from design condition

After analysing the above facts and looking at the ash content and GCV of coal, it is quite clear that the reduction in tube thickness by 25% to 30% has happened due to firing of lower GCV coal with higher ash content. *Therefore, replacement of coils in economizer is proposed due to accelerated erosion caused while firing higher ash content coal compared to design. It is observed that the weighted monthly GCV of coal for the period 2003-04 to 2012-13 ranges from a lowest level of 1540 kcal/kg to a highest level of 3760 kcal/kg as against the design range of quality of coal 3000 kcal/kg. It is also observed that in most of the months, GCV of coal received was less than average 2700 kcal/kg (approx.) as against design coal GCV of 3000 kcal/kg. It also appears that the failure of economizer tubes was due to the poor quality of coal.*

The committee concluded that accelerated erosion of economizer coil has occurred due to supply of high ash content coal and this has happened over a period of 20 years. *The economizer would have accommodated ash erosion having 3000 GCV (42% ash) of coal. The ash content in the coal during last several years has been observed to vary from 38% to 56% as fired for a typical day. The ash content in the coal as fired has been found to be more than 42% for most of the time. Therefore, the expenditure which would be incurred by replacing coils in economizer to accommodate ash erosion from low GCV coal is in the nature of 'improvement and betterment'.*(Emphasis supplied by the querist.)

5. Accounting Standard and accounting principle in support of capitalisation:

The querist has further stated that Accounting Standard (AS) 10, 'Accounting for Fixed Assets'[2], issued by the Institute of Chartered Accountants of India (ICAI) provides following conditions to be satisfied for capitalisation of subsequent expenditure incurred on a fixed asset already capitalised:

- Paragraph 23 of AS 10 states that ***"Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance".*** It is clear from this paragraph that the expenditure incurred, which will increase the future benefit beyond its original standard, will be capitalised. As per the above accounting standard, expenditure on fixed asset subsequent to their installation towards repairs and replacement should be expensed in the year in which such repair / replacement is made. Repairs and replacement means expenditure incurred on a fixed assets for "restoration of a capital asset to its full productive capacity or a contribution thereto, after damage, accident, or prolonged use, without increase in its previously estimated service life or productive capacity". *However, expenditure on fixed assets subsequent to their installation towards improvement or betterment, i.e., "expenditure having the effect of extending the useful life of an existing fixed asset, increasing its normal rate of output, lowering its operating cost, increasing rather than merely maintaining efficiency or otherwise adding to the worth of benefits it can yield" will be capitalised and added to the original cost of the fixed assets.*

- As stated above, *the economizer eroded due to use of the high-ash coal during last several years which was observed to vary from 38% to 56% as fired for a typical day. Moreover, this has been the case during most part of the year. Therefore, expenditure*

[2] The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016

that is incurred by replacing the coils in economizer to accommodate ash erosion from low GCV coal is in the nature of improvement and betterment. Hence, the expenditure has been capitalsed accordingly.

(Emphasis supplied by the querist.)

6. *Observations of the auditors of C & AG of India:*

The draft observations of C & AG of India while conducting supplementary audit under section 143(6) of the Companies Act for the financial year 2014-15 and replies submitted by the company are as follows:

Comments of C & AG of India	Management Reply
Equity and Liabilities *Assets* *Fixed Assets* *Tangible Assets (Note No.12) - Rs. 212.89 crore (Net Block)*	Paragraph 23 of Accounting Standard 10 states that *"Subsequent expenditures related to an item of fixed assets should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."*
The above includes Rs. 4.31 crore (net block) being the value of replacement of economizer upper bank coil (50 numbers) of Unit-II boiler and repair of the remaining coil. As the expenditure was of repair and maintenance nature, the same should have been charged to revenue instead of capitalizing the same as per AS 10.	As per the above Accounting Standard, expenditure on fixed assets subsequent to their installation may be categorised into (i) repair (ii) improvement or betterment. Repair means expenditure incurred on a fixed asset for "restoration of a capital asset to its full productive capacity or a contribution thereto, after damage, accident, or prolonged use, without increase in its previously estimated service life or productive capacity". On the other hand, betterment is defined as *"expenditure having effect of extending useful life of a fixed asset, increasing its normal rate of output, lowering its operating cost, or otherwise adding to the worth of benefit it can yield".* An expenditure that has the effect of improving

	the previously assessed standard of performance, i.e., extension of asset's useful life, increase in its capacity, or subsequent improvement in quality of output or a reduction in previously assessed operating cost is capitalised. The Expert Advisory Committee of the ICAI is of the view that "previously assessed standard of performance is not the actual performance of asset at the time of repair / improvement etc, but the standard performance of the same machine in its original state".
This has resulted in overstatement of Plant & Equipment (Net Block) and understatement of generation and other expenses to the extent of Rs. 4.31 crore. While confirming the facts and figures, the views of the Management on the fact stated above may be furnished.	In the present case, the expenditure incurred is the replacement and the same has been capitalised in the accounts for the year 2014-15. *A Technical Committee has been constituted by the company and the report of the Committee has studied the replacement (replacement of 25 number of coils) and concluded that it an improvement and betterment with following facts.* The weighted monthly GCV of coal for the period 2003-04 to 2012-13 ranges from a lowest level of 1540 kcal/kg to a highest level of 3760 kcal/kg as against the *design range of quality* of coal 3000 kcal/kg. Most of the months, GCV of coal received was less than average 2700 kcal/kg (appx.) as against design coal GCV of 3000 kcal/kg. The failure of economizer tubes was not on account of design deficiency but due to the poor quality of coal. The economizer was originally designed to accommodate ash erosion having 3000 GCV (42% ash) of coal. The ash content in the coal during last several years has been observed to vary from 38% to 56% as fired for a typical day.

	The ash content in the coal as fired has been found to be above the design range of ash of 42% for most of time. *Therefore, expenditure which has been incurred by replacing coils in economizer to accommodate ash erosion from low GCV coal is in the nature of improvement and betterment.* In support of capitalisation, it is submitted that CERC while approving tariff of another company has allowed the replacement of economizer as capital expenditure. However, while capitalising the expenses of Rs. 4.49 crore for replacement and improvement of economizer, the decapitalisation estimated amounting to Rs. 11.96 lakh has not been accounted for due to omission which will be rectified during 2015-16. In view of above, there is no overstatement of Plant & Equipment (Net Block) and understatement of generation and other expenses to the extent of Rs. 4.31 crore. The para may be dropped.

7. Final comments of C & AG of India and replies submitted by the management are as follows:

Comments of C & AG of India	**Management Reply**
Equity and Liabilities *Assets* *Fixed Assets* *Tangible Assets (Note*	The weighted monthly GCV of coal for the period 2003-04 to 2012-13 ranges from a lowest level of 1540 kcal/kg to a highest level of 3760 kcal / kg as against the design range of quality of coal 3000 kcal/kg. Most of the months, GCV of coal received was

No.12) - Rs.212.89 crore (Net Block) The above includes Rs.4.31 crore (net block) being the value of 50 nos. of economizer upper bank coil replaced in Unit-II boiler and repair of the remaining coil. As these expenses have not increased the future benefits from the existing assets beyond its previously assessed standard of performance as required under AS 10 for capitalisation of the item, these should not have been capitalised. Rather, these should have been charged to revenue. Capitalising the amount instead of charging to revenue has resulted in overstatement of Plant & Equipment (Net Block), understatement of generation and other expenses and overstatement of profit for the year by Rs.4.31 crore each.	less than average 2700 kcal/kg (appx.) as against design coal GCV of 3000 kcal/kg. The failure of economiser tubes was not on account of design deficiency but due to the poor quality of coal. The economizer was originally designed to accommodate ash erosion having 3000 GCV (42% ash) of coal. The ash content in the coal during last several years has been observed to vary from 38% to 56% as fired for a typical day. The ash content in the coal as fired has been found to be above the design range of ash of 42% for most of time. Therefore, the expenditure incurred by replacing coils in economizer to accommodate ash erosion from low GCV coal is in the nature of improvement and betterment and satisfying the conditions of capitalisation as per Accounting Standard 10. However, the company will make further review during the year 2015-16.

8. *The company's view on capitalisation*:

Elaborate justification in support of reason of replacement and capitalisation has been given at paragraphs 3 and 4 above. Further, the company is of the view that replacement of economiser coils has enhanced the efficiency of the boiler and minimised the tube leakages in economiser area, which has resulted in reduction in operating cost and has helped in bringing the said boiler into more stable working condition and satisfied the requirements under AS 10 on capitalisation. So, the accounting treatment made by the

company, as stated above, is in consonance with generally accepted accounting principles and Accounting Standards.

9. The querist has separately clarified that the power plant as stated above was capitalised during the year 1994-95 (Unit-1) and 1996-97 (Unit-2) in compliance with AS 10. Total cost of asset was capitalised under accounting head 'Boiler and Turbine Generator' in the books of account and shown in the fixed assets under plant and machinery. Upto 2015-16, if any component of an asset (including boiler and turbo generator) was replaced, the cost of component capitalised as part of boiler and turbo generator was decapitalised and replaced cost was added to the cost of asset.

B. Query

10. In view of above facts and accounting requirements, the company seeks the opinion of the Expert Advisory Committee as to whether the accounting treatment made in the accounts for 'capitalisation of Rs. 4.31 crore towards replacement of economizer coil' is in consonance with generally accepted accounting principles and Accounting Standards. If not, suggest the correct treatment.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised in the query relates to capitalisation of expenditure of Rs. 4.31 crore towards repairs and replacement of economizer coils incurred in the financial year 2014-15. 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 or not such expenditure shall be allowed for tariff fixation by the CERC, etc.

12. At the outset, the Committee wishes to point out that since the query refers to the financial year 2014-15, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by MCA vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

13. In the context of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the 'Rules' (hereinafter referred to as AS 10 (pre-revised)), the Committee notes paragraphs 12.1 and 23 of Accounting

Standard (AS) 10, 'Accounting for Fixed Assets', notified under the 'Rules', which state as below:

> "12.1. Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously standard of performance is included in the gross book value, e.g., an increase in capacity."
>
> ***"23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."***

From the above, the Committee notes that subsequent expenditure related to a fixed asset may be categorised into (i) repairs and (ii) improvements or betterments. The Committee notes that repairs implies, "the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated service life or capacity." It frequently involves replacement of parts. On the other hand, betterment is defined as "... an expenditure having the effect of extending the useful life of an existing fixed asset, increasing its normal rate of output, lowering its operating cost, or otherwise adding to the worth of benefits it can yield. ... A betterment is distinguished from an item of repair or maintenance in that the latter has the effect of keeping the asset in its customary state of operating efficiency without the expectation of added future benefits." (These definitions are reproduced from the Dictionary for Accountants by Eric C. Kohler, Sixth Edition.)

14. From the above, the Committee is of the view that normally, expenditure on repairs, including replacement cost necessary to maintain the previously estimated standard of performance, is expensed in the same period and only such expenditures that have the effect of improving the previously assessed standard of performance, e.g., an extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs are capitalised. The Committee is of the view that 'previously assessed standard of performance' is not the actual performance of the asset at the time of

repair/improvement etc., but the standard performance of the same asset in its original state. In this context, the Committee notes from the Facts of the Case that the repairs and replacement was made due to frequent forced outage of the boiler due to tube failure/leakages as the coils of the economiser had eroded because of use of low GCV coal with high ash content as against the design coal GCV. Further, the Committee notes that the querist has stated that the replacement of economiser coils has enhanced the efficiency of the boiler and minimised the tube leakages in economiser area, which has resulted in reduction in operating cost and has helped in bringing the said boiler into more stable working condition. From this, it appears to the Committee that though the replacement of economizer coils result into the increase in efficiency, minimising the tube leakages and reduction of operating cost but the same is only maintaining/stabilising the level of the performance of the concerned equipment(s), viz., the boiler, at the time of such repair/replacement and it cannot be considered to increase the future benefits of the concerned equipments beyond the *previously assessed* standard of performance. Accordingly, the expenditure incurred on replacement should not be capitalized; rather the same should be expensed in the statement of profit and loss.

15. In this regard, the Committee also wishes to point out that if the economizer coil is considered as a major component of the boiler and the same has a different useful life from that of the main asset, viz., boiler, the company may also consider to apply the 'component accounting', as prescribed under Schedule II to the Companies Act, 2013. In this regard, the Committee notes the requirements of Note 4 of Schedule II to the Companies Act, 2013, which provide as follows:

> "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."

Further, as per the MCA Notification dated August 29, 2014, the said requirement shall be voluntary in respect of the financial year commencing on or after April 1, 2014 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015. Thus, from the financial year 2015-16, component accounting needs to be followed mandatorily in respect of a part/component of an asset whose cost is

significant to the total cost of the asset and where useful life of that part is different from the useful life of the remaining asset. Accordingly, the Committee is of the view that the company may also follow the requirements of 'component accounting' from the financial year 2014-15 voluntarily in the extant case if the economizer coil is considered as a major component of the boiler and the same has a different useful life from the boiler in the extant case.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the accounting treatment made in the accounts for 'capitalisation of Rs. 4.31 crore towards replacement of economizer coil' is not in consonance with generally accepted accounting principles and Accounting Standards. The expenditure incurred should rather be charged to the statement of profit and loss, as discussed in paragraph 14 above unless the company is following component accounting.

Query No. 11

Subject: Adjustment of the effect of first recognition of group gratuity liability against opening balance of reserves and surplus as an appropriation in the current financial year.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a limited company established by the Government of Tamil Nadu in the year 1978 with an object to secure suitable overseas placements for the Indian professionals, skilled workers and others, who are desirous of securing jobs abroad. The company also holds a valid registration certificate issued by the Government of India, Ministry of Labour, as required under the Emigration Act, 1983, to perform the functions of a recruiting agency.

[1] Opinion finalised by the Committee on 21.7. 2016.

2. The querist has stated that in the current financial year 2014-15, the company has made the following appropriation from the opening balance of reserves and surplus:

> The company provides post-employment benefits to its employees in the form of gratuity. With regard to the same, the company has gratuity fund with the Life Insurance Corporation of India (LIC). In the F.Y. 2014-15, the company adjusted Rs. 24.76 lacs being the *actuarial liability* for the earlier years towards *group gratuity payable to employees* against the accumulated surplus as an appropriation from the reserves and surplus by invoking the transitional provision as per paragraphs 144 and 145 of Accounting Standard (AS) 15, 'Employee Benefits' (Revised 2005).
>
> Since the net liability as per AS 15 Report provided by the LIC is recognised for the first time by the company in the F.Y. 2014-15, the transitional provisions as per paragraphs 144 and 145 of the Standard are applicable. According to the querist, paragraph 145 provides that the net liability should be adjusted against the opening balance of revenue reserves and surplus.

3. The querist has separately informed that the company has not applied AS 15 in the true sense, since inception. All employee benefits were accounted for only on cash basis. No provision for any benefit had been made till 31st March, 2015. Although a LIC policy was taken to cover the employees for gratuity, no provision was ever made for actuarial liability.

B. Query

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

(i) Whether provision for gratuity for the prior period based on actuarial valuation can be adjusted against the opening balance of revenue reserve and surplus of the current financial year 2014-15.

(ii) If the answer to (i) is no, what is the correct accounting treatment?

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to

first time recognition of gratuity liability for the prior periods in respect of employees of the company in the financial year 2014-15. 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, correctness of determination of the company's liability for gratuity benefit for its employees as per the requirements of AS 15, etc.

6. The Committee notes that while recognising the gratuity liability for the first time in its financial statements for the financial year 2014-15, the querist has referred to paragraphs 144 and 145 of AS 15, notified under the Companies (Accounting Standards) Rules, 2006, which provide as follows:

> ***"144. On first adopting this Standard, an enterprise should determine its transitional liability for defined benefit plans at that date as:***
>
> > ***(a) the present value of the obligation (see paragraph 65) at the date of adoption;***
> >
> > ***(b) minus the fair value, at the date of adoption, of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102);***
> >
> > ***(c) minus any past service cost that, under paragraph 94, should be recognised in later periods.***
>
> ***145. If the transitional liability is more than the liability that would have been recognised at the same date as per the pre-revised AS 15, the enterprise should make an irrevocable choice to recognise that increase as part of its defined benefit liability under paragraph 55:***
>
> > ***(a) immediately as an adjustment against the opening balance of revenue reserves and surplus (as adjusted by any related tax expense), or***
> >
> > ***(b) as an expense on a straight-line basis over up to five years from the date of adoption.***
> >
> > …"

From the above, the Committee notes that as per the above transitional provisions, the company had the option to adjust the difference between the

transitional liability as per AS 15 (revised) and the liability that would have been recognised as per AS 15 (pre-revised) as on the date of transition, net of any related tax expense (saving) against the opening balance of revenue reserves and surplus on the date of transition. However, the Committee is of the view that the transitional provisions are provided with a view to facilitate a smooth switch-over to new accounting requirements from the date the new Standard (AS 15 (revised 2005) in the extant case) comes into force. In other words, the benefit of the transitional provisions was available only at the beginning of the first year of the application of AS 15. With regard to applicability of AS 15 (revised 2005), the Committee further notes the Announcement of the Institute on 'Deferment of Applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005)', published in March 2007 issue of the Journal, which states as follows:

> "The Council of the Institute of Chartered Accountants of India (ICAI), at its 265th meeting held on February 3-4, 2007, decided to defer the date of applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005), issued by the ICAI, keeping in view the practical difficulties and general hardship being faced by industry. As per the decision, AS 15 comes into effect in respect of accounting periods commencing on or after December 7, 2006 (instead of April 1, 2006, as stated in the said Standard) and is mandatory in nature from that date. Earlier application of the Standard is encouraged."

From the above, the Committee notes that AS 15 (revised) was encouraged to be followed from April 1, 2006 and was mandatorily applicable in respect of accounting periods commencing on or after December 7, 2006, viz., financial year 2007-08 and accordingly, the transitional provisions were applicable for the financial 2006-07 (in case the company opts to follow AS 15 (revised) voluntarily) or 2007-08, as the case may be and not for a subsequent financial year. Therefore, the question of applicability of transitional provisions in the financial year 2014-15, as being applied by the company in the extant case does not arise.

7. The Committee further notes that since in the extant case, the requirements of AS 15 (revised) are not followed after it is applicable mandatorily from the financial year 2007-08 (as the company has accounted for all employee benefits on cash basis), the same would be an accounting error of those periods and therefore, should be treated as a 'prior period item' within the meaning 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 and should be rectified by a charge to the statement of profit and loss in the current reporting period. In this regard, the Committee also notes the following paragraphs of AS 5:

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

D. Opinion

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

(i) and (ii) The provision for gratuity for the prior period based on actuarial valuation as per the requirements of AS 15, which is recognised for the first time in the financial year 2014-2015 cannot be adjusted against the opening balance of revenue reserve and surplus, as proposed by the querist. The same should rather be treated as 'prior period item' as a charge to the statement of profit and loss in accordance with the requirements of AS 5, as discussed in paragraphs 6 and 7 above.

Query No. 12

Subject: Capital contributions from owners without issuance of shares – whether to be included in Net Owned Funds.[1]

A. Facts of the Case

1. XYZ, a European public limited company headquartered in United Kingdom (UK) with its principal activity to transact as an insurer /reinsurer,

[1] Opinion finalised by the Committee on 21.7. 2016

prepares its financial statements in accordance with applicable UK GAAPs, the UK Companies Act 2006 (CA06) and is regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). XYZ is a group company of XYZ Group plc. XYZ Group plc, through its subsidiaries, is a global insurance and reinsurance company providing property, casualty and specialty products to industrial, commercial and professional firms, insurance companies, and other enterprises throughout the world. The group, headquartered in Ireland, has approximately 7000 employees and about 60 offices across the globe. The group has $13.7 billion in equity and over $11 billion of gross premium written during the year 2015.

2. XYZ has applied for reinsurance branch license as per Insurance Regulatory and Development Authority of India (Registration and Operations of Branch Offices of Foreign Reinsurers other than Lloyd's) Regulations, 2015 (hereinafter referred to as IRDAI Branch Office Regulations), notified in October 2015. One of the eligibility criteria for the applicant is to have Net Owned Funds (NOF) of INR 5000 crore, which is defined under the IRDAI Branch Office (BO) Regulations as follows:

"Net Owned Fund (NOF) shall consist of

i) paid up equity capital,

ii) free reserves,

iii) securities premium account

sum of which is reduced by

iv) accumulated losses,

v) book value of intangible assets,

..."

(Emphasis supplied by the querist)

The audited financial statements of XYZ as at December 31, 2015, prepared under the UK GAAP, has following items as 'Capital and Reserves':

Particulars	**Amount as contained in XYZ Financial Statement (€ 000)**	**Amount (INR 000) @ RBI Reference Rate of 72.5010**
Called up Capital	259,157	18,789,142
Capital Contribution Account	892,463	64,704,460
Profit and Loss Account	336,190	(24,374,111)
Capital and Reserves	***815,430***	***59,119,490***

The balance sheet of XYZ has some contribution from its 'parent company' - XYZ (UK) Holdings Limited (parent company of XYZ) which has been recognized as 'capital contribution' in accordance with the UK accounting principles.

3. The IRDAI has raised a query regarding the nature of 'capital contribution' and whether the same is eligible to be included in the aforesaid definition of net owned fund as per IRDAI BO Regulations.

4. The querist has stated that the parent company of XYZ having regard to the capital strength and solvency has been making contributions to XYZ ('the Applicant') from time to time to enhance its capital position. These contributions are actual transfer of investment, cash or both and not notional transfers. These contributions are accounted for in the books of parent company as 'investment in group undertaking'. These contributions are without any contractual obligation to repay (as supported by an email from the parent company). The funds made available to XYZ by the parent company is to be utilized at the discretion of the Board of XYZ and cannot be demanded back by the parent company although the Board of XYZ can decide to pay dividend to the parent company in order to return any surplus cash that may be available. XYZ records such contributions as an increase in the equity categorized under 'Capital & Reserve'. As per the accounting practices followed in United Kingdom where a company receives consideration from one or more shareholders without any contractual

obligation to repay it (a gift or capital contribution), this is an increase in equity.

5. Further, XYZ ('the Applicant') being an insurer/reinsurer is regulated by Prudential Regulation Authority (PRA) and Financial Conduct Authority of UK. The PRA recognises capital contribution as a part of Core Tier 1 Capital under the head 'Profit and Loss Account and other Reserves'. As per principles laid under the UK generally accepted accounting principles (GAAPs) and UK Companies Act, distributable profits include a company's accumulated, realised profits less accumulated and realised reserves. It should be noted that the term 'realised' is not defined under the UK accounting principles and is subject matter of interpretation. Section 853(4) of the 2006 Act says that "References to "realised profits" and "realised losses", in relation to a company's accounts, are to such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses". In addition, as per the querist, specific examples of realised profits have been provided under the Act which includes gift (such as a 'capital contribution') received in the form of qualifying consideration. Therefore, capital contributions or gifts are regarded as realised profits for the recipient company (XYZ) if they are received in cash or as an asset that is readily convertible to cash. If they are not received in qualifying consideration, the amount is unrealised, although it might become realised if the consideration is converted into qualifying consideration, or the asset is depreciated or sold.

6. The querist has also stated that under Indian Companies Act (Companies Act 2013), the expression 'net owned fund' is not defined, however, it would be worthwhile to refer to the definition of the term 'net worth'. Net Worth is defined under the Companies Act, 2013, as "the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation". Further, the term 'free reserves' is defined under the Companies Act, 2013 as follows:

> *"free reserves means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:*
>
> Provided that—
>
> > *(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or*
> >
> > *(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value,*
>
> *shall not be treated as free reserves."*
>
> (Emphasis supplied by the querist)

According to the querist, the above-mentioned definition of free reserves is in alignment with the definition of 'realised profits' as provided under the UK accounting principles.

7. In light of the above analysis, the querist is of the view that capital contribution is in the nature of equity which could be classified as free reserve under the IRDAI BO regulations' definition of NOF on account of following:

- The amount of capital contribution is received in cash or as an asset that is readily convertible to cash.
- There are no legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity.
- The board of the company may decide to pay dividend to the parent company to remit surplus cash and thus it reflects the fact that parties with ownership interests in the company have rights in relation to the receipt of dividend. Also, this meets the definition of 'Free reserves' under the Indian Companies Act, 2013.

B. Query

8. On the basis of the above, the querist has sought an opinion from the Expert Advisory Committee as to whether the 'capital contribution' as included in the financial statements of XYZ meets the criteria of 'free reserves'/equity to be considered for determination of 'Net Owned Fund' under Indian GAAPs.

C. Points considered by the Committee

9. The Committee notes from the facts of the case that XYZ (UK) Holdings Ltd., which is a parent company has made capital contribution to the company (XYZ) (which is a European public limited company and has applied for reinsurance branch license in India). XYZ has not issued shares to the parent company with regard to the capital contribution. In this context, an issue has been raised by the querist as to whether the capital contribution by the parent company to XYZ meets the criteria of 'free reserves'/equity to be considered by XYZ for determination of 'Net Owned Fund' under Indian GAAPs. 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 distribution of the capital contribution, etc. The Committee also wishes to point out that the opinion expressed hereinafter is purely from the perspective of accounting principles in India, viz., Indian GAAPs and not from legal perspective, such as, interpretation of Indian Companies Act, 2013, UK Companies Act, IRDAI BO Regulations, etc. Further, the Committee also wishes to point out that net owned funds may be defined by different authorities/regulators (for example, Insurance Regulatory and Development Authority of India in the extant case) for different purposes and, accordingly, the term defined for one purpose may not be relevant for other purposes. It may also be emphasized that the opinion expressed hereinafter is on the basis of the facts supplied by the querist.

10. At the outset, the Committee notes that the term 'net owned fund' has not been defined/explained specifically in the Indian GAAPs. However, it uses the terms, 'equity' and 'free reserves' and accordingly, the Committee has examined the issue only in the context of whether the capital contribution by the parent company can be considered for inclusion in the said terms. In this context, the Committee notes the following definitions as per the Guidance Note on Terms Used in Financial Statements and the following paragraphs of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

> *Guidance Note on Terms Used in Financial Statements*
>
> **"15.06 Shareholders' Equity**
>
> The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual *assets* after meeting prior claims."

Framework for the Preparation and Presentation of Financial Statements

"49 (c) *Equity* is the residual interest in the assets of the enterprise after deducting all its liabilities."

"64. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, **funds contributed by owners**, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital." (Emphasis supplied by the Committee)

"69. Income and expenses are defined as follows:

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

(b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."

(Emphasis supplied by the Committee)

The Committee notes that the querist has stated in the facts of the case that these contributions are actual transfer of investment, cash or both and not notional transfers. These contributions are accounted for in the books of parent company as 'investment in group undertaking'. These contributions are *without any contractual obligation* to repay to the parent company. The funds made available to XYZ by the parent company is to be utilized at the discretion of the Board of XYZ and cannot be demanded back by the parent company although the Board of XYZ has discretion to return any surplus cash that may be available out of the capital contribution. Thus, since the capital contribution in the extant case is not a contractual obligation on the

part of the company (XYZ) to repay the amount to the parent company; instead, there is a discretion with the Board of XYZ to return any surplus cash available with it out of the capital contribution, the Committee is of the view that it cannot be considered as liability, rather the same should be considered as 'equity'.

11. As far as the issue of considering 'contribution from parent company' as free reserves, purely from accounting perspective is concerned, while not interpreting the term for any legal purpose, the Committee notes the definitions of the term 'free reserves', 'reserve', capital reserve' and 'revenue reserve' as defined in the Guidance Note on the Terms used in Financial Statements as follows:

"6.13 Free reserve

A *reserve* the utilisation of which is not restricted in any manner."

"14.04 Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of *assets* or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*."

"**3.10 Capital Reserve**

A *reserve* of a corporate enterprise which is not available for distribution as *dividend*."

"14.08 Revenue Reserve

Any *reserve* other than a *capital reserve*."

From the above, the Committee notes that free reserve is a reserve, viz., the portion of earnings, receipts and other surplus, which is *appropriated* by the management and the utilisation of which is not restricted in any manner. In this context, the Committee notes the wordings from the copy of the letter received by the XYZ from the parent company while making capital contribution, which is supplied by the querist for the perusal of the Committee as follows:

> "On behalf of the board directors of XYZ (UK) Holdings Ltd., I am pleased to inform that XYZ (UK) Holdings Ltd. intends to make a contribution to the surplus of the company in the amount of approximately USD 230,000,000 …
>
> The contribution may be utilised for the company's corporate purposes at the sole discretion of the directors of the company. The contribution is made as capital without the requirement for consideration, without condition, and not in return for any right, shares or charge over the assets or surplus of your company"

From the above, the Committee notes that although the use of the contribution is solely at the discretion of the directors of the company but it appears that it can be utilised only for corporate purposes and not for distribution amongst the owners. Therefore, it does not appear that utilisation of contribution is not restricted in any manner. Further, the Committee notes that such contribution has been disclosed in the balance sheet of XYZ as 'capital' contribution. Accordingly, the Committee is of the view that the contribution by the parent company in the extant case cannot be considered as 'free reserve' under Indian GAAPs.

D. Opinion

12. On the basis of the above, subject to considerations in paragraphs 9 and 10 above, the Committee is of the opinion that the capital contribution in the extant case can be considered as equity under Indian GAAPs. However, the contribution by parent company in the extant case cannot be considered as 'free reserve' under Indian GAAPs, as discussed in paragraph 11 above.

Query No. 13

Subject: ***(i) Accounting treatment of cost incurred on real estate development on lease land.***

(ii) Accounting treatment of right to use the land given by the Government.

(iii) Accounting treatment of viability gap funding provided by the Government to the Concessionaire in a service concession agreement.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company' or 'Concessionaire'), incorporated on 24th August, 2010, is a special purpose vehicle (SPV) promoted by A Limited and B Limited. The company was awarded a contract on competitive bidding basis by the Government of Andhra Pradesh ('Government') to implement metro rail system for Hyderabad city. The company signed the Concession Agreement (CA) with the Government on 4thSeptember, 2010, a copy of which has been provided by the querist for perusal of the Committee. The company commenced construction of the project which is currently progressing in full pace. The relevant details of the CA have been given in the following paragraphs.

2. Scope of the Project (Extract from Article 2 of CA):

(a) Construction and procurement of the rail system and real estate development on the site set forth in Schedule-A as specified in Schedule-B together with provision of project facilities as specified in Schedule-C and in conformity with the specifications and standards set forth in Schedule-D;

(b) Operation and maintenance of the rail system in accordance with the provisions of this Agreement; and

(c) Performance and fulfillment of all other obligations of the Concessionaire in accordance with the provisions of this Agreement and matters incidental thereto or necessary for the performance of any or all of the obligations of the Concessionaire under this Agreement.

[1] Opinion finalised by the Committee on 21.7. 2016.

3. Grant of Concession (Extract from Article 3 of CA)

   a. Subject to and in accordance with the provisions of this Agreement, the applicable laws and the applicable permits, the Government hereby grants to the Concessionaire the concession set forth herein including the exclusive right, license and authority to construct, operate and maintain the Project (the 'Concession') for a period of 35 (thirty five) years commencing from the Appointed Date, and the Concessionaire hereby accepts the Concession and agrees to implement the Project subject to and in accordance with the terms and conditions set forth herein.

      Provided that in the event the Concessionaire shall have discharged its obligations without any material breach thereof for a period of 32 (thirty two) years from the Appointed Date, it may by notice to be given no later than the 33rd (thirty third) anniversary of the Appointed Date, seek extension of the Concession Period, and in such an event, it shall be entitled to an additional Concession Period of 25 (twenty five) years on the terms and conditions set out herein. For the avoidance of doubt, material breach shall for the purposes hereof mean suspension and/or cumulative levy of damages exceeding a sum equivalent to performance security.

   b. Subject to and in accordance with the provisions of this Agreement, the Concession hereby granted shall oblige or entitle (as the case may be) the Concessionaire to:

      (i) Right of Way, access and license to the site for the purpose of and to the extent conferred by the provisions of this Agreement;

      (ii) Finance and construct the rail system;

      (iii) Manage, operate and maintain the rail system and regulate the use thereof by third parties;

      (iv) demand, collect and appropriate fare from users liable for payment of fare for using the rail system or any part thereof and refuse entry of any user if the fare due is not paid;

(v) perform and fulfill all of the Concessionaire's obligations under and in accordance with this Agreement;

(vi) bear and pay all costs, expenses and charges in connection with or incidental to the performance of the obligations of the Concessionaire under this Agreement; and

(vii) neither assign, transfer or sublet or create any lien or encumbrance on this Agreement, or the Concession hereby granted or on the whole or any part of the rail system nor transfer, lease or part possession thereof, save and except as expressly permitted by this Agreement or the Substitution Agreement.

c. Subject to and in accordance with the provisions of this Agreement and applicable laws, the Concession hereby granted shall, without prejudice to the provisions of the above clause, entitle the Concessionaire to undertake development, operation and maintenance of the real estate and to exploit such development for commercial purposes (the 'Real Estate Development') with the right to sub-license any or all parts thereof by means of Project Agreements.

4. Definitions given in CA for important terms (Article 48 of CA)

4.1 Definition of 'Project'

'Project' means construction, operation and maintenance of the Rail System in accordance with the provisions of this Agreement, and includes all works, services and equipments relating to or in respect of the Scope of the Project.

4.2 Definition of 'Project Assets'

'Project Assets' means all physical and other assets relating to and forming part of the site including:

(a) Rights over the site in the form of license, Right of way or otherwise

(b) Tangible assets such as civil works and equipment including foundations, embankments, pavements, interchanges, bridges, drainage works, rolling stock, electrical systems,

communication systems, fare collection systems, rest areas, relief centers, maintenance depots, administrative offices and stations

(c) Project facilities situated on the site

(d) Building and immovable fixtures or structures forming part of real estate development

(e) All rights of the concessionaire under the project agreements

(f) Financial assets, such as receivables, security deposits, etc.

(g) Insurance proceeds and

(h) Applicable permits and authorisations relating to or in respect of the Rail System

4.3 Definition of 'Rail System'

'Rail System' means municipal tramway in Hyderabad comprising mass rapid transit system built or to be built and operated on the Site and includes civil, mechanical and electrical works, rolling stock, rail tracks, signaling and telecommunication equipment and all other Project assets necessary for and associated with operation of trains on the site and shall include real estate development.

4.4 Definition of 'Real Estate Development' (Article 3.1.3 read with Article 48 of CA)

Subject to and in accordance with the provisions of this Agreement and Applicable Laws, the Concession hereby granted shall, without prejudice to the provisions of Clause 3.1.2, entitle the Concessionaire to undertake development, operation and maintenance of the real estate specified in Schedule-A, subject to the conditions stipulated in Schedule–B and Schedule–D, and to exploit such development for commercial purposes (the "Real Estate Development") with the right to sub-license any or all parts thereof by means of Project Agreements.

4.5 Definition of 'Site' (Article 10.1 read with Article 48 of CA)

The Site of the Rail System shall comprise of the real estate described in Schedule A and in respect of which the Right of Way shall be provided and granted by the Government to the Concessionaire as a license under and in accordance with this Agreement (the "Site"). For the avoidance of doubt, it is hereby acknowledged and agreed that references to the Site shall be constructed as references to the real estate required for the Rail System as set forth in Schedule-A, and includes Real Estate Development.

5. Salient features of the Concession

Salient features of the concession have been provided by the querist as under:

5.1 The Concession

The Concession grants *exclusive right, license and authority to construct, operate and maintain the Metro Rail System including Real Estate Development* in Hyderabad in Public Private Partnership (PPP) model on Design, Build, Finance, Operate and Transfer (DBFOT) basis. (Emphasis supplied by the querist.)

5.2 Concession period

The concession period is for 35 years (including 5 years of construction period) which can be extendable by another 25 years at the option of the company subject to the following conditions:

(a) Option should be exercised during 33rd year of concession.

(b) The company should have discharged its obligations without material breach for 32 years. (Material breach shall for this purpose mean suspension of agreement and/or cumulative levy of damages exceeding a sum equivalent to performance security (Rs. 360 crs)

Note: The company does not foresee any challenge in discharging the above obligations and become eligible for exercising the option for extension of concession period.

5.3 Construction and operation periods

The construction of the project shall be completed within 5 years from the 'Appointed Date', as defined in the CA and balance period of 30 years is available for operation and maintenance. The Government declared 5th July 2012 as Appointed Date and the concession period started from the said date and currently the construction of the project is going on. While the cap on concession period of 35 years (extendable by another 25 years is applicable to real estate development also, there is no time limit prescribed for commencing and completing the construction of real estate development.

5.4 Concession fee (Article 26 of CA)

In consideration for grant of concession, the company shall pay to the Government:

By way of a concession fee a sum of Re. 1 per annum and

(a) an additional concession fee for the 21st year commencing from commercial operations date (COD)@ 0.5% of the total realisable fare, net of any taxes on fare and for each subsequent year an additional concession fee @ 0.5% per annum as compared to the immediately preceding year, subject to a maximum of 10%.

5.5 Grant (Article 25 of the CA)

The clauses of Article 25 of the CA on this subject have been reproduced by the querist as below:

"Grant

The Government agrees to provide to the Concessionaire cash support by way of an outright grant equal to the sum set forth in the Bid, namely, Rs.1,458 crore (Rupees one thousand four hundred and fifty eight crore) only, in accordance with the provisions of this clause (the "grant").

The grant shall be disbursed to the Concessionaire by way of equity support, and the balance remaining, if any, shall be

disbursed as O&M support in accordance with the provisions of the following clauses.

Equity Support

Subject to the conditions specified in this clause, the grant shall be credited to the escrow account and shall be applied by the Concessionaire for meeting the total project cost (the "equity support").

The equity support shall not exceed the sum specified in the bid and as accepted by the Government, but shall in no case be greater than the equity, and shall be further restricted to a sum not exceeding 30% (thirty per cent) of the total project cost. For the avoidance of doubt, the total project cost to be reckoned for the purposes of this clause shall include equity support.

Equity support shall be due and payable to the Concessionaire after it has expended the equity, and shall be disbursed proportionately along with the loan funds thereafter remaining to be disbursed by the Senior Lenders under the Financing Agreements. The Government shall disburse each tranche of the equity support as and when due, but not later than 15 (fifteen) days of receiving a request from the Concessionaire along with necessary particulars.

In the event of occurrence of a Concessionaire default, disbursement of equity support shall be suspended till such Concessionaire default has been cured by the Concessionaire.

Subject to the provisions of the Scheme of Financial Support to Public Private Partnership in Infrastructure and the Jawaharlal Nehru National Urban Renewal Mission as notified by the Central Government (the "Schemes for Financial Assistance"), the Government shall, for funding the Grant, use its best endeavors and provide all reasonable support to the Concessionaire for obtaining viability gap funding under the Schemes for Financial Assistance. For the avoidance of doubt, it is expressly agreed that in the event of the Concessionaire being able to receive such viability gap funding for the Project, the same shall, for the purposes of this Agreement be deemed to be Grant by the

Government hereunder, to be disbursed in accordance with the provisions of the Schemes for Financial Assistance. It is further agreed that the Government shall at all times discharge its obligation to disburse Grant under and in accordance with this Article whether or not funds are disbursed to the Concessionaire under the Schemes for Financial Assistance.

O&M Support

The balance of the Grant, if any, remaining after disbursement of the equity support shall be disbursed to the Concessionaire in accordance with this Clause for meeting O&M expenses and debt service of the Project (the "O&M support"). The O&M support shall be disbursed by the Government in quarterly installments and the first such installment shall be released within 90 (ninety) days of Commercial Operation Date (COD). Each installment shall be a sum equal to 7.5 (seven point five) per cent of the equity support and such installments shall be disbursed by the Government until the Grant is exhausted."

Notes:

(i) In this connection, the querist has clarified that this grant is considered as part of promoters' contribution by the lenders for the purpose of reckoning debt-equity ratio to fund the total project cost, and not an 'equity share capital' in the strict sense. No shares need to be allotted to the Government against this 'Equity Support'.

(ii) The eligible amount of grant of Rs. 1,458 crore as bid by the company constitutes only 12% of the total project cost as defined for this purpose and hence, it would be totally expended to meet the construction of the project and nothing would be left for availing during O&M phase.

5.6 Golden share (Extract from Article 5.4 of the CA)

5.4.1 The Concessionaire and the Selected Bidder (viz., A Ltd.) shall execute an agreement with the Government, substantially in the form specified at Schedule-W (the 'Shareholders' Agreement'), providing for the issue and allotment of one non-transferable equity share of the company (the "Golden Share") in favour of the Government, and shall provide for the following:

(a) Appointment of a nominee of the Government on the Board of Directors of the Concessionaire;

(b) An irrevocable undertaking that the rights vested in the Government shall not be abridged, abrogated or in any manner affected by any act done or purported to be done by the Concessionaire or any of its Associates or Affiliates;

(c) An irrevocable undertaking that any divestment of equity in the Concessionaire shall not in any manner affect the rights of the Government herein and that the successors, assigns and substitutes of the Concessionaire shall be bound by such undertaking; and

(d) Any other matter mutually agreed upon between the Parties.

5.4.2 The Parties expressly agree that the Shareholders' Agreement shall further provide that so long as the Government holds the Golden Share, an affirmative vote of the Government or the Director appointed by the Government shall be necessary and required for the passing of, by the General Meeting of the Company or the meeting of Board of Directors thereof, as the case may be, any resolution providing for all or any of the following or any matter incidental or consequential thereto:

(a) to alter or add to the provisions of the memorandum;

(b) to alter or add to the articles of association;

(c) to change the name of the company;

(d) to purchase the company's own shares or specified securities;

(e) to issue sweat equity shares;

(f) to issue further shares without pre-emptive rights to non-members or to convert loans or debentures into shares;

(g) to reduce the share capital;

(h) to remove the registered office of the company outside the limits of the State;

(i) to commence any new lines of business;

(j) to keep registers and returns at any other place than within city, town or village in which the registered office is situated;

(k) to consent to a director or his relative or partner or firm or private company holding an office or place of profit, except that of managing director, manager, banker, or trustee for debenture-holders of the company;

(l) to make inter-corporate-loans and investments or guarantee/security to be given, etc., if the aggregate amount thereof, exceeds the limit of 10 per cent of the company's paid-up share capital;

(m) to apply to a Court to wind-up the company;

(n) to wind-up the company voluntarily;

(o) for various other matters pertaining to the winding up of the company; and

(p) any other matter which is required by the Companies Act, 1956 to be passed by a special resolution of the shareholders of the company.

5.4.3 The Parties agree that the Shareholders' Agreement shall provide that till the time the Government holds the Golden Share, it shall be entitled to nominate a person of its choice for appointment as a non-retiring Director on the Board of the Concessionaire, and upon such nomination, the Concessionaire shall appoint such person as Director in accordance with the Applicable Laws.

6. Salient features of the project have been provided by the querist as under:

6.1 Construction and operation of the metro rail

The Hyderabad Metro Rail System will have a length of approximately 71.16 km consisting of 3 elevated corridors namely Miyapur – LB Nagar (28.87 kms) (referred to as Corridor-I), Jubilee Bus Station to Falaknuma (14.78 kms) (referred to as Corridor-II) and Nagole- Silparamam (27.51 kms) (referred to as Corridor-III). There will be three depots, one for each Corridor, located at Miyapur, Falaknuma and Nagole.

The Rail System shall be designed to a capacity of 50,000 PHPDT (Peak Hour Peak Direction Traffic) each for Corridors I & III and 35,000 PHPDT for Corridor II. All the three corridors pass through highly congested and busy traffic routes in Hyderabad city, with very high vehicular and pedestrian movement.

The Government shall provide right of way (ROW) to undertake construction of elevated corridors and also required land of 269 acres to undertake depot construction and real estate development in both depot lands and at select locations alongside the corridors including parking and circulation areas, for which no separate charges are payable to the Government towards cost of land.

6.2 Mechanical and electrical equipment required to be procured, erected and Commissioned for metro rail operation are:

The metro system can be operated only if the following systems are built, procured, installed and properly integrated to work in unison:

Main systems:

(i) Viaduct -Viaducts are elevated civil structures constructed so that the Metro systems run above the road level allowing road based traffic to continue to move on road without much obstruction. The Viaducts typically occupy a small foot print on the existing roads.

(ii) Depot buildings

(iii) Station buildings

(iv) Track system consisting of rails, fasteners, turnouts etc.

(v) Overhead electrical traction system

(vi) Rolling Stock – Modern electric multiple unit (EMU) which run on the tracks and carries people along the route.

(vii) Signaling System – Signalling system ensures efficient train control and safety in train movements. It also assists in optimisation of metro infrastructure investments and running of an efficient train service on the network. The signalling system shall be based on fixed or moving blocks.

(viii) Communication System – The proposed communication system will cater to the following requirements - Assistance to Train Traffic Control, Maintenance Control, Emergency Control, Station to station dedicated communication, Telephone Exchange, Passenger Announcement System and Passenger Information and Display System within the station and from Central Control to each station, Centralized Clock System, Train Destination Indicator, Instant on line Radio Communication between Central Control and Moving Cars and maintenance personnel, Data Channels for Signaling, SCADA (Supervisory control and data acquisition), Automatic Fare Collection, BMS etc.

(ix) Power Supply and SCADA (Supervisory control and data acquisition) System – Receiving substations, traction substations at stations, distribution lines.

(x) Operation Control Center Equipment : The control of train operation will be done from computer based control centre. Facilities for setting of the route and clearing of the signals will be done by workstation which can be either locally (at station) operated or operated remotely from the Operation Control Centre (OCC). The whole section will have automatic signaling.

Other/Support systems (major ones):

(xi) Elevators, Escalators and Lifts

(xii) Air-conditioning in the enclosed and covered parts of the Stations and in Trains;

(xiii) Lighting in Stations and Trains;

(xiv) System-wide Graphics and Signage;

(xv) Various Maintenance Equipment for maintenance of all equipment and subsystems of Rail system such as lathe machines, inspection cars, accident restoration units including retaining ramps, accident relief medical vans, and diesel engine for salvaging immobilized cars/trains;

(xvi) Stand by DG sets to offset power failure etc;

6.3 Repairs and replacements during operation phase

The company (the Concessionaire) is responsible to operate and maintain the metro rail during the concession period as per the standards of performance stipulated in the CA. It is estimated that the company is required to add rolling stock (train cars) at the end of 5th, 10th and 20th years of operation to cater to the forecasted ridership increase. In addition, at the end of 20th year of operation, major replacements of other project assets are also expected to be incurred by the company which involves major capital outlay.

Upon expiry of concession period, the company is entitled to receive termination payment equal to 80% of the adjusted depreciated value of all project assets acquired and installed after the 20th year of commercial operation date (COD). No compensation is payable for the assets acquired and installed before and during 20th year of COD.

6.4 Real Estate Development

(i) The Concession permits real estate development (also called Transit Oriented Development (TOD)) *on commercial basis* in the parking and circulation areas and depot lands

through which the company can earn lease rentals, maintenance and parking income. For this purpose *the Government shall provide requisite land at depots (212 acres) as well as at* different locations at or near the stations (57 acres) to the company to take up real estate development, as part of concession (emphasis supplied by the querist). No separate charges are payable by the company to the Government for the said land parcels.

(ii) Understandably, since the metro rail project is highly capital intensive and making it financially viable based on only fare box revenue within a short period of 15 years (loan tenor permitted by lenders) is not possible, the Government designed this public private partnership (PPP) model of granting concession rights to earn fare box revenue coupled with rights to make real estate development, to facilitate implementation of this project on commercially viable lines.

6.5 Scope of Real Estate

The volume of real estate development permitted to be undertaken as per the CA can be summarised as under, over which the company can earn lease, maintenance and parking income:

i. Upto to 6 million sft over the parking and circulation areas at or near stations: For this purpose, 25 land parcels (totaling to about 57 acres) at different locations at or near the stations have been identified and handed over to the company to take up real estate development as part of concession. Entire ground floor area at these locations shall be utilised exclusively for parking and circulation and the floors above ground floor can be used for real estate development. (*No separate consideration is payable by the company to the Government towards the cost of the said land parcels.)*

ii. Upto 12.5 million sft. of space in depot lands: For this purpose, 212 acres of land at three different locations have been identified and handed over to the company to take up both depot development and real estate development, as part of the concession. However, 80% of the depot lands

shall be exclusively used to construct only depot buildings wherein stabling and maintenance of trains will be undertaken. The balance 20% of the depot land is available for exclusive real estate development. However, the Concessionaire is also entitled to develop real estate over and above the ground floor of depot buildings. However the total limit for real estate development in depot lands is restricted to 12.5 million. (*No separate amount is payable by the company to the Government towards the cost of the depot lands.)*

iii. In addition, the company can demarcate upto 20% of the floor area of each station for shops and/or kiosks and paid services needed for commuters. This works out to approx. 1 million sft of space through which the company can earn lease rentals and maintenance income.

iv. *To sum up, 18.5 million sft of real estate development at or near stations and depots and 1 million space within stations is available for the company to earn lease, maintenance and parking income.*

(Emphasis supplied by the querist)

6.6 Other important issues relating to real estate development:

(a) The company has plans to develop commercial office space, malls, multiplex theatres, shopping complexes, retail space, built-to-suit (customised) buildings for IT companies etc. and lease out the space at best competitive lease rental rates and other terms and conditions.

(b) As explained above, there is a cap on the total area permitted to be developed as real estate.

(c) The company shall take prior permission from the Government for entering into lease agreements with lessees of real estate if the period of agreement is beyond 11 months. All real estate development shall however be subject to obtaining permissions and other governing rules of local administration, for example, plan approval, fire permission etc.

(d) The company is not permitted to start earning revenue from the real estate development unless it achieves COD (commercial operations date) of metro rail first. However, the company can start construction and firm up marketing arrangements of leasing real estate space before it achieves COD of metro rail.

(e) However, there are no restrictions imposed on the company under the Concession Agreement as to the type of development e.g., office space, commercial space, IT space, residential space etc. Also there are no restrictions on 'pricing' (or rates) of lease rents and maintenance charges that can be charged by the company. The company is free to develop any type of real estate development and collect lease rents and maintenance charges at the rates as deemed fit by the company. (Emphasis supplied by the querist.)

6.7 Revenue Sources:

As permitted by the concession agreement, the following are the various sources of revenue to the project:

- Fare box revenue: This is ticket tariff to be collected from passengers at the predetermined rates notified by the Government from time to time and linked to year on year changes in wholesale price index plus an annual fixed percentage increase.
- Non-fare box revenue:
  - Rental income from lease of real estate space.
  - Maintenance income for operating and maintaining the real estate development
  - Parking charges for operating and maintaining the parking space
  - Advertisement revenue by leasing the space for display of advertisements in stations and real estate buildings.

6.8 Transfer of Assets on Expiry of the Concession Period

The project assets constructed by the company shall be transferred to the Government at the end of the concession period without any consideration in return for the terminal value. However, in respect of additions to project assets acquired and installed by the company after the 20th year of Commercial Operations Date (COD), the company is entitled for a termination payment equal to 80% of the adjusted depreciated value of such project assets.

6.9 Depreciation (Clause 47.3.1)

Article 47.3.1 of CA provides as under:

"For the purpose of depreciation under the Applicable Laws, the property representing the capital investment made by the Concessionaire in the Project Assets shall be deemed to be acquired and owned by the Concessionaire. For avoidance of doubt, the Government shall not in any manner be liable in respect of any claims for depreciation to be made by the concessionaire under the Applicable Laws".

The above clause entitles the company to treat the entire project assets (rail system assets and real estate assets) as free hold fixed assets and accordingly to account / claim depreciation.

6.10 Construction Pattern – Stage-wise implementation and operation plan

To facilitate early and effective completion of the construction and early generation of revenues, the company decided to implement the total project in 6 stages, each stage covering a distance of around 8 to 12 Kms. Stage 1 is expected to be completed within 40 months from the commencement of construction and thereafter each of the remaining stages will be completed in a span of 3 to 4 months, thus the total project will be completed within the maximum stipulated time of 60 months.

As and when construction of each stage is completed and certified by the Competent Authority to be fit for operation, such stage comes into commercial operation and fetches fare revenue. For earning income from real estate development, it is not necessary

for the company to wait for achievement of COD for all stages that is upto 60 months. Immediately after the Stage 1 becomes operational, the company can start booking revenues from real estate development and other non-fare revenues.

Hence, during the fourth and fifth years of construction, there will be a scenario on the financial year end date, wherein some of the stages would be operational and earning revenue while remaining stages would still be under construction. (Emphasis supplied by the querist.)

B. Query

7. Based on the aforementioned facts, the company seeks professional opinion from the Expert Advisory Committee on the following issues:

(i) As per the concession agreement entered with the Government, the scope of the project (refer paragraph 2) includes construction and procurement of the Rail System and real estate development. The rights for commercial exploitation of real estate development will be available only if the Rail System is constructed, operated and maintained. There is no compulsion in the Concession Agreement that the company must carry out the real estate development. However, to make the project financially viable, it is necessary for the company to exploit the real estate development. The company is free to develop its own product mix say commercial space, office space, residential space, etc. and the company is free to charge the lease rentals and maintenance charges at the rates as deemed fit by the company. However, right to operate and earn revenue is subject to overall concession period of 35 years or 60 years as the case may be. After the commercial operations, 60% (approx.) of the revenue will come from fare revenue and 40% (approx.) from non-fare revenue, i.e., mainly from real estate development. The land for construction of the real estate development will be provided by the State Government at free of cost. Upon expiry of the concession period, the company will hand over the Rail System and the real estate development done by it to the State Government.

(a) Since the Government is giving the land free of cost for real estate development, it could be argued that an element of cost is included in the cost of construction of the rail system which is attributable to the cost of the land used for real estate development. In such scenario, whether the company needs to estimate the cost of the land attributable to real estate and account for it in the books accordingly. If yes, what is the appropriate method for estimating the cost? Does this cost be deducted from the cost of Rail System and added to the cost of real estate assets?

(b) In the above scenario, since the real estate development is not fully regulated by the Government unlike metro rail system, whether, the costs incurred on real estate development fall outside the scope of AS 26 and shall be accounted as fixed assets governed by the principles of AS 10, 'Accounting for Fixed Assets'[2]? What would be appropriate policy for amortisation or depreciation?

(ii) With a view to support the infrastructure projects, the Central Government announced the Scheme for support to PPPs in infrastructure (viability gap funding Scheme) in 2004. The Scheme aims to ensure wide spread access to infrastructure provided through the PPP framework by subsidising the capital cost of their access. Meeting the funding gap to make economically essential projects commercially viable would obviate the need for Government funding for such projects and allow private sector participation in the projects, thus facilitating private sector efficiencies in infrastructure development. The scheme provides for financial support in the form of grants, one time or deferred to infrastructure projects undertaken through public private partnerships with a view to make them commercially viable. The Scheme provides for viability gap funding upto 20% of the project cost.

[2] The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

As per the concession agreement, the Government agrees to provide to the Concessionaire, cash support by way of an outright grant equal to the sum set forth in the bid, namely, Rs. 1,458 crore. The grant shall be disbursed to the Concessionaire by way of equity support, and the balance remaining, if any, shall be disbursed as O&M support (Refer paragraph 5.5 above). In the case of the company in the extant case, the entire grant will be utilised to meet the project cost. The concession agreement provides that the company has to put in their committed equity before availing the grant from the State Government for construction and implementation of the rail system. In the event of occurrence of Concessionaire's default, disbursement of grant shall be suspended till such default is cured by the Concessionaire. The Concession Agreement or VGF scheme does not envisage for refund of the grant already paid by the Central Government in the case of default of any of the conditions of the concession agreement either by the Concessionaire or the State Government.

Given the nature, purpose and conditions of the 'grant' to be received as viability gap funding from the Government as detailed in paragraph 5.5 above, whether the 'grant' shall be treated as a capital reserve as part of shareholders' funds or to be reduced from the cost of assets or to be recognised as income in the statement of profit and loss.

C. Points considered by the Committee

8. The Committee notes that the querist has raised the following three issues:

(i) Recognition and measurement of the land provided by the Government to the company to develop real estate.

(ii) Treatment of costs incurred on real estate development on the land provided by the Government (Grantor) and appropriate policy for amortisation or depreciation.

(iii) Recognition of the viability gap funding referred to as 'Grant' under the Concession Agreement.

The Committee has, therefore, considered only the above issues and has not considered any other issue that may arise from the Facts of the Case, such as, treatment of metro rail infrastructure developed by the company, treatment of obligation to replace assets, treatment of reimbursement for addition to assets after 20th year, treatment of 'golden share', timing of recognition of viability gap funding, etc.

Issue: Recognition and measurement of the land provided by the Government to the company to develop real estate:

9. The Committee notes that the company receives under the concession agreement, a right to charge users of the metro rail and a right to use land for real estate development which can be used subsequently for earning lease rentals over the period of the concession agreement in exchange for the construction services of the metro rail infrastructure provided by the company. Thus, in the view of the Committee, it is a composite project, where in exchange of construction service, the company is receiving the afore-mentioned two rights.

10. With regard to accounting for the right to use of land for real estate development, the Committee notes that paragraphs 1 and 3.1 of Accounting Standard (AS) 19, 'Leases', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') defines lease as:

> ***"1. This Standard should be applied in accounting for all leases other than:***
>
> ***(a) ...***
>
> ***(b) ...; and***
>
> ***(c) lease agreements to use lands."***
>
> ***"3.1 A <u>lease</u> is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time."***

The Committee notes that in the given case, the grantor has conveyed to the company in return for construction services for metro rail infrastructure, the right to use land for the concession period. Thus, the company has obtained the land on leasehold basis for real estate development. However,

since paragraph 1 of AS 19 excludes the accounting for lease agreements to use land, the Committee is of the view that the accounting for right to use of land would be governed by the principles of Accounting Standards (AS) 26, 'Intangible Assets'. In this regard, the Committee notes that paragraph 6.1 of AS 26, notified under the Rules, defines an intangible asset as ***"an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes".*** The Committee is of the view that the right to use of land evidenced by a contract (Concession Agreement) is an identifiable non-monetary asset. Accordingly, such right shall be recognised and measured in accordance with the requirements of AS 26. Similarly, the right to charge fare from the users of metro rail is also an intangible asset and shall also be recognised and measured in accordance with the requirements of AS 26. Thus, there are two intangible assets.

11. From the above, the Committee is of the view that the company has received more than one intangible asset for a composite consideration. The Committee notes that in the given case, the company is giving a non-cash consideration, that is, construction services, for acquiring the intangible assets. In this regard, the Committee notes that paragraph 34 of AS 26 states that "An intangible asset may be acquired in exchange or part exchange for other asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets". The Committee further notes that paragraphs 11.1 and 22 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Rules, state as follows:

> "11.1 When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration."
>
> "***22. When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of***

> ***the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. ..."***

On a harmonious reading of paragraphs 11.1 and 22 of AS 10, the Committee is of the view that the cost of the asset acquired is determined by reference to the fair market value of the consideration given or fair market value of the asset acquired, whichever is more clearly evident. The Committee is further of the view that in the given case, the more evident of the two, fair market value of the intangible assets acquired and the fair market value of the construction services rendered, is the fair market value of the construction services rendered. Therefore, the intangible assets should be recognised at fair market value of the construction services which, in the view of the Committee, would ordinarily be cost plus estimated margin of construction services.

12. As discussed above, the Committee notes that the company has received more than one intangible asset for a composite consideration. The Committee notes that AS 26 does not provide any guidance on how to recognise and measure where an enterprise receives more than one intangible asset for a composite consideration. However, the Committee notes that paragraph 15.3 of AS 10, provides as follows:

> "15.3 Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers."

Accordingly, on a composite reading of paragraph 15.3 of AS 10 and paragraph 11 above, the Committee is of the view that the fair market value of the construction services will be apportioned to the composite consideration received from the Government including right to charge users of the metro rail and the right to use land for real estate development on a fair basis determined by competent valuers. The company shall recognise the right to use land for real estate development as an intangible asset and measure it at the apportioned fair market value of the construction services rendered.

Issue: Treatment of costs incurred on real estate development on the land provided by the grantor and amortisation or depreciation policy thereof

13. With regard to treatment of costs incurred on real estate development resulting into creation of real estate assets on the land provided by the

grantor, the Committee notes that paragraph 49 (a) of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, defines an asset as follows:

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

The Committee notes that in the given case, real estate development on the leasehold land is a resource controlled by the company since, in terms of the concession agreement, the company has the ability to direct the use of and obtain substantially all of the benefits from such a resource and can also prevent others from directing the use of and obtaining the benefits from the resource. Further, lease rentals are economic benefits that are expected to flow to the enterprise from the real estate development. Therefore, the costs incurred for real estate development meet all the characteristics of an asset.

14. Further, the Committee notes that paragraph 6.1 of AS 10, notified under the Rules, defines a 'fixed asset' as follows:

> ***"6.1 <u>Fixed asset</u> is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business."***

In the given case, real estate development is the asset which is held with the intention of being used for the purpose of providing services and not held for sale in the normal course of business. Therefore, the cost incurred on real estate development satisfies the definition of fixed asset and accordingly, should be accounted for as per the principles of AS 10.

15. With regard to amortisation or depreciation of cost incurred on real estate development recognised as fixed asset, the Committee notes that paragraph 3.2 of Accounting Standard (AS) 6, 'Depreciation Accounting'[3], notified under the Rules, defines depreciable asset as:

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[3] The opinion should be read in the context of Accounting Standard (AS) 6, 'Depreciation Accounting'. However, it may be noted that the Standard has been withdrawn by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

"3.2 Depreciable assets are assets which

(i) are expected to be used during more than one accounting period; and

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business."

The Committee notes that the developed real estate is expected to be used by the enterprise during more than one accounting period which has a limited useful life and is held by the enterprise for use in providing services for lease rentals and not for the purpose of sale in the ordinary course of business. Therefore, the real estate development satisfies the definition of depreciable asset and should be amortised as per AS 6. In this regard, the Committee notes that paragraph 3.4 of AS 6 defines 'depreciable amount' as follows:

"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."

In the given case, the real estate development is not held by the enterprise for sale, therefore, the residual value of the real estate development is nil and the depreciable amount will be the cost incurred on the real estate development.

16. With regard to the policy for depreciation, the Committee notes that paragraphs 3.1 and 3.3 of AS 6 defines 'depreciation' and 'useful life', respectively as follows :

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

> ***"3.3 Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise."***

In the given case, the depreciable asset is expected to be used by the enterprise till the concession period. Therefore, the useful life of the real estate development is the concession period which is pre-determined. Accordingly, depreciation should be charged in each accounting period over the useful life considering the requirements of AS 6.

Issue: Recognition of the Viability Gap Funding

17. With regard to the recognition of the 'Viability Gap Funding' referred to as 'Grant' under the concession agreement, the Committee notes that paragraph 3.2 of Accounting Standard (AS) 12, 'Accounting for Government Grants', notified under the Rules, defines 'government grants' as follows:

> ***"3.2 Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise."***

18. From the Facts of the Case, the Committee notes that the concessionaire receives viability gap funding from the State Government in exchange of its services in the form of the infrastructure and real estate development under concession agreement. The Committee is of the view that a grant is of the nature of a non-exchange transaction. Therefore, the viability gap funding in the extant case cannot be considered as grant for the purposes of AS 12.

19. Accordingly, the Committee is of the view that the viability gap funding received or receivable from the State Government referred as 'grant' in the concession agreement is also a consideration received or receivable from the grantor, viz., the Government for the services to be rendered in the contract apart from the two intangible assets acquired as discussed above. Therefore, the same should be recognised as a 'receivable' as and when the same accrues.

20. The Committee is of the view that the amount received or receivable as viability gap funding cannot be treated as a capital reserve as part of shareholders' funds or reduced from the cost of assets. However, since it is part of the consideration, it should be recognised as part of the contract revenue the statement of profit and loss and not as 'other income'.

D. Opinion

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

(i) (a) Right to use land is an intangible asset and shall be accounted for in accordance with paragraphs 10, 11 and 12 above.

(b) Cost incurred on real estate development is a fixed asset and should be depreciated over the concession period, as discussed in paragraphs 13 to 16 above.

(ii) Viability gap funding received or receivable from the Government is a consideration received or receivable from the Government for the services to be rendered in the contract. Therefore, the same should be recognised as a receivable as and when the same accrues. The amount received or receivable as viability gap funding cannot be treated as a capital reserve as part of shareholders' funds or reduced from the cost of assets. However, since it is part of the consideration, it should be recognised as part of the contract 'revenue' in the statement of profit and loss and not as 'other income'.

Query No. 14

Subject: ***Depreciation for separate unit of refinery on the basis of an estimate of its own useful life.***[1]

A. Facts of the Case

1. A Government of India undertaking (hereinafter referred to as 'the company') is engaged in refining of crude oil having a refining capacity of 3.0 MMTPA. The company is jointly owned by A Ltd., B Ltd and Government of Assam (GOA). A Ltd. holds 61.65% shares whereas B Ltd. and GOA own 26% and 12.35% respectively. The refinery is located in Golaghat district of Assam and is the fourth refinery in the state of Assam.

2. The refinery was commissioned in the year 2000, i.e., commercial production commenced from 01.10.2000. The refinery consists of various units, such as, the Crude Distillation Unit, Vacuum Distillation Unit, Delayed Coking Unit, Hydro cracker Unit, Hydrogen Generation Unit, Coke Calcinations Unit, Sulphur Recovery Unit. Initially, the refinery was producing high speed diesel (HSD), aviation turbine fuel (ATF), superior kerosene oil (SKO), liquefied petroleum gas (LPG), naphtha, sulfur, raw petroleum coke (RPC) and calcined petroleum coke (CPC). Subsequently, an additional facility for production of motor spirit (MS) was installed in the refinery in the year 2006-07. In the financial year (F.Y.) 2014-15, the refinery also commissioned a Wax Plant Unit as an additional facility which allows the company to produce paraffin wax.

3. The querist has stated that Schedule II to the Companies Act, 2013 has brought in changes in respect of calculation of depreciation based on determination of useful lives of the assets and componentisation of assets. The Schedule prescribes the useful life of different categories of assets as a whole (unlike the depreciation rates prescribed in Schedule XIV to the Companies Act, 1956) and states that where cost of a part of the asset is significant to the 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. According to the querist, to meet the requirement of new Companies Act, 2013, the company has adopted Schedule II for calculation of depreciation based on estimated useful life for all the assets of company. Accordingly, written down value of existing assets

[1] Opinion finalised by the Committee on 2.9.2016.

as on 01.04.2014 are being depreciated over the remaining useful life of the assets as prescribed in Schedule II after retaining 5% of the book value. Being a refinery, useful life of the process units are being considered as 25 years as prescribed by Schedule II to the Companies Act, 2013. Accordingly, useful life of the existing plant and machinery assets has been considered as 25 years from the date of capitalisation. During the year 2014-15, the refinery also commissioned its Wax Plant as an additional facility and considered useful life as 25 years from the date of capitalisation for this unit.

4. While conducting the audit of annual accounts for 2014-15, the Comptroller and Auditor General (CAG) auditors have raised the queries against the treatment as below:

Query 1:

The tangible assets of the company include an amount of Rs. 24.75 crore towards plant & machinery for Diesel Quality Upgradation plan (DQUP) and others. DQUP, a part of Hydrocracker Unit, was capitalized during 2009-10. The useful life of the above assets of DQUP was considered 25 years and their useful life will expire in 2034-35 considering the capitalisation in 2009-10 as per Companies Act, 2013. However, the date of commercial operation of Hydrocracker Unit, i.e., the main unit and also refinery was 01.10.2000 and its useful life will expire on 01.10.2025. As per Companies Act, 2013, written down value of existing assets as on 01.04.2014 should have been depreciated over the remaining useful life of the assets after retaining 5% of the book value.

Audit was under observation that the additional plant and machinery for upgradation of the Hydrocracker unit should have same useful life as that of Hydrocracker unit and therefore, should have been depreciated by 01.10.2025 after retaining 5% of the book value and not to be depreciated after the life of the main asset i.e. by 2034-35. Therefore, the current useful life considered by the company has resulted in understatement of depreciation and amortisation expenses with corresponding overstatement of profit as well as tangible asset.

Query 2:

Similarly on the same line of argument, the query was raised on the useful life considered for the plant & machinery for wax plant which was capitalised

during 2014-15 for an amount of Rs. 327.31 crore with useful life of 25 years (as per Companies Act, 2013) which will expire on 2039-40, which was later to the date of expiry of the useful life of the refinery which is 01.10.2025. Audit observed that the wax plant is the part of the refinery and therefore, the plant and machinery of such unit should have same useful life as that of the refinery. Hence, these assets should have been depreciated by 01.10.2025 after retaining 5% of the book value. Accordingly, useful life considered by the company has resulted in understatement of depreciation and amortisation expenses with corresponding overstatement of profit as well as tangible assets.

5. Reply given by the company's management:

To the above mentioned query raised by Government auditors, the company has given its views as under:

Reply to Query 1:

The Schedule II of the Companies Act, 2013 has brought in changes in respect of calculation of deprecation based on determination of useful lives of the assets and componentisation of assets. The Schedule prescribes the useful life of the different categories of assets as a whole and states that where cost of a part of the asset is significant to the 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.

Corporate Laws and Corporate Governance Committee of the Institute of Chartered Accountants of India (ICAI) has also issued an Application Guide on the Provisions of Schedule II to the Companies Act, 2013. A company now needs to identify material/ significant components of an asset separately for depreciation. A component of an asset may have a different useful life which can be higher/ lower than the useful life of the main asset. If the component has a lower useful life the same is to be considered for the purpose of depreciation, *but if the component has a higher useful life, the company has the choice to using either higher or lower useful life. Higher useful life is used only when management intends to use the component even after the expiry of the main asset.* (Emphasis supplied by the querist.)

Accordingly, asset additions during DQUP to the Hydrocracker unit are separate components which have a useful life longer than the main asset.

Even though the life of the main asset would expire in 2025, the main asset is still expected to operate and generate revenues (as asset renewal is a continuous process) and accordingly these new additions to the Hydrocracker unit have been taken to have a life upto 2034-35. Therefore, the useful life of this component has been considered as that which has been prescribed in Schedule II, i.e., 25 years. Further, in case the original asset becomes redundant and needs to be replaced, the additions during DQUP to the Hydrocracker unit can be used in the new unit also.

Reply to Query 2:

In line with explanation given for Query 1 above, a company needs to identify material / significant components of an asset separately for depreciation. A component of an asset may have a different useful life which can be higher/lower than the useful life of the main asset. If the component has a lower useful life the same is to be considered for the purpose of depreciation, *but if the component has a higher useful life, the company has the choice to using either higher or lower useful life. Higher useful life is used only when management intends to use the component even after the expiry of the main asset.*

The company has commissioned Wax Plant Unit as an additional facility to the refinery in F.Y. 2014-15. Wax Plant is a separate processing unit and Schedule II of the Companies Act, 2013 has given the useful life for refinery / processing plant and facilities as 25 years. Further if required, Wax Plant can operate independently of the refinery. Accordingly, useful life of the Wax Processing Unit has been considered as 25 years.

B. Query

6. On the basis of above facts, the company seeks the opinion of the Expert Advisory Committee on the following issues:

(a) Whether the company should consider useful life of the plant and machinery for Diesel Quality Upgradation plan (DQUP) which was added to the Hydrocracker unit amounting to Rs. 24.75 crore during F.Y. 2009-10 as 25 years from 2009-10 or as 25 years from the date of initial capitalization, i.e., 01.10.2000.

(b) Whether the company should consider useful life for the plant and machinery of the additional facility added to the refinery in

the form of Wax Plant which was capitalised during 2014-15 for an amount of Rs. 327.31 crore as 25 years from the year of commissioning of the Wax Plant or as 25 years from the initial year of the refinery commissioning, i.e., 01.10.2000.

(c) Going forward, in case additional facilities are added to the refinery and the useful life of the refinery as per Schedule II of 25 years is over, what need to be considered as the useful life for any such new additions?

C. Points considered by the Committee

7. The Committee notes that the basic issues raised in the query relate to the determination of useful life of additional facility, i.e., Wax Plant/Processing Unit added to the refinery and assets under Diesel Quality Upgradation Plan (DQUP) added to Hydrocracker Unit of the refinery for the purposes of providing depreciation on these additional facility/assets. In other words, whether the useful lives of the Wax Plant Unit/ assets under DQUP should be considered as same as the useful life of refinery/Hydrocracker Unit or these should be determined independently considering their own useful lives. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, whether the rate of depreciation or useful life used for determining depreciation for refinery/units is appropriate, etc. Further, the Committee wishes to point out that since the query refers to the financial year 2014-15, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

8. At the outset, the Committee notes from the Facts of the Case that the querist has referred to the requirements of Application Guide on the Provisions of Schedule II to the Companies Act, 2013 in the context of component accounting. In this regard, the Committee wishes to point out that subsequent to the issuance of the Application Guide on the Provisions of Schedule II to the Companies Act, 2013, the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013 was issued by the Institute of Chartered Accountants of India

(ICAI) in the year 2016, which is applicable for accounting periods commencing on or after April 1, 2016 and its earlier application is encouraged. Accordingly, from the date of the Guidance Note becoming applicable, the requirements contained in the Application Guide to the extent covered by the Guidance Note shall be dealt with in accordance with the requirements of the Guidance Note.

9. In the context of Wax Plant Unit, the Committee notes that in the extant case, the company is treating the refinery as a single unit of measurement of a fixed asset and the various processing units of the refinery as its components. In this regard, the Committee is of the view that in the context of the accounting standards, a component is an integral part of a machine or equipment, without which it cannot function/operate. However, in the extant case, the refinery was operating even without the Wax Plant Unit and the Wax Plant Unit also appears to be capable of operation independently. Therefore, the Committee is of the view that this addition/ extension should not be considered as component in the context the same is used as explained above. Accordingly, the requirements of 'component accounting' as referred to by the querist are not applicable in the extant case and, therefore, the Committee has not examined the issue in the context of Wax Plant Unit. In this context, the Committee notes paragraph 12.2 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets'[2] and paragraphs 9 and 24 of Accounting Standard (AS) 6, 'Depreciation Accounting'[3], notified under the Companies (Accounting Standards) Rules, 2006 which provide as follows:

AS 10

"12.2 The cost of an addition or extension to an existing asset which is of capital nature and which becomes an integral part of the existing

[2] The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

[3] The opinion should be read in the context of Accounting Standard (AS) 6, 'Depreciation Accounting'. However, it may be noted that the Standard has been withdrawn by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately."

AS 6

"9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life."

"24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life."

From the above, the Committee is of the view that since in the extant case, the Wax Plant Unit has a separate identity and since it has been specifically stated in the Facts of the Case that it can operate independent to the refinery, it is capable of being used after the existing asset is disposed of. Accordingly, Wax Plant Unit should be accounted for as a separate fixed asset and depreciated independently considering its own useful life rather than the useful life of the existing asset, viz., refinery.

10. In the context of determination of useful life of the assets added to the Hydrocracker Unit under Diesel Quality Upgradation Plan (DQUP), the Committee notes from the Facts of the Case that these asset additions apparently result in the upgradation of the Hydrocracker Unit, which should be considered as components of the Hydrocracker Unit considering the Unit as the main asset. Accordingly, considering the requirements of above-reproduced paragraphs 9 and 24 of AS 6, the Committee is of the view that the assets added under DQUP to the Hydrocracker Unit should be depreciated over the remaining useful life of the Hydrocracker Unit/Refinery.

In this context, the Committee further notes the requirements of 'component accounting' as per Note 4 of Schedule II to the Companies Act, 2013, which are voluntarily/mandatorily required to be followed by the company in respect of the financial years commencing on or after April 1, 2014/April 1, 2015, respectively, as follows:

> "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."

On the basis of the above, the Committee is of the view that under 'component accounting' approach, where useful life of a component is different from that of the remaining asset, useful life of that component is determined separately from the useful life of the remaining asset and it is depreciated over its own useful life rather than the useful life of the remaining asset. The Committee further notes that as per the requirements of Accounting Standard (AS) 6, 'Depreciation Accounting', 'useful life' represents the period over which a depreciable asset is expected to be used by the enterprise. In this context, the Committee notes from the Facts of the Case that the useful life of additions to Hydrocracker Unit has been considered to be longer than that of the Unit/Refinery merely based on the presumption that these can be used in a *new* unit once the original asset/unit becomes redundant and that the Unit/Refinery will also be continued to be operated even after its useful life would be over, i.e. the useful life is expected to be revised in future in excess of that considered initially. In this context, the Committee is of the view that determination of useful life of component should be based on its expected use in existing asset(s) and not merely on its use in future new units or expected revision in useful life of existing asset(s). Accordingly, the Committee is of the view that in the extant case, useful life of components (assets added under DQUP) should not be considered to be longer than the existing useful life of the existing Unit/ Refinery for providing depreciation thereon.

11. In the context of the opinion, the Committee also wishes to point out that the useful lives prescribed under Schedule II to the Companies Act, 2013 are only indicative. In case, the useful life of an asset as estimated by the company, supported by the technical advice, external or internal, differs, i.e., higher or lower from the indicative useful life given under Schedule II, the former should be applied by the company for providing depreciation.

D. Opinion

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

(a) The useful life of the plant and machinery for Diesel Quality Upgradation Plan (DQUP) added to the Hydrocracker Unit during 2009-10 in the extant case should not be considered to be longer than the existing useful life of the existing asset(s), viz., Unit/ Refinery, as discussed in paragraph 10 above.

(b) The useful life of the Wax Plant Unit, the additional facility added to the refinery, capitalized during 2014-15 for an amount of Rs. 327.31 crore, should be considered independently considering its own useful life rather than the useful life of the existing asset, viz., refinery, as discussed in paragraph 9 above.

(c) Going forward, in case additional facilities are added to the refinery/units, the guidance given in (a) and (b) above should be followed.

Query No. 15

Subject: Recognition of deferred tax asset/liability in respect of depreciation on Held-To-Maturity (HTM) category investments as per Accounting Standard 22, 'Accounting for Taxes on Income'.[1]

A. Facts of the Case

1. The querist has stated that a bank follows the guidelines of the Reserve Bank of India for making provision for investments in books of account. As per the guidelines of the Reserve Bank of India, investments held under held-to-maturity (HTM) need not be marked to market and will be carried at

[1] Opinion finalised by the Committee on 2.9.2016.

acquisition cost, unless it is more than the face value, in which case the premium is to be amortised over the period remaining to maturity.

2. However, for the purpose of income tax, bank treats all the securities/ investments including HTM category securities as stock-in-trade. In other words, bank has been claiming depreciation on such investments for income tax purpose.

3. The querist has further stated that on account of the above-mentioned accounting treatment, the following questions are being raised:

(i) Whether there is a timing difference arising out of depreciation on investment held under HTM category and;

(ii) Whether bank is required to create deferred tax liability (DTL) for the same;

The statutory central auditors of the bank are of the view for creating DTL on such depreciation on HTM securities as per Accounting Standard (AS) 22, 'Accounting for Taxes on Income' and the auditors are insisting for creating DTL.

Views of the querist:

4. According to the querist, Accounting Standard (AS) 22, 'Accounting for Taxes on Income' envisages recognition of deferred tax assets/deferred tax liabilities for the timing differences. As per the Standard,

> ***"Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."***
>
> ***"Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently."***

From the above, it is clear that two conditions need to be fulfilled for timing difference:

(i) There should be difference between accounting income and taxable income as accepted by income tax department; and

(ii) Reversal of the difference so originated should occur in subsequent periods.

Further, paragraph 7 of AS 22, inter alia, reads *as "Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income"*(emphasis supplied by the querist). That means only when an item of expense/income is given same treatment both under taxable income and accounting income, it will fall within the definition of timing difference. For example, if an item of expenditure is claimed as expenses in one period and allowed as deduction while computing taxable income in another period, then it will result in timing difference. However, if an item is given totally two different treatments under accounting income and taxable income, the same has to be treated as permanent difference. In the case of depreciation on investment, the treatment in the books of account and for the purpose of income tax is totally different. Hence, according to the querist, that cannot be considered as timing difference.

B. Query

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

(i) Whether there is a timing difference arising out of depreciation on investment held under HTM category; and

(ii) Whether bank is required to create deferred tax liability (DTL) for the same.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to deferred tax implications of depreciation on HTM investments for income tax purposes leading to difference in value of HTM investments for accounting and tax purposes in the situation as specified in the facts of the case. Therefore, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, appropriateness of treatment of HTM investments as stock-in-trade for tax purposes. Further, the Committee refrains from expressing any view on the correctness of interpretation of tax treatment by the querist.

7. The Committee notes that as per the querist, for income tax purposes, the HTM investments are treated as stock-in-trade, viz., investments are carried at lower of cost and market price and the difference is charged as

depreciation for income tax purposes, however for accounting purposes, no such depreciation is charged. Thus, it leads to difference in valuation of HTM investments for tax purposes and accounting purposes. If such differential valuation is accepted by the Income-tax department, a question arises as to whether the difference is a timing difference or a permanent difference.

8. The Committee notes the following paragraphs from AS 22, issued by the Institute of Chartered Accountants of India:

> ***"4.6 Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.***
>
> ***4.7 Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently."***
>
> "5. Taxable income is calculated in accordance with tax laws. In some circumstances, the requirements of these laws to compute taxable income differ from the accounting policies applied to determine accounting income. The effect of this difference is that the taxable income and accounting income may not be same.
>
> 6. The differences between taxable income and accounting income can be classified into permanent differences and time differences. Permanent differences are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. For instance, if the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference.
>
> 7. Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would

be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. Another example of timing difference is a situation where, for the purpose of computing taxable income, tax laws allow depreciation on the basis of the written down value method, whereas for accounting purposes, straight line method is used. Some other examples of timing differences arising under the Indian tax laws are given in Illustration 1."

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

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

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

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

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

D. Opinion

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

(i) Yes, there is a timing difference arising out of depreciation for income tax purposes, on investment held under HTM category, as discussed in paragraph 10 above and;

(ii) The bank is required to create deferred tax asset/liability for such a timing difference in accordance with the provisions of AS 22.

Query No. 16

Subject: Date of commencement of commercial production of Multilayer Double Coated Paper Board Green Field Project and capitalisation of borrowing costs incurred during the test run period of the Project.[1]

A. Facts of the Case

1. T Limited is a listed company, promoted by the Government of Tamil Nadu (GOTN) to manufacture newsprint and printing and writing paper (PWP) using bagasse (a sugar cane waste) as primary raw material. It has a paper production capacity of 4,00,000 MT per annum. The company has set up a green field Multilayer Double Coated Board Plant (hereinafter referred to as MDCB plant) to produce packaging boards of 2,00,000 MT per annum at a capital outlay of Rs.1,650 crore in Tamil Nadu. The scope of MDCB project includes setting up a board machine, a 30 MW power plant and other support infrastructures like power sub-station, water treatment plants, mill-wide air conditioning system, automatic storage retrieval systems, etc.

[1] Opinion finalised by the Committee on 26.10.2016.

2. The querist has stated that MDCB plant is installed to manufacture high-end coated boards for making carton boxes for packaging food and beverages, pharmaceuticals, personal and health care products, electronic goods, etc. In the coated board market, product quality is very critical. The products have to be of high quality to avoid rejection by customers. T Limited started the test run of the MDCB plant without the coating section on 21.01.2016. The test run of the coating section which is vital, began on 17.02.2016. Production till end of February 2016 was largely uncoated and therefore, rejected and re-pulped. Board production during 01.03.2016 - 14.3.2016 was 32.77% of the machine capacity, of which 46.10% of production was rejected and re-pulped as the product did not meet the quality standards. Generally, rejection level should be less than 5% of production. The plant continued the test run beyond 14.3.2016 till 30.04.2016 for making further technical adjustments in the machine to meet quality standards, reduce the rejection level and achieve commercially feasible/ viable production.

3. The querist has also stated that between 15.03.2016 and 30.04.2016, the company produced 12,122 MT equivalent to 46.42% of the machine capacity. Of this, 2,336 MT equivalent to 19.27% of production was rejected and re-pulped. With the technical adjustments carried out, the rejection level declined to 6.59% of production during the last week of April 2016. With the declining trend in the rejection level, the company considered that the plant was ready for commercial production from 01.05.2016.

4. The company ceased capitalisation of borrowing cost with effect from 15.03.2016 on substantial completion of all activities necessary to prepare the MDCB plant for production of coated boards, in accordance with paragraph 19 of Accounting Standard (AS) 16, 'Borrowing Costs'. At this point, the production was 32.77% of the machine capacity and 46.10% of production was below the quality standards and, therefore, rejected and re-pulped. High level of rejection reinforces the need to carry out further technical adjustments in the machine. Therefore, test run was continued till 30.04.2016 to meet quality standards and reduce the rejection level. The company treated all directly attributable costs of the MDCB project and all indirect construction costs (including cost of start-up & commissioning, test run and experimental production net of income earned) incurred as 'capital work-in-progress' as on 31.03.2016. As the company ceased capitalisation of borrowing cost effective from 15.03.2016, the borrowing cost for the

period 15.03.2016 - 31.03.2016 was charged off to the statement of profit and loss during the financial year 2015-16.

5. The querist has further stated that the Comptroller and Auditor General (CAG) in the course of supplementary audit u/s 143(6)(a) of the Companies Act, 2013, for the financial year (F.Y.) 2015-16, has made a comment as under:

> *"The company decided that Unit II of Multilayer Double Coated Board (MDCB) (which had been commissioned on 21.01.2016) be in test run up to 14th March 2016 and declared that plant was ready to commence commercial production on 15th March 2016. In accordance with the provisions of AS 16, capitalisation of interest cost was ceased from that date. However, income from sales continued to be adjusted against Capital Work in Progress instead of showing the same as sales in profit and loss account. This has also resulted in understatement of profit by Rs.2.53 Crore.*
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> *Further, as Unit II of MDCB was ready to commence the commercial production on 15th March 2016, continuation of the same under Capital Work in Progress as on 31st March 2016 is incorrect."*

According to the querist, the CAG's comment is based on the premise that the company completed the test run of the MDCB project on 14.03.2016, i.e., on the date of cessation of borrowing cost and the plant was ready to commence commercial production on 15.03.2016. (Emphasis supplied by the querist.)

Company's stand:

6. As per paragraph 19 of AS 16 ***"Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete"***. The criteria for cessation of borrowing cost under AS 16, according to the querist, is *linked to substantial completion of all activities necessary to prepare the qualifying asset. The criteria for capitalisation of costs under AS 10, 'Accounting for Fixed Assets*[2] i*s linked to the date of readiness of the plant*

[2]The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

to commence commercial production. Thus, AS 10 and AS 16 have to be dealt with independently as the principles/criteria for accounting treatment in the respective standards are different. Further, since AS 16 specifically deals with the accounting treatment of borrowing cost, the same will override AS 10. Footnote 1 to paragraph 9.4 of AS 10 also confirms this position, the relevant portion of which is reproduced below:

> "...Since Accounting Standard (AS) 16, Borrowing Costs specifically deals with the treatment of borrowing costs, the treatment provided by AS 16 would prevail over the provisions in this respect contained in this paragraph as these provisions are general in nature and apply to "all expenses"."

(Emphasis supplied by the querist.)

7. MDCB plant is a self-constructed asset. Activities necessary to prepare the MDCB plant for production were substantially completed on 14.03.2016, with production at 32.77% of the machine capacity and rejection level at 46.10% of production. As all activities necessary to prepare the MDCB plant for production of coated boards were substantially completed on 14.03.2016, the company ceased capitalisation of borrowing cost with effect from 15.03.2016 to comply with the *mandatory* accounting requirements of paragraph 19 in AS 16 and continued the test run beyond 14.03.2016 to improve the quality standards and reduce the rejection to the normal level. With rejection level at 46.10% in the production of 32.77% of machine capacity during the period 1.3.2016 to 14.03.2016, it was not prudent to consider that the plant was ready to commence commercial production on 15.03.2016. Generally, rejection level should be less than 5% of production.

8. The querist has stated that continuation of test run beyond 14.03.2016, the date of cessation of capitalisation of borrowing cost, was not due to abnormal / extraneous reasons but primarily to attend to the technical issues in the machine so as to meet quality standards and reduce the rejection level. *The Multilayer Coated Board Machine is highly sophisticated with DCS controls inbuilt into every section of the machine. The machine requires regular technical adjustments of its electrical and electronic parts for producing coated boards with consistent quality and commercially feasible quantity. These technical adjustments have to be carried out on a continuous basis when test run production is on. These adjustments take considerable time and other companies who have installed board machines in their plants*

have had the experience of longer test run even upto 10 – 12 months before declaring commercial production. (Emphasis supplied by the querist.)

9. The company started the test run of MDCB plant with coating section only on 17.02.2016. Production during the last week of the January and most of February was largely uncoated and therefore rejected and re-pulped. *The company, in the midst of test run of the MDCB Plant, ceased capitalization of borrowing cost on 14.03.2016 i.e. the date on which all activities necessary to prepare the MDCB plant for production were substantially completed for the limited purpose of complying with the mandatory accounting requirements as per paragraph 19 of AS 16.* Board production during 1.3.2016 - 14.3.2016 was 2,548 MT equivalent to 32.77% of the machine capacity. Of this, 1,175 MT equivalent to 46.10% of production, was rejected and re-pulped as the product did not meet the quality standards. *With 46.10% of production being rejected on quality considerations in the production of 32.77% of capacity being achieved, it was hardly possible to declare 15.03.2016 as the date of readiness of MDCB plant for commercial production. High level of rejection reinforces the need to carry out further technical adjustments in the machine. Therefore, test run was continued till 30.04.2016 to meet quality standards and reduce the rejection level.* Between 15.03.2016 and 30.04.2016, the company produced 12,122 MT equivalent to 46.42% of the machine capacity. Of this, 2,336 MT equivalent to 19.27% of production was rejected and re-pulped. *With the technical adjustments carried out, the rejection level in the last week of April 2016 declined to 6.59% of production. With the declining trend in the rejection level, the company considered that the plant was ready for commercial production from 01.05.2016.* (Emphasis supplied by the querist.)

10. Thus, the company considered all the relevant factors, such as, technological evaluation of the readiness of the plant & machinery and other facilities, the quality and quantity of the output produced etc., and reckoned 01.05.2016 as the date of readiness of the MDCB plant to commence commercial production. Since the MDCB plant continued the test run till 30.04.2016 for the reasons stated above, the company treated all directly attributable costs of the MDCB project, borrowing cost up to 14.03.2016 (date of cessation of capitalization under AS 16) and all indirect construction costs (including cost of start-up & commissioning, test run and experimental production net of income earned) incurred as 'capital work-in-progress' on 31.03.2016. *Having regard to the facts and circumstances of*

the case, the main issue now is whether MDCB Plant should be considered ready to commence commercial production on 15.03.2016 or 01.05.2016. (Emphasis supplied by the querist.)

11. The querist has also stated that the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) in its earlier opinion finalized on 5.7.2001 (published as Query No. 25 of Volume XXI of the Compendium of Opinions), besides defining the term "commercial production" has also discussed in length, the factors to be considered for determining when a plant is ready to commence commercial production, the relevant extracts are given below:

(i) "Duration of a trial run and experimental production and when the plant is ready for commercial production is based on factors such as technological evaluation of the readiness of the plant and machinery and other facilities, the quality and the quantity of the output produced, etc… when the plant is ready for commercial production, is a question of fact which should be determined on the basis of the factors stated above."

(ii) "It should be borne in mind… that "commercial production" is a term of somewhat wider import than the mere term "production". Even during a period of test runs and experimentation, a plant may be engaged in actual production, but until the test runs are completed and the plant is properly adjusted on the basis thereof, it may not be said to be ready for "commercial production". The term "commercial production" refers to production in commercially feasible quantities and in a commercially practicable manner."

It is apparent from the above explanatory notes of the EAC of the ICAI that the issue when a plant can be considered ready for commercial production depends on various factors, such as, *technological evaluation of the readiness of the plant and machinery and other facilities, the quality and the quantity of the output produced, etc.,* which are all business related. Therefore, when a plant is ready to commence commercial production is an issue of business judgement to be exercised by the management having regard to all relevant technological and commercial factors as above. (Emphasis supplied by the querist.)

12. The querist has also separately raised a supplementary issue with regard to capitalisation of borrowing costs incurred during the test run period

of the project and supplied the views of the company on the issue as follows:

> Having commenced production in the MDCB plant, the company ceased capitalization of interest effective from 15.03.2016 even with high rejection level at 46.10% of production. The company continued test run beyond 14.03.2016. On the date of cessation of borrowing costs i.e., on 14.03.2016, the production standard could not be met as 46.10% of the production was being rejected on quality considerations in the meager production of 32.77% of machine capacity. This warranted necessary alterations / modifications to the plant and machinery and the corrections were carried out during the test run period from 15.03.2016 to 30.04.2016.
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> As a result of the above corrective measures in the board machine, the rejection level was reduced from 46.10% to 19.27% during the period 14.03.2016 - 30.04.2016 and further to 6.59% in the last week of April 2016. With declining trend in the rejection level, the company completed the test run on 30.04.2016. On 01.05.2016, the plant was ready to commence commercial production when the company achieved normal production standards. According to the querist, as per AS 16 (paragraph 19 read with paragraph 20), capitalisation of borrowing costs need not be ceased unless and until all *activities necessary to prepare the qualifying assets for its intended use are complete*. However, paragraph 20 of AS 16 envisages certain activities, viz., routine administrative and minor modification work which have no bearing on bringing the qualifying asset to its working condition for its intended use and therefore, mandates cessation of borrowing costs during the pendency of these non-core activities.
>
> In the subject case, the activities undertaken by the company during the period 15.03.2016 – 30.04.2016 were not of the non-core activities envisaged in paragraph 20 of AS 16 but were part of normal trial run activities (a core construction activity of plant) without which intended use of the qualifying asset cannot be achieved.
>
> Further, continuation of test run beyond 14.03.2016 till 30.04.2016 was not due to any abnormal reasons but primarily to correct technical defects and improve the quality, reduce the rejection level from 46.10% to the acceptable level of around 5% and achieve commercially feasible

quantities. *Such corrective activities during the trial run production period are must to bring the plant for its intended use*. Therefore, continuation of test run from 15.03.2016 – 30.04.2016 was a *normal* period of test run.

The Expert Advisory Committee of the ICAI in various opinions issued on the matter of capitalization of asset, have issued clarificatory notes highlighting the criticality of test run activity in the context of construction of a plant and the accounting treatment to be given in respect of expenditure incurred during the trial run period. The relevant extracts have been provided by the querist as below:

(i) Normal trial run also contributes to construction of plant as trial run activity is regarded as an activity which is necessary to prepare the asset for its intended use. This is because flaws in the assets noticed during trial run production are rectified to bring the plant to its intended use. (Paragraph 21 of EAC Opinion finalised on 05.07.2001)

(ii) The purpose of the test run is to ascertain whether the plant and machinery and other relevant facilities, as installed, give the commercially feasible output in terms of quality and quantity. If, during the test run, the production standards are not met, normally, the production is stopped and necessary alterations / modifications are made in the plant and machinery. It may be necessary to carry out test run(s) further until the output of commercially feasible quality and quantity is obtained. (Paragraph 11 of EAC Opinion finalised on 31.07.2012 and published as Query No. 18 of Volume XXXII of the Compendium of Opinions)

(iii) As per the requirements of AS 16, borrowing costs related to construction of an asset incurred upto the time the asset is ready for its intended use, i.e., ready to commence commercial production, should be capitalised, and, thereafter, all borrowing costs should be charged to revenue. (Paragraph 20 of EAC Opinion finalised on 05.07.2001)

(iv) *The borrowing costs incurred during the normal period of trial run should be capitalised. (paragraph 22 (b) of EAC Opinion dated 5.7.2001)*

Considering the facts and circumstances of the case, the relevant Accounting Standard and the views of the EAC as above, the company is of the view that the company should have continued capitalisation of borrowing costs incurred during the normal period of the test run, i.e., upto 30.04.2016.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee (EAC) on the following issues:

(i) On the basis of the facts mentioned as above, with rejection level at 46.10% of production, which is 32.77% of machine capacity, whether the MDCB plant should be considered as ready to commence commercial production, i.e., on 15.03.2016.

(iii) With further technical adjustments carried out in the machine between 15.03.2016 and 30.04.2016 and the rejection level reduced to 6.59% in the last week of April 2016, whether the company can consider 01.05.2016 as the date of readiness of the plant to commence commercial production.

(iv) Whether the action of the company in ceasing capitalisation of borrowing cost on 14.03.2016 despite continuation of normal test run of MDCB plant upto 30.04.2016 was correct and if not, whether 30.04.2016 can be taken as the cut-off date for cessation of capitalisation of borrowing costs for the purpose of AS 16.

C. Points considered by the Committee

14. The Committee notes that the basic issues raised in the query relate to the point of time when the MDCB plant should be considered to be ready to commence commercial production and the cut-off date to be taken for cessation of capitalisation of borrowing costs for the purposes of AS 16. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, elements of costs (direct and indirect) which need to be capitalised with the plant, etc. At the outset, the Committee wishes to point out that since the querist has referred to the provisions of Accounting Standard (AS) 10 (pre-revised), 'Accounting for Fixed Assets', the Committee has considered the requirements of pre-revised Standard and not the requirements of revised

Accounting Standard (AS) 10, 'Property, Plant and Equipment'. Further, since the company was operating at a certain specified level of production during 15.3.2016 to 30.4.2016, the Committee presumes from the Facts of the Case that such a level of production was normal and essential for the trial run to commence considering the nature of the process of the industry in which the company is operating (failing which the opinion of the Committee may not be applicable). Moreover, since the time gap between the date of cessation of capitalisation of borrowing costs, i.e., 15.3.2016 and the date when the plant is ready to commence commercial production, i.e., 1.5.2016 was 1.5 months only and as per the accounting requirements, Accounting Standards are intended to apply to items which are material, it is also presumed that the amounts involved in the extant case are material.

15. The Committee notes from the Facts of the Case that during 1.3.2016 to 14.3.2016, the production was 2,548 MT equivalent to 32.77% of the machine capacity and of this, 1,175 MT equivalent to 46.10% of production was rejected and re-pulped as the product did not meet the quality standards. However, on 15.3.2016, the company ceased the capitalisation of borrowing costs under AS 16. Further, between 15.03.2016 and 30.04.2016, the company produced 12,122 MT equivalent to 46.42% of the machine capacity. Of this, 2,336 MT equivalent to 19.27% of production was rejected and re-pulped. With the technical adjustments carried out, the rejection level declined to 6.59% of production during the last week of April 2016. Thus, the issue raised is with respect to whether 15.03.2016 on which the borrowing costs were ceased to be capitalized should be considered as the date of readiness of the plant to commence commercial production. Accordingly, the issue does not pertain to consideration of readiness of plant before 15.3.2016. Therefore, the Committee is concentrating on the issue raised only. On the basis of the above-mentioned facts, the Committee notes that although on 15.03.2016, the plant was operating, but was functioning at sub-optimum level, viz., somewhere between 32.77% and 46.42%. Further, the output produced at this capacity was being sold, though the rejection level as on that date was somewhere between 19.27% to 46.10% of the production. On this basis, the querist has contended that the plant cannot be considered as ready to commence commercial production on 15.3.2016 and the period between 15.3.2016 to 30.4.2016 should also be considered as the period of trial/test run of the plant and therefore, the plant should be continued as capital work in progress till 30.4.2016 in the books of account. Thus, the Committee notes that the issues to be examined are the duration of test run and the point of time at which the cost of the plant should be capitalized as

fixed asset in the financial statements. In this regard, the Committee notes the following requirements of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> "9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.
>
> 9.4 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. ..."

From the above, the Committee notes that the above provisions require expenditure on test runs and experimental production to be capitalised as an element of cost of an asset till it is ready to commence commercial production and then the same to be capitalised as a fixed asset (the plant). The Committee is of the view that the duration of trial run and the date when an asset is ready to commence commercial production is a question of fact which should be determined on the basis of various factors, such as, technological evaluation of the readiness of the asset, the quality and the quantity of the output produced, etc. Commercial production means production in commercially feasible quantities and in a commercially practicable manner. Thus, if an asset is operational and is able to produce the commercially feasible quality and quantity of goods, no further costs should be capitalised as fixed asset even if it is not achieving targeted production. The Committee is further of the view that what is important is when the asset/plant is ready to commence commercial production and not the capacity of the plant achieved. Moreover, commercially feasible quality means an acceptable quality level that is commercially feasible to be sold in the market and the same should be determined considering the past experience (if any), target market, industry practice, etc. Thus, the Committee is of the view that the date of readiness of the plant to commence commercial

production should be determined considering the afore-mentioned factors and not solely on the basis of the capacity or level of production.

16. With regard to the supplementary query raised by the querist related to the point of time when the capitalization of borrowing costs on a qualifying asset should cease, the Committee notes paragraphs 19 and 20 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the 'Rules', reproduced below:

> "***19. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.***
>
> 20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete."

From the above, the Committee notes that the Standard requires cessation of borrowing costs when the activities necessary to prepare the qualifying asset for its intended use are complete. In other words, borrowing costs should cease to be capitalized after the qualifying asset is ready for its intended use. The Committee is of the view that normally, when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete i.e., when the qualifying asset is ready for its intended use, the asset would also be ready to commence commercial production. The Committee agrees with the view of the querist that test/trial run is also an essential part of the construction activity to prepare the asset ready for its intended use and therefore, the borrowing costs incurred even during the test/trial run should be continued to be capitalized. However, the duration of test/trail run should be determined considering the factors as aforementioned in paragraph 15 above.

17. Incidentally, the Committee notes from the Facts of the Case that the CAG has commented that the plant had been commissioned on 21.01.16 and that the plant was declared to be ready to commence commercial production on 15th March, 2016. However, the Committee also notes that

the querist has stated that the company considered that the plant was ready for commercial production from 1.5.2016 and reckoned 1.5.2016 as the date of readiness of the MDCB plant to commence commercial production. Thus, it is not clear that whether the plant was declared to be ready to commence commercial production on 15th March, 2016 or not. However, in this regard, the Committee wishes to point out that once considering all the above-mentioned factors, as discussed in paragraph 15 above, a plant has been declared as ready to commence commercial production, it cannot be said later that the plant was not so ready due to not achieving the targeted level of production or sale due to rejection level, etc.

D. Opinion

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

(i) and (ii) whether the MDCB plant should be considered as ready to commence commercial production on 15.03.2016 or on 01.05.2016, is a question of fact which should be determined on the basis of various factors, such as, technological evaluation of the readiness of the asset, the quality and the quantity of the output produced, etc., as discussed in paragraph 15 above.

(iii) The test/trial run is also an essential part of the construction activity to prepare the asset ready for its intended use and therefore, the borrowing costs incurred even during the test/trial run should be continued to be capitalized, as discussed in paragraph 16 above. However, the duration of test/trail run should be determined considering the factors as aforementioned in paragraph 15 above.

Query No. 17

Subject: Accounting for interest earned on unutilized idle funds received as loan from the Governments/ Financial Institution for executing the capital projects.[1]

A. Facts of the Case

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

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

3. The Ministry of Power (MOP), Government of India (GoI) has introduced Restructured Accelerated Power Development and Reforms Programme (RAPDRP) Scheme during 11th Five Year Plan as Central Sector Scheme (relevant extracts from which have been separately supplied by the querist for the perusal of the Committee). A corporation, ABC, has been made a nodal agency to operationalise the programme under the guidance of the Ministry of Power. For implementation of the approved projects, funds are provided as a loan for the works within the scope of scheme from the Government of India on the terms decided by the Ministry of Finance. Accordingly, the company is receiving funds from ABC for executing above capital projects.

4. With regard to RAPDRP, the querist has also separately informed that as a part of distribution reforms, GOI had launched APDRP (Accelerated Power Development Programme) in 2001 which was later rechristened as APDRP (Accelerated Power Development and Reforms Programme) during the 10th Five Year Plan. To continue the support to distribution reforms

[1] Opinion finalised by the Committee on 26.10.2016.

during the 11th Five Year Plan, GOI has reintroduced R-APDRP (Restructured APDRP) with revised terms and conditions. The R-APDRP primarily aims at reducing Aggregate Technical and Commercial (AT&C) losses in urban areas. It is a necessary condition of the scheme that the utilities would need to demonstrate performance improvement for availing financial benefits provided under the scheme. The R-APDRP programme covers urban areas - towns and cities with population of more than 30,000 (10,000 in case of special category states). MOP, GOI has appointed ABC as the nodal agency for implementing this programme. R-APDRP programme is being taken up in two parts. Part-A includes the projects for establishment of baseline data and information technology (IT) applications for energy accounting/ auditing and IT based consumer service centers. Part-B includes regular distribution strengthening projects. Scope of works of Part-A and Part-B are as follows:

Part-A includes among others:

- Consumer Indexing
- GIS Mapping, Asset Mapping
- Metering of Distribution Transformers / Feeders
- Automatic Data Logging
- Feeder Segregation/ Ring Fencing
- IT applications for redressal of consumer grievances, meter reading, billing & collection,
- Energy Audit
- Establishment of the Base Line data System

Part-B will include among others:

- New 33/11 KV substation.
- Augmentation of power transformers (PTs) and installation of additional PTs.
- 33 KV line on single and double suspension with Panther conductor.
- New 33 KV and 11 KV line with AAA Dog conductor/XLPE Cable.

- Augmentation of conductor size of existing 33 and 11 KV lines.
- HVDS scheme using 16 KVA and 25 KVA transformer.
- Installation, augmentation and relocation of distribution transformers.
- New LT line & re-conditioning by XLPE AB Cable size 3x50+1x35+1x16 sq.mm and replacement of bare conductor by 3x95+1x70+1x16

5. *Funding of Schemes/ Projects:*

- GoI through ABC is providing 100% loan for Part A of the schemes including IT applications and projects for establishing base line data.
- GoI through ABC is providing 25% loan for Part B of the schemes (90% for special category States).
- The counterpart funding (75%) has been arranged from another corporation, XYZ.

6. *Conversion of GoI Loan to Grant:*

- The entire amount of GoI loan (100%) for Part A of the project shall be converted into grant after establishment of the required base-line data system within a stipulated time frame and duly verified by monitoring agency.
- Upto 50% (90% for special category States) loan provided by the GoI for Part-B projects shall be converted into grant progressively on achievement of AT&C loss reduction targets.

7. The querist has stated that there is a time gap between receiving of funds and actual utilization of funds. Therefore, the company temporarily parks / invests the idle funds which are not utilised immediately in nationalised banks for earning opportunity cost on such idle funds. The interest earned on such investments is treated as interest income and is shown under the income head of the financial statements for the year.

8. The querist has also submitted that the company is an electricity distribution licensee and being governed under the Electricity Act, 2003, the

tariff (sale price) of electricity is decided by the Madhya Pradesh Electricity Regulatory Commission (MPERC). As per the MPERC regulation and practice followed by MPERC, while determining the *tariff* (sale price), MPERC reduced interest earned on fixed deposit from total cost of supply of power and only remaining amount is allowed to recover from the consumers as revenue from sale of power.

9. Due to above treatment of interest income while computing *tariff*, since total interest income (earned on investment as well as earned on advance) is adjusted against the cost of supply to determine the tariff of power, the company is of the view that the appropriate treatment of interest earned on unutilized idle project funds is to treat it as revenue income rather than to reduce the interest from capital work in progress. The querist has also stated that the work under RAPDRP scheme is being executed by the company through contractor selected on the basis of tendering system on turnkey basis. As per the provision of the tender document, various types of advances are provided by the company to the turnkey contractor. The company charges interest on such advances from the contractors. This interest is shown as other income in the accounts of the company. However, Comptroller and Auditor General (CAG auditor) is of the view that same has to be credited in the cost of work and therefore, opinion of the Committee is also sought on this matter.

10. The querist has referred to paragraphs 6, 7 and 8 of an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) finalised on 22/04/2000 (published as Query No. 6 of Volume XX of the Compendium of Opinions) on the subject 'Treatment of interest earned on idle project funds', which are reproduced as under:

> "6. The Committee notes from the facts of the query that the final product of the company is compulsorily acquired by the government at the compensation rate fixed by the government. The Committee also notes that in determining the compensation rate, any interest (or other similar income) earned by the company from investment of idle funds is deducted from the cost of production.
>
> 7. The 'Guidance Note on Treatment of Expenditure During Construction Period', issued by the Institute of Chartered Accountants of India, recommends that interest from investment of idle project funds should be adjusted in the capital cost of the project (paragraphs 8.1,

> 15.2 and 17.11). The Committee is of the view that this general principle is not applicable in the present case due to its special circumstances. As mentioned earlier, interest arising from investment of idle project funds (as well as other funds) is reduced from the cost of production and a return on capital employed is added to the resultant figure to determine the compensation rate for the final product. Thus, there is a clear nexus between interest earned and sale proceeds from the final product. The higher the interest earned, the lower the sale proceeds, and vice versa. The Committee is of the view that the accounting treatment of interest should clearly reflect its nature as discussed above.
>
> 8. Based on the above, the Committee is of the view that interest earned by the company on investment of idle funds should be treated as of revenue nature and shown separately in the financial statements, if material. The Committee is of the view that under the facts and circumstances of the case, adjusting the interest earned on investment of idle project funds against the project cost would not be appropriate."

11. The querist has submitted that the facts and grounds of the above opinion are similar to that of the company. If the company earns less interest, then MPERC shall allow more revenue from sale of power and vice-versa. Based on the above opinion, the company is of the view that the accounting treatment of interest earned on idle funds as interest income seems appropriate instead of adjusting with cost of the project or showing as payable towards funding agency.

12. However, while conducting audit of annual accounts of the company for the financial year (F.Y.) 2013-14, the Government auditor (CAG auditor) observed that as the company has incurred an extra expenditure on the scheme by way of payment of interest; hence, any income realised should be adjusted against the project cost instead of treating as income. (The querist has supplied a copy of CAG comments issued to the company for the perusal of Committee.)

13. The querist has also informed that the auditor was requested to consider the above opinion of the Expert Advisory Committee of the ICAI on the same subject matter but it was not considered by them.

14. Further, the querist has stated that as per general instruction no.3 to the Companies (Accounting Standards) Rules, 2006, the Accounting Standards are intended to apply only to items which are material.

B. Query

15. In light of the above facts and EAC opinion, the Committee is requested to provide the opinion on the following issues:

(i) Accounting treatment of interest earned on unutilised idle funds received as loan /equity / grants from the governments / financial institution for executing the capital projects and interest earned on advances from the contractors.

(ii) As observed by the CAG in its comment, the amount of interest earned on surplus fund is Rs. 11.79 crore as against the total turnover of the company, which is Rs. 6956 crore. Therefore, in the light of principle of materiality, whether the treatment given by the company in its books of account is correct or not.

C. Points considered by the Committee

16. The Committee notes that the basic issues raised in the query relate to accounting treatment of interest earned on unutilised idle funds received as loan /equity / grants from the governments / financial institution for executing the capital projects and interest on advances from the contractors. 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, whether the projects/assets coming into existence under RAPDRP scheme can be considered as 'qualifying asset' under Accounting Standard (AS) 16, 'Borrowing Costs', accounting for interest on borrowed funds, accounting for conversion of loan into grant, etc. Further, the Committee has expressed its opinion purely from accounting perspective and not from the perspective of determination of tariff by MPERC. At the outset, with regard to the contention of the querist in respect of the earlier opinion of the Committee, the Committee wishes to point out that the earlier opinion had been given considering the requirements of the Guidance Note on Treatment of Expenditure during Construction Period, which was withdrawn by the Council of the ICAI in August, 2008 and therefore, the opinion expressed considering the requirements of the said Guidance Note is not relevant in the extant case. Moreover, there are other earlier EAC opinions on the similar subject which, although have not been referred to by the querist but may be relevant in the extant case. Further, the Committee wishes to point out that since the query refers to the financial year 2013-14, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the

Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification. At the outset, the Committee has also presumed from the Facts of the Case that during the financial year 2013-14, there was no reasonable assurance that the conditions for conversion of loan into grant will be complied with and therefore, the funds provided by the GoI are being treated as loan.

17. With regard to interest income earned on idle funds invested, the Committee notes that as per the requirements of paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', "all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise". Thus, the income in the extant case can be adjusted against the project cost only when an Accounting Standard requires the same. In this regard, the Committee notes that in case of borrowed funds, requirements of AS 16 shall be applicable. Accordingly, the Committee notes paragraphs 10 and 11 of AS 16, notified under the Rules as follows:

> ***"10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.***
>
> 11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred."

The Committee notes from paragraphs 10 and 11 of AS 16 above that the income earned from temporary investment of specific borrowed funds while the project is in the stage of construction is to be adjusted with the borrowing

costs to be capitalised with the qualifying assets only in case the funds are borrowed specifically for qualifying assets. Since in the extant case, the company is receiving borrowed funds from ABC/Government for specific capital projects, the funds can be considered to be specific borrowed funds. Therefore, the Committee is of the view that if the projects undertaken under RAPDRP scheme or the assets coming into existence therefrom can be considered as qualifying assets under AS 16, income earned from temporary investments of the borrowed funds during the construction period should be set-off against the borrowing costs to be capitalised with the qualifying assets as per the principles of AS 16.

18. With regard to interest income earned on advance to contractors, the Committee notes from the Facts of the Case and the extracts of the RAPDRP scheme provided by the querist that two types of advances (mobilisation advance and material advance) have been provided by the company to the contractor. One advance payment, which is 70 percent of the contract price appears to be given for purchase of materials by the contractor and the other 10 percent payment is being made at the beginning of the contract after receipt of an irrevocable advance payment security for the equivalent amount in favour of the company. Thus, from the facts of the case, it appears that the advances in the extant case are incidental to construction activity of the project and are an integral part of the contract with contractors and therefore, the Committee is of the view that interest earned thereon can be considered to be arising from activities that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its working condition for its intended use. In this regard, the Committee notes that as per the requirements of Accounting Standard (AS) 10, 'Accounting for Fixed Assets'[2], notified under the Companies (Accounting Standards) Rules, 2006, only those items of costs which are directly attributable to bringing the fixed asset to its working condition can be included in the cost of the asset. The Committee is of the view that the same principles can also be extended in respect of an item of income arising during the acquisition/construction of a fixed asset/project. Thus, only those items of income arising from the activities would go on to reduce the fixed asset/project cost, that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its

[2] Accounting Standard (AS) 10, 'Accounting for Fixed Assets', has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

working condition for its intended use. Accordingly, interest earned on the advances out of the borrowed funds in the extant case should be adjusted against the cost of the relevant fixed asset/project, to the extent of interest expense capitalised.

19. In other cases, viz., when the project/asset(s) under RAPDRP scheme cannot be considered as qualifying asset(s) or where funds are received as equity or as grant, considering the above-reproduced requirements of AS 16 and since there is no other specific requirement in any other accounting standard for adjusting such interest income with the cost of the project/fixed asset(s), the Committee is of the view that such income from temporary investment of the these funds cannot be adjusted against the cost of the project/fixed asset(s) and should be recognised in the statement of profit and loss.

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

> *"c. Materiality*
>
> Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."

21. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If an information is not material, on the consideration of materiality as mentioned in the paragraph 20 above, its accounting would not have any effect on the decisions of the users of the financial statements. Thus, assessment of materiality is a matter of judgement and needs to be determined under the specific facts and circumstances of the company concerned. Accordingly, in the extant case also, the Committee is of the view that it needs to be determined under the specific facts and circumstances of the company as to whether interest income (earned on investment as well as earned on advances), if not accounted for appropriately, can influence the decisions of the users of the financial statements. For this purpose, apart from the volume

of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered. Moreover, materiality concept should be seen in totality.

D. Opinion

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

(i) (a) If the projects undertaken under RAPDRP scheme or the assets coming into existence therefrom can be considered as qualifying assets under AS 16, income earned during the construction period from temporary investments of the borrowed funds in the extant case should be set-off against the borrowing costs to be capitalised with the qualifying assets as per the principles of AS 16. Further, with regard to interest income earned on advances to contractors out of the borrowed funds, the same in the extant case can be adjusted against the cost of the project/fixed asset, to the extent of interest expense capitalised, as discussed in paragraph 18 above.

(b) In case the funds are borrowed for non-qualifying assets, or if the funds were received as equity funds/grant, the interest earned on the temporary investment of such funds cannot be adjusted against the cost of the project/fixed asset(s) and should be recognized in the statement of profit and loss, as discussed in paragraph 19 above.

(ii) The aforesaid opinion of the Committee would be applicable only if the amounts involved are material and the considerations of materiality should be applied in the specific facts and circumstances of the company. For this purpose, apart from the volume of transactions and quantum of turnover, other factors such as nature of the item, impact on profit/loss etc., should also be considered, as discussed in paragraphs 20 and 21 above.

Query No. 18

Subject: Forfeiture of bank guarantees of contractors.[1]

A. Facts of the Case

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

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

3. The Ministry of Power, Government of India has introduced Restructured Accelerated Power Development and Reforms Programme (RAPDRP) scheme during 11th five year plan as central sector scheme. ABC Corporation has been made nodal agency to operationalise the programme under the guidance of Ministry of Power. For implementation of the approved projects, funds are provided as a loan for the works within the scope of scheme from the Government of India on the terms decided by the Ministry of Finance. Accordingly, the company is receiving funds from ABC Corporation for executing the above capital projects. The querist has separately informed that in the process of tendering of contract, the contractor has to submit two types of securities:

- Bid security commonly known as earnest money deposit. This security shall be forfeited by the company if the contractor fails to accept the allotted work or in other specified circumstances including failure of the bidder to furnish performance security. The company releases this security upon signing of agreement and submission of performance security.
- Performance security for satisfactory execution of work. This

[1] Opinion finalised by the Committee on 26.10.2016.

security shall be forfeited by the company on the breach of condition of contract during the execution of work.

4. The querist has submitted that the company awarded one tender under RAPDRP Scheme to M/s A Infrapower for execution of some capital work but they denied to provide requisite performance guarantee to the company. Accordingly, the company forfeited the bank guarantee (BG) submitted by the firm as earnest money deposit (EMD) and accounted for it as income. The querist has separately informed that in this case, letter of award was issued to contractor to take up the works after selection of contractor in the tendering procedure. M/s A Infrapower had denied to provide requisite performance guarantee and accordingly, the company has forfeited bank guarantee submitted as EMD. Hence, the company is of the view that since no work is executed by the contractor and security is forfeited at the tendering level itself, the question of adjustment with the cost of work does not arise. Accordingly, the company accounted for the said receipt as other income.

5. The querist has further submitted that the company awarded another tender under RAPDRP Scheme to M/s B for execution of some capital work. The firm has also drawn mobilisation advance from the company and subsequently, they expressed inability to execute the aforesaid work. Accordingly, the company forfeited the BG submitted by firm and after adjusting the amount of mobilization advance, remaining amount has been treated as other income. The querist has separately informed that in this case, after signing of the agreement for work, contractor has drawn mobilisation advance amounting to Rs. 9.29 crore but the work was not executed. M/s B subsequently expressed inability to execute the work. Accordingly, the company forfeited 'Performance Security' amounting to Rs. 19.37 crore. The company, after adjustment of advance of Rs. 9.68 crore, accounted for Rs. 9.69 crore as income. In this case also, there was no work executed by the contractor. Since these receipts arise because of inefficiency on the part of the contractor, i.e., delay in completion of contracts and supply of materials or non-completion of work at all, relying upon the earlier opinions of EAC on the similar matters, the company has accounted for this receipt as income in the accounts of the company.

6. In both the above cases, the company earned total Rs. 21.24 crore towards encashment of bank guarantees due to default of contractors in execution of RAPDRP capital works. Since the amount earned was in connection with RAPDRP works, the company credited this amount to RAPDRP bank account by treating it as its other income.

7. The querist has also provided abstracts of the relevant terms of the tender document which are as follows:

"19. Bid Security

19.1 Unless otherwise specified in the BDS, the Bidder shall furnish as part of its bid, a bid security in original form and in the amount and currency as specified in the BDS.

19.2 The bid security shall be a demand guarantee, at the Bidder's option, in any of the following forms:

(a) an unconditional bank guarantee; or

(b) an irrevocable letter of credit; or

(c) a banker's cheque from a reputable source.

The bid security shall be submitted either using the bid security form included in Section 4 (Bidding Forms), in the case of a bank guarantee, or in another substantially similar format approved by the Employer prior to bid submission. In either case, the form must include the complete name of the Bidder. The bid security shall be valid for twenty-eight days (28) beyond the original validity period of the bid, or beyond any period of extension if requested under ITB 18.2.

19.3 Any bid not complying with ITB 19.1 and ITB 19.2, shall be rejected by the Employer as non-responsive.

19.4 The bid security of unsuccessful Bidders shall be returned as promptly as possible upon the successful Bidder's furnishing of the performance security pursuant to ITB 40.

19.5 The bid security of the successful Bidder shall be returned as promptly as possible once the successful Bidder has signed the Contract and furnished the required performance security.

19.6 The bid security may be forfeited or the bid securing declaration executed:

(a) if a Bidder withdraws its bid during the period of bid validity specified by the Bidder on the Letter of Bid Form, except as provided in ITB18.2 or

(b) if the successful Bidder fails to:

(i) sign the Contract in accordance with ITB 39; or

(ii) furnish a performance security in accordance with ITB 40."

8. The querist has referred to paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets',[2] issued by the Institute of Chartered Accountants of India (ICAI), which provides as follows:

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

9. Due to above treatment, the company is of the view that the amount of forfeiture of bank guarantee/ liquidated damages recovered from the contractors or suppliers, are not directly attributable, like rebates and trade discounts, to acquisition of asset. They can also not be regarded as price adjustments. Such damages result from inefficiency on the part of the contractor/supplier, i.e., delay in completion of works contracts and supply of materials or non-completion of work at all, as the case may be. Therefore, such claims received from the contractors/suppliers cannot be adjusted in the cost of the assets.

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[2] AS 10 has been subsequently revised as AS 10, 'Property Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364 (E) dated 30.03.2016.

10. The querist has also referred to paragraph 6 of an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), finalised on 3rd February, 1994 (published as Query No. 1.15 of Volume XIII of the Compendium of Opinions) on the same subject matter which is reproduced as under:

> "6. On the basis of the above, the Committee is of the opinion that the accounting policy of the company with regard to the liquidated damages/ penalties recovered/recoverable from the contractors or suppliers, as stated at para 2 of the query, is not correct. Such damages/penalties should be shown as income separately, in the profit and loss account, and not be adjusted in the cost of the relevant asset or repairs and maintenance or raw materials account. However, if the amount of such damages/penalties is not material, it can be shown as a part of miscellaneous income. Insofar as the timing of the recognition of such damages/penalties in accounts is concerned, these should be recognised when the following conditions are satisfied, namely-
>
> (i) The amount of such damages/penalties, is reasonably measurable; and
>
> (ii) It is not unreasonable to expect its ultimate collection."

11. The querist has submitted that the facts and grounds of the above opinion are similar with the company and in present case, the bank guarantee is forfeited only because of inefficiency on the part of the contractor for non-execution of work.

12. However, while conducting audit of annual accounts of the company for the financial year 2013-14, the government auditor (CAG auditor) observed that as the company has incurred extra expenditure on the scheme by awarding of work at higher cost. Hence, any income realised should be adjusted against the project cost instead of treating as income. This has resulted in overstatement of capital work in progress (CWIP) and understatement of loss by the same amount.

13. Auditor was requested to consider the above opinion of the Expert Advisory Committee of the ICAI on same subject matter but it was not considered by them.

14. The querist has also stated that as per general instruction no. 3 to the Companies (Accounting Standards) Rules, 2006, the Accounting Standards are intended to apply only to items which are material.

B. Query

15. In light of the above facts and earlier EAC opinion, the Committee is requested to provide the opinion on the following issues:

(i) Accounting treatment of forfeiture of bank guarantees of contractors.

(ii) As stated above, the amount of bank guarantee is Rs. 21.24 crore as against the total turnover of the company Rs. 6956 crore. Therefore, in the light of principle of materiality, whether the treatment given by the company in its books of account is correct or not.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised relates to accounting treatment of forfeiture/invoking of bank guarantees of contractors. The Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, classification and presentation of forfeited/invoked bank guarantee as 'revenue' or 'other income', etc. Further, the Committee wishes to point out that its opinion is expressed considering the specific facts of the two cases referred by the querist and may not be relevant for other similar situations. The Committee further wishes to point out that its opinion is expressed purely from accounting perspective and not from any legal perspective. The Committee has presumed from the Facts of the Case that forfeited/invoked bank guarantees are not under dispute/arbitration. Further, the Committee wishes to point out that since the query refers to the financial year 2013-14, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

17. The Committee notes that in the extant case, there have been two cases of forfeiture/invoking of bank guarantees. In one case, the company

awarded one tender under RAPDRP Scheme to M/s A Infrapower for execution of some capital work but it denied to provide requisite performance guarantee to the company and, accordingly, the company forfeited/invoked the bank guarantee (BG) submitted by the contractor as EMD. In other case, the company awarded another tender under RAPDRP Scheme to M/s B for execution of some capital work. The firm has also drawn mobilisation advance from the company but the work was not executed. Subsequently, the contractor expressed inability to execute the aforesaid work. Accordingly, the company forfeited/invoked the bank guarantee submitted by the contractor after adjusting the amount of mobilisation advance. Further, the Committee notes that in both the cases, there was no work executed by the contractors. Now, the question that has been raised relates to accounting for such forfeiture/invoking of bank guarantees.

18. With regard to the issue raised, the Committee notes the following definition of the term 'income' as per paragraph 69(a) and paragraphs 91 and 92 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

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

> "91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

> 92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty."

From the above, the Committee notes that an increase in future economic benefits related to an increase in asset which can be measured reliably should be recognised as income in the statement of profit and loss. In this regard, the Committee notes from the Facts of the Case that in both the cases referred above, the contractors have either denied to provide requisite performance guarantee or expressed inability to execute work and therefore, the company has forfeited/invoked the bank guarantee which has resulted in inflow of economic benefits/resources (viz., increase in cash/bank balance) and therefore, the same should be recognised as income.

19. With regard to the issue as to whether such income can be adjusted against the cost of the project/asset(s) arising from the project, the Committee notes that paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies' states that ***"All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."*** Thus, any item of income can be adjusted against the cost of the fixed asset/project only when an Accounting Standard requires the same. In this regard, the Committee notes that there is no specific requirement in any Accounting Standard for adjusting such income against cost of the project/asset(s). The Committee further notes that income in the extant case results from forfeiture/invoking and cancellation of certain contracts on which the contract work had not even started. Thus, the income from forfeiture/invoking in the extant case is of the nature of a penalty on the contractors due to non-fulfillment of the tender/contract conditions. Moreover, in the extant case, the forfeiture is not intended to be a compensation for additional costs, if any, incurred on the project. These are received due to cancellation of the contract and do not have any nexus with extra costs that may result for the company due to cancellation of the contract. Accordingly, the Committee is of the view that income arising from forfeited/invoked bank guarantees cannot be adjusted against the cost of the asset/project; rather, the same should be recognised in the statement of profit and loss.

20. With regard to the issue raised by the querist in relation to materiality aspect of the interest income, the Committee notes that paragraph 4.3 of the Preface to the Statements of Accounting Standards, issued by Institute of Chartered Accountants of India, states, inter alia, that "The Accounting

Standards are intended to apply only to items which are material". The Committee further notes that paragraph 17(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', explains 'materiality' as below:

> *"c. Materiality*
>
> Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."

21. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If an information is not material, on the consideration of materiality as mentioned in the paragraph 20 above, its accounting would not have any effect on the decisions of the users of the financial statements. Thus, assessment of materiality is a matter of judgement and needs to be determined under the specific facts and circumstances of the company concerned. Accordingly, in the extant case also, the Committee is of the view that it needs to be determined under the specific facts and circumstances of the company as to whether income arising out of bank guarantees forfeited/invoked, if not accounted for appropriately, can influence the decisions of the users of the financial statements. For this purpose, apart from the volume of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered. Moreover, materiality concept should be seen in totality.

D. Opinion

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

(i) Income arising from forfeited/invoked bank guarantees cannot be adjusted against the cost of the asset/project; rather, the same should be recognised in the statement of profit and loss, as discussed in paragraph 19 above.

(ii) The treatment made by the company is correct. However, considerations of materiality should be applied based on the specific facts and circumstances in the given case, i.e., as to whether income arising out of bank guarantees forfeited/invoked,

can influence the decisions of the users of the financial statements, as discussed in paragraphs 20 and 21 above. For this purpose, apart from the volume of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered.

Query No. 19

Subject: (i) Accounting treatment of base stock; and
(ii) Valuation of inventory booked by the customers.[1]

A. Facts of the Case

1. A company is engaged in manufacturing of contract material made of silver and silver alloy for low voltage electrical switchgear industry. Silver is a basic raw-material and silver content in parts / components generally varies from 70% to 100%.

2. The querist has stated that two processes are involved for the manufacturing:

(i) *Melting:* Silver is melted with copper or nickel or cadmium, casted in the form of billet or plate. In case of billet, it is hot extruded in required shape, strip or wire and components are punched / headed. In case of plate, first all 6 sides machined, thereafter hot rolled, annealed and cold rolled in required thickness and thereafter components are punched.

(ii) *Powder Metallurgy:* Silver powder is made by atomisation, chemical reduction or by cementation. Subsequently, powder is mixed with the tungsten, nickel, cadmium oxide or tin oxide in required ratio as per the requirement. The billet is pressed,

[1] Opinion finalised by the Committee on 20.12.2016.

sintered, extruded in the form of strip or wire and subsequently, components are punched or formed as per requirement.

3. There are 20 to 30 operations to make components of silver or silver alloy right from melting to finished product and at every stage, silver scrap is generated which goes into recycling. In the whole process of manufacturing, out of average 4 kg silver, the company gets 1 kg finished product and balance 3 kg silver goes back into refining. According to the querist, on an average, the company has 7500 kg of silver in stock. Out of this, 3500 kg silver always remains on the shop floor; it is fixed stock remaining on the shop floor at all the time and cannot be reduced; it remains as a permanent inventory.

4. The querist has stated that silver price is fluctuating and hence, few customers of the company book silver in advance, which is the principal raw material for the finished goods at an agreed price and whenever the product is ready, the company bills such customer based on the silver price booked by them *plus* other material and manufacturing costs.

5. Accounting policy for inventory valuation of the company is as under:

"Consumable tools, raw material, packing material, work in progress, finished goods and stores & spares have been valued at lower of cost and net realisable value. Cost of finished goods and work-in-progress has been ascertained at estimated cost. Cost of raw material has been ascertained on weighted average cost basis. Cost of other inventories has been ascertained on First-In-First-Out method (FIFO). Silver booked by customers for their process work has been valued at the rates at which the same is booked by them. Scrap is valued at Net Realisable Value."

6. The querist has further stated that at present, the company is valuing at cost or net realisable value (NRV) whichever is lower. Further, in case of silver booked by customer, the company is valuing inventory at booked price of silver by customer. At present, the company has identified four stages of production and estimated related cost at each stage for the purpose of valuation is as under:

Stage (i) – Rs. 100/-

Stage (ii) – Rs. 400/-

Stage (iii) – Rs. 900/-

Stage (iv) – Rs. 1200/-

7. The querist has separately clarified that the company gets an order from customer, for example, silver quantity 220 kgs for supply of electric contacts over a period of time and customer fixes the silver price prevailing on the same day on London Metal Exchange (LME) basis, for example, say at Rs. 41,000 per kg, and pay money in a day or two for that much of quantity of silver; in this example, 220 kgs * Rs. 41,000 = Rs. 90.20 lacs. The company buys silver within a day or two depending upon the availability of silver in the market and the company has to buy a lot, may be 300 kg or may be 500 kg, on that day's LME price basis, for example, say at Rs. 40,000 per kg or at Rs. 42,000 per kg. Thus, the company's purchase price may vary because of fluctuation in market but for all purposes, the customer's price is fixed and the company supplies the electric contacts to the customer over a period of time at the same price.

8. As the principal raw material of the company is silver, hence at various stages, silver is being consumed and the valuation is done based on the cost of silver or net realisable value (NRV) whichever is lower plus the related cost attached to that stage for cases where silver is not booked in advance. In case, where silver is booked in advance, valuation is done at booked price of silver plus the related cost attached to that stage.

9. According to the querist, there is a wide fluctuation in the silver price which impacts the valuation heavily. The management is of the view that due to fluctuation of silver price, ranging between Rs. 5,000/- per kg to Rs. 10,000/- per kg, the business performance is never reflected properly and is heavily influenced by this fluctuation in silver price. Further, it affects the balance sheet every quarter sometimes positive and sometimes negative and it is not a true reflection of our business. The shareholder of the company considers the company as a commodity company whereas in reality, the company is precious engineering company engaged in manufacturing of high technology critical components for Original Equipment Manufacturers (OEMs).

B. Query

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

(i) Whether silver booked by the customer for their process work can be valued at the rate at which the same is booked by them.

(ii) Whether the company should value raw material, i.e., base stock of 3500 kg of silver at cost which will remain unchanged instead of present valuation of lower of cost and net realisable value.

or

Whether 3500 kg of silver which normally remains in cycle of production can be considered as part of plant and machinery and capitalised instead of present valuation of lower of cost and net realisable value.

C. Points considered by the Committee

11. The Committee notes that the basic issues raised in the query relate to valuation of silver (main raw material of the finished product) booked by the customers; and accounting treatment of base stock of 3500 kg of silver as inventory or a part of plant and machinery and its valuation. The Committee has, therefore, examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, valuation of other items of inventory and propriety of accounting policy in respect thereof, such as, scrap, consumable tools, packing material, etc., correctness of determination of costs of processing/conversion at various stages, accounting for the forward contracts for advance booking of the silver by the customers, etc. The Committee presumes from the Facts of the Case that the stock of silver booked by the customers is not held by the company on behalf of its customers.

12. For the sake of convenience, at first, the Committee deals with the second issue relating to the treatment of base stock as inventory or a part of plant and machinery. In this regard, the Committee notes the definition of the term 'inventories' as given in Accounting Standard (AS) 2, 'Valuation of Inventories', and the definition of the term 'property, plant and equipment' as given in Accounting Standard (AS) 10 (Revised), 'Property, Plant and Equipment', notified by the Ministry of Corporate Affairs vide Notification dated 30th March, 2016, which are reproduced below:

AS 2

"3.1 <u>Inventories</u> are assets:

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

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

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

AS 10 (Revised)

"<u>Property, plant and equipment</u> 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 a period of twelve months."

13. 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 using it for the purpose of producing or providing goods or services rather than for sale in the normal course of business, 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. The Committee notes from the Facts of the Case that although the base stock of silver of 3500 kg may be essential at all times for uninterrupted production, however, the stock is intended to be used in the process of production for sale of finished goods. Moreover, although the quantity of silver stock may be fixed or constant at all times, the composition of such stock would keep on changing as there would be inflow of new silver stock purchased and outflow of silver issued for further processing. Further, the fixed quantity of stock is not maintained due to any technological requirement of any plant and machinery; rather seems to be due to administrative convenience so that the inventory of silver is always available for use in production process. Accordingly, the Committee is of the view that the base stock of silver is an

inventory as per AS 2 and cannot be considered and recognised as a 'property, plant and equipment'. Therefore, the same should be valued at cost or net realisable value, whichever is lower, as per the requirements of paragraphs 5 and 24 of AS 2 (reproduced in paragraph 14 below).

14. With regard to the valuation of inventory of silver booked by the customers in advance, the Committee notes that silver is a basic raw material in the extant case. Further, the Committee notes the following paragraphs of AS 2:

> "***3.2. 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."***
>
> ***"5. Inventories should be valued at the lower of cost and net realisable value."***
>
> "22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to 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 balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.
>
> 23. 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 inventory is based on general selling prices...
>
> 24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value."

From the above-reproduced paragraph 24 of AS 2, the Committee notes that the materials held for use in the production process should normally be valued at cost unless (i) there has been a decline in the price of materials, and (ii) it is estimated that the cost of the finished product will exceed its net realisable value. If these two conditions are fulfilled, then the materials held should be valued at net realisable value.

15. The Committee notes that in the extant case, valuation of the silver booked by the customers in advance is done at booked price of silver plus the related cost attached to that stage. From this, it appears that such stock of silver is being valued at a value which is different from the cost as the prices at which the silver is booked by the customer would generally be different from the prices at which the same is purchased by the company. Thus, the Committee is of the view that the aforementioned principle of valuation of materials held for use in the production process, as discussed in paragraph 14 above is not being followed by the company and accordingly, the same is not appropriate and in accordance with the requirements of AS 2. In this regard, the Committee wishes to point out that the value at which the stock of silver is booked by the customer would be relevant only for determination of net realisable value of the silver or its finished product. Further, the net realisable value would be considered for the purposes of valuation of the inventory only when there has been a decline in the price of silver, and it is estimated that the cost of the finished product will exceed its net realisable value, as discussed in paragraph 14 above.

D. Opinion

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

(i) No, the silver booked by the customer for their process work should not be valued at the rate at which the same is booked by them, as discussed in paragraphs 14 and 15 above.

(ii) The base stock of silver is an inventory as per AS 2 and cannot be considered and recognised as a 'property, plant and equipment' and therefore, the same should be valued at cost or net realisable value, whichever is lower, as per the requirements of paragraphs 5 and 24 of AS 2, as discussed in paragraph 13 above.

Query No. 20

Subject: Considering capital reserve for calculation of net worth of a company.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the querist company') is a subsidiary company of a 100% Government of Gujarat undertaking, engaged in generation of electricity and having installed capacity of 6394 MW.

2. The querist has submitted the following background and facts with regard to the query raised:

- A Ltd. has submitted a bid in consortium with B Ltd. against 'Request for Qualification (RFQ) for Tender' regarding selection of Mines Developer-cum-Operator (MDO) of Gare Pelma Sector I coal block floated by the company.
- A Ltd. is a wholly owned step–down subsidiary of C Ltd.
- In this connection, A Ltd. filed its net worth certificate based on audited financials of 31st March, 2015. This certificate was filed in connection with the requirement of the RFQ that bidder and each consortium member should have net worth equal to or more than 100% of paid up capital.
- This query highlights key issues in net worth, clarifications submitted by A Ltd. on queries raised by the querist company and financials of A Ltd. for the year ended 31st March, 2011 and 31st March, 2015.

3. The querist has informed that A Ltd. has submitted the following calculation of its net worth:

[1] Opinion finalised by the Committee on 16.1.2017.

Particulars	**Revised Net Worth (AUD million)**
Paid-up Share Capital	5.76
Add : Free Reserves	
— Capital Reserves	409.32
— Accumulated losses	(335.16)
— Misc. Expenditure not written off (w/o)	—
— Deferred Expenditure not w/o	—
Net Worth	**79.92**

The clarification of A Ltd. on 'Capital Reserve' reads as under (Ref: Certificate dated 14th September, 2016):

> "This is attributable to a meeting of creditors of the company convened and held on 24th February, 2011 pursuant to Section 439A of the Companies Act, wherein it was resolved that D Energy Group Pty. Ltd. (Seller) and the company would execute a Deed of Company Arrangement to effect the sale of the company to C Ltd.
>
> The sale to C Ltd. was completed on 28th February, 2011 whereupon all creditor claims against the company was transferred to the Seller, other than certain excluded claims. As per the Deed of Company Arrangement, the creditors' liability of AUD 409.323 million was waived off. This extinguishment of the liabilities was treated as 'Other Comprehensive Income' in the books of the company and the same was captured in the 'Capital Reserve' for the year ending 31st March, 2011."

Besides, A Ltd. has entered into a deed of arrangement separately for this purpose. It should be noted that A Ltd. was transferred by D Energy Group Pty Ltd. to C Limited. Pursuant to the transfer, all creditors of A Ltd. were transferred to the seller, namely, D Energy Group Pty Ltd. except certain excluded claims. These creditors retained by A Ltd. waived off their claims and the same was credited by A Ltd. to 'Capital Reserves'. Such reserve, according to the querist, is also on account of restructuring exercise and therefore, it should not form part of the 'net worth' under the criteria prescribed by RFQ. When this is excluded from 'net worth', then A Ltd. will not have positive net worth computed as under and the 'net worth' criteria does not get fulfilled:

Particulars	**Revised Net Worth (AUD million)**
Paid-up Share Capital	5.76
Add : Free Reserves	
— Capital Reserves	—
— Accumulated losses	(335.16)
— Misc. Expenditure not w/o	—
— Deferred Expenditure not w/o	—
Net Worth	**(329.40)**

4. The querist has stated that 'capital reserve' should not form part of 'net worth'. The querist has invited attention to the fact that the 'net worth' is not supposed to include any reserves arising on account of amalgamation, etc. The 'net worth' definition of RFQ reads as under:

> "Net Worth shall mean as aggregate value of the paid up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not been written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation. Bidder and each consortium member should have net worth equal to or more than 100% of paid up share capital."
>
> The 'net worth' definition as per the Companies Act, 2013 reads as under:
>
>> "Net Worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation."

From this, it is clear that 'net worth' is supposed to include *reserves created out of profits only* (emphasis supplied by the querist). Besides, it should not include reserves created out of amalgamation, restructure, etc. The intention

itself is clear that only earned profits should form part of the 'net worth'. In the present case, A Ltd. has included profits arising on claims waived by creditors. This does not signify income earned by A Ltd.; rather, this projects inefficiency on the part of A Ltd. who is unable to discharge its claims. This signifies that A Ltd. was not earning sufficient profits to repay its claims. 'Net worth' should include earning sufficient profits to repay its claims. 'Net worth' should include profits which are earned by the company and which arose through normal business operations. Besides, the RFQ requires 'net worth' criteria to be fulfilled so as to ascertain strength of the participants. If such 'net worth' would include claims written back by the company, it does not portray strength of A Ltd. but its execution weakness. Therefore, according to the querist, as per definition of 'net worth' as given in the Tender, as per Companies Act, 2013 and as per Indian Accounting Standards, such write back should not form part of the 'net worth' in order to determine eligibility of A Ltd.

5. The querist has further submitted that such write back is accounted as 'Other Comprehensive Income' and then transferred to 'Capital Reserves'. Had it been on revenue account, it should have been accounted as normal profit and loss and should have formed part of 'Reserves' and not 'capital reserves'. Hence, such 'capital reserves' should be excluded from computation of 'net worth'. Net worth is most suggestive whether a company will continue to carry on business or not or will effectively discharge its contractual obligations and this requires the existence of genuine and real business profit and not anything arisen out of such adjustment or some waiver of liabilities which may pertain to even capital items and which are not recurring business profit earned out of the business activities.

6. The querist has also raised concerns about doubtful 'Going Concern' of A Ltd. It should be noted that A Ltd. is continuously making losses. Considering this, statutory auditor of A Ltd. has disclosed following in the audit report of A Ltd. for the year ended 31st March, 2015:

> *"Without qualifying our opinion, we draw attention on Note 2 in the financial report which indicates that the consolidated entity incurred a net loss of $25.13 million during the year ended 31st March 2015 and, as of that date, the Company's current liabilities exceeded its current assets by $36.26 million. These conditions, along with other matters as set forth in Note 2, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue*

as a going concern and therefore, the Company may be unable to realize its assets and discharge its liabilities in the normal course of business, and at the amounts stated in the financial report".

This, according to the querist, casts significant doubt on sustainability of A Ltd. Further, the querist has also drawn attention to the financial position of C Group of which A Ltd. is a part. The following table summarises consolidated financial position of the C Group:

Rs. (in crores)

As on 31st March / **Particulars**	**2012**	**2013**	**2014**	**2015**
Share Capital	238.97	239.24	239.24	245.09
Reserves and Surplus	4467.09	3433.22	1218.30	(692.86)
Net Worth	**4706.05**	**3672.46**	**1457.54**	**(447.77)**

7. From this, as per the querist, it may be appreciated that even the group does not appear to be in a position to support the going concern status of A Ltd. Also in the annual report of C Group, the financial data of A Ltd. is shown as under:

Rs. (in crores)

As on 31st March / **Particulars**	**2012**	**2013**	**2014**	**2015**
Net Profit/(Loss)	(282.90)	(391.20)	(714.00)	(946.00)

Considering this also, the bid should not be accepted. From the data which are available in the published balance sheet, it is absolutely clear that at a group level, there is a negative net worth and at individual level, the auditors have clarified in very clear terms which is stated hereinabove. The auditors have emphatically stated that the company (A Ltd.) will not be able to carry on the business if it is not supported by the group parent company. When this statement is read together with the group position as on 31st March, 2015, it becomes clear that because of the negative net worth, even at the group level, the group will not be able to support and the entire business may come to a standstill. This will adversely affect the ability to carry on the business. The auditors' observations, according to the querist, are very serious so far as the ability to carry on the business is concerned.

B. Query

8. Considering the above-mentioned facts and as per definition of net worth provided in RFQ document in the opinion of the querist, net worth of A Ltd. for the financial year ended 31st March, 2015 is negative, i.e., 329.40 AUD million. In view of the above, it is requested by the querist to give opinion whether contention of not considering capital reserve (created as above) for calculation of net worth of a company is appropriate in the light of Indian Generally Accepted Accounting Principles (GAAPs) and accounting concepts.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that A Ltd. has submitted a bid in consortium with B Ltd. against request for qualification (RFQ) for tender by the querist company. For this purpose, A Ltd. has filed its net worth certificate based on audited financials for 31st March, 2015 which includes capital reserve which was created as a result of waiver of certain creditors. The querist company is of the view that such reserve should not be included in calculation of net worth. In this background, the issue that has been raised is whether contention of not considering capital reserve (created as above) for calculation of net worth of the company (A Ltd.) is appropriate in the light of Indian GAAPs and accounting concepts. 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 treating extinguishment of the liabilities as 'other comprehensive income' and then transfer it to 'capital reserve' is in accordance with the applicable Indian GAAPs or not, whether bid should be accepted or not, whether capital reserve can be considered and classified as free reserve, etc. Further, the Committee notes that the concerns have been raised in the Facts of the Case over the doubtful going concern of A Ltd., however, the financial statements of A Ltd. are apparently prepared on the basis of going concern assumption. Accordingly, the Committee has examined the issue on the basis of existing financial statements that have been prepared and not on the basis of financial statements that may be prepared, considering the going concern assumption in the extant case to be inappropriate. Further, the Committee presumes that items appearing in the financials of A Ltd., as provided in the Facts of the Case have been accounted for/reported considering the requirements of Indian GAAPs, although the figures for these items have been expressed in AUD currency and not in INR. The Committee also wishes to point out that the opinion expressed hereinafter is

purely from the perspective of accounting principles, viz., Indian GAAPs and not from legal perspective, such as, interpretation of the terms of RFQ for Tender or Indian Companies Act, 2013, etc. or bidding perspective. Further, the Committee wishes to point out that net worth may be defined by different authorities/regulators for different purposes and, accordingly, the term defined for one purpose may not be relevant for other purpose.

10. At the outset, the Committee notes the definition of the following terms from the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India (ICAI):

> **"11.01 Net Assets**
>
> The excess of the *book value of assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds**."
>
> "**11.08 Net Worth**
>
> See **Net Assets**"

From the above, the Committee notes that the term, 'net worth' has been defined in terms of net assets which is excess of the book value of assets over liabilities. Thus, it does not exclude any kind of reserve – capital reserve or reserve created out of restructuring/amalgamation. Accordingly, the Committee is of the view that purely from accounting perspective, net worth includes all reserves, whether capital or revenue. However, the Committee wishes to point out that whether a particular item (for example, capital reserve) is to be included or not in net worth would depend on the purpose for which such net worth is being computed, for instance, from the Companies Act, 2013 perspective, some specific reserves are excluded from the definition of net worth. Similarly, for bidding purposes, the net worth may be defined by an entity considering the purpose for which it is to be used.

D. Opinion

11. On the basis of the above and without examining the issue from legal perspective, such as, interpretation of the terms of RFQ for Tender or Indian Companies Act, 2013, etc., as discussed in paragraph 9 above, the Committee is of the view that purely from accounting perspective, net worth should include capital reserve, as discussed in paragraph 10 above.

Query No. 21

Subject: Accounting treatment of release of funds by Project Implementation Trust Fund.[1]

A. Facts of the Case

1. The Government of India (GoI) is currently developing a Dedicated Freight Corridor (DFC) between Delhi and Mumbai, covering an overall length of 1483km. The DFC passes through the states of Uttar Pradesh, Delhi, Haryana, Rajasthan, Gujarat and Maharashtra, with the end terminals located at Dadri near Delhi and Jawaharlal Nehru Port in Mumbai. The Dedicated Freight Corridor is envisaged to offer high-speed connectivity for high axle load wagons (25 tonne) of double stacked container trains supported by high power locomotives.

2. In parallel, the Government of India is developing an Industrial Corridor, as a global manufacturing and investment destination utilising the high capacity DFC between Delhi and Mumbai, as the backbone. In essence, the Industrial Corridor project is aimed at the development of futuristic industrial cities in India which can compete with the best manufacturing and investment destinations in the world.

3. The Industrial Corridor project was conceived as a symbol of Indo-Japan strategic partnership during the visit of the Hon'ble Prime Minister of India to Tokyo in December, 2006. A Memorandum of Understanding (MOU) was signed between Ministry of Commerce & Industry (MoC&I), Government of India and the Ministry of Economy, Trade and Industry (METI), Government of Japan on this occasion to promote Japanese investments in India and explore opportunities for mutual cooperation as part of Special Economic Partnership Initiatives (SEPI) under the Common Economic Partnership Agreement (CEPA) to be reached between India and Japan. The Government of India had approved the development of Industrial Corridor project on 16th August, 2007. Subsequently, institutional and financial structure and financial assistance for the Industrial Corridor project was approved by the Government of India in September 2011.

4. Industrial Corridor region covers parts of Uttar Pradesh, Haryana, Rajasthan, Gujarat, Madhya Pradesh and Maharashtra besides the National Capital Territory of Delhi. Initially, 7 nodes have been taken up for

[1] Opinion finalised by the Committee on 16.1.2017.

development as industrial cities in the first phase. These are a combination of brownfield and greenfield areas identified by the respective State Governments based on the availability of land, water and other parameters as listed below:

- Ahmedabad-Dholera Investment Region, Gujarat (903 sq. kms.);
- Shendra-Bidkin Industrial Park, Aurangabad, Maharashtra (84 sq. kms.);
- Manesar-Bawal Investment Region, Haryana (402 sq. kms.);
- Khushkhera-Bhiwadi-Neemrana Investment Region, Rajasthan (160 sq. kms.);
- Jodhpur-Pali-Marwar Industrial Area, Rajasthan (155 sq. kms.);
- Pithampur-Dhar-Mhow Investment Region, Madhya Pradesh (372 sq. kms.);
- Dadri-Noida-Ghaziabad Investment Region, Uttar Pradesh (218 sq. kms.); and
- Dighi Port Industrial Area, Maharashtra (253 sq. kms.)

5. A special purpose vehicle (SPV), XYZ Corporation Limited was incorporated in January 2008 as the project development agency for Industrial Corridor project. XYZ Corporation Limited's mandate is to act as project development agency and be the catalyst for development and implementation of the Industrial Corridor project in the respective States. Presently, the total paid up capital of the company is Rs. 100.00 crore being Government of India (49%), Japan Bank of International Corporation (26%), Housing and Urban Development Corporation (19.9%) as its major shareholders.

6. *Financial and institutional structure:* As per the financial and institutional structure of Industrial Corridor project approved by the Cabinet Committee on Economic Affairs (CCEA) on 15th September, 2011, a corpus in the name of Industrial Corridor Project Implementation Fund was created by the Government of India, based on an average requirement of Rs. 2500 crore per city, for the development of industrial cities. As per the structure approved, the corpus of the Fund / Trust will be Rs. 17,500 crore and the entire corpus will be utilised based on the progress made for each city, subject to a ceiling of Rs. 3,000 crore per city from the GoI grant. An

additional grant of Rs. 1,000 crore would be given to the Fund/Trust for passing on to XYZ Corporation Limited as grant-in-aid over the next five years to carry out project development activities and to form project specific SPVs and sectoral holding companies consisting of project specific SPVs in the range of infrastructure areas. The Government of India's contribution to the Fund/Trust would be used as a *Revolving Corpus.* It has also been approved that each Industrial Corridor city is to be implemented by a special purpose vehicle set up as a joint venture between the Central Government represented through the Fund / Trust and the respective State Government. The equity in node/ city level SPVs and in these project specific SPVs and holding companies will be held by the Fund/ Trust. (Emphasis supplied by the querist.)

7. The Fund/Trust will be administered by a Board of Trustees chaired by Secretary, Department of Economic Affairs and will comprise the Secretary, Department of Industrial Policy and Promotion (DIPP), Financial Advisor (DIPP), representatives of the Department of Expenditure, Planning Commission, and Chief Executive Officer (CEO) & Managing Director (MD), XYZ Corporation Limited, who will also be the CEO of the Fund/ Trust. The Corpus of the Trust would be used for:

(a) Providing equity and/ or debt to the nodal/ city level SPVs for development of non-PPP infrastructure and for investment in project specific SPVs that may be set up by a node/ city level SPV;

(b) Providing equity and/or debt to other project specific SPVs and sectoral holding companies consisting of project specific SPVs; and

(c) Providing grant to XYZ Corporation Limited for project development.

Further, as per the same approval, XYZ Corporation Limited will get perspective plans and master plans prepared and will identify and develop projects and arrange for professional inputs for risk management, project structuring, project appraisal, preparation of Expression of Interest/ Request for Proposal/ bid documents etc., evaluation of bids, bid process management and project management. It will undertake due diligence and analyse, examine and appraise proposals and assist the Fund/ Trust in monitoring all projects. XYZ Corporation Limited will act as the project development partner

or knowledge partner to all SPVs and state government agencies for the implementation of these industrial cities. It will bring in the vision of a state-of-the-art, world-class city at each node and assist each SPV in translating the vision to reality through identification of projects, undertaking project preparatory activities like preliminary project reports, feasibility studies, preparation of detailed project reports (DPRs), development of projects, bidding out projects for private participation and providing assistance to SPVs for:

(a) putting in place suitable risk management measures like tying up/ procurement of land, linkages (water, power, transport, gas, etc.) including land procurement from State Governments for strategic projects and projects cutting across the Industrial Corridor states/ region like power plants, water supply, transportation, logistics parks, exhibition cum convention centres etc. which are being directly driven by XYZ Corporation Limited to achieve early implementation to induce growth at the Industrial Corridor cities;

(b) legal vetting of documents and obtaining requisite approvals from competent authorities;

(c) finalising commercial arrangements like off-take agreements / Power Purchase Agreements, etc.; and

(d) obtaining viability gap support from State and Central Government.

The querist has supplied the relevant extracts of the Cabinet Note on the Financial and Institutional Structure of Industrial Corridor project for the perusal of the Committee. (Emphasis supplied by the querist.)

8. Industrial Corridor Project Implementation Trust Fund was created through the execution of the Trust Deed on 27th September, 2012 with the initial corpus of Rs. 312.40 crore and an additional grant of Rs. 99 crore for passing on to XYZ Corporation Limited as grant-in-aid to carry out project development activities and to form project specific SPVs and sectoral holding companies consisting of project specific SPVs in a range of infrastructure areas. The querist has supplied a copy of the Trust Deed of Industrial Corridor Trust for the perusal of the Committee.

9. ABC Model Solar Power project was conceived by the Government of India in partnership with the Government of Japan. A Memorandum of Understanding (MoU) was executed among New Energy and Industrial Technology Development Organisation (NEDO) Japan; Department of Economic Affairs, Ministry of Finance, Government of India; Ministry of New and Renewable Energy, Government of India; and XYZ Corporation Limited on 30th April, 2012. Under the terms of the MoU, the Government of Japan will provide various equipment to the project in the form of grant. Besides, the project was structured in a manner so as to ensure a partnership between the Government of India (in the form of funding and implementing agency) and the Government of Japan (for supplying the technology and equipment). The querist has supplied a copy of the MOU for the perusal of the Committee.

10. The investment proposal for the project was placed before the Board of Trustees of Industrial Corridor Trust for their consideration and approval. The Board considered that since the project was based on grant from NEDO, Government of Japan and the entire project development activities have been undertaken by XYZ Corporation Limited, the same may be implemented through a 100% SPV of XYZ Corporation Limited so that the upsides, if any may flow back to the Revolving Fund of Industrial Corridor Trust. The proposal for the formation of SPV for the implementation and operation of the Model Solar Power Project to be incorporated as a 100% subsidiary of XYZ Corporation Limited, was approved by the Cabinet Committee on Economic Affairs (CCEA) as an exception. It was also approved that a sum of Rs. 13 crore required for subscription to the equity of a 100% subsidiary of XYZ Corporation Limited as well as Rs. 22.34 crore as debt to the SPV will be released by the Industrial Corridor Trust and the upsides from such investment will flow back to the Industrial Corridor Trust. (The querist has provided the relevant extracts of the Cabinet Note for the perusal of the Committee.) Accordingly, the project SPV in the name of XYZ-ABC Project Corporation Limited was incorporated on 18th March, 2014. An amount of Rs. 13.00 crore was transferred from Industrial Corridor Trust to XYZ Corporation Limited out of the corpus of Rs. 17,500 crore and on the same day, the amount was released by XYZ Corporation Limited towards subscription amount to XYZ-ABC Project Corporation Limited. Appropriate modification was carried out in the Shareholder's Agreement of XYZ Corporation Ltd. and no objection was obtained from all the shareholders of XYZ Corporation Limited so that for any upsides from XYZ-ABC Project Corporation Limited to XYZ Corporation Limited, the shareholders may not raise claim and the same can flow back to the corpus of the Industrial

Corridor Trust. The querist has separately informed that such upsides include dividend and surplus from XYZ-ABC Project Corporation Limited as well as recovery of investments on liquidation/cessation of operations of the company. (The querist has provided relevant extracts of minutes of the meeting of Board of Directors of XYZ Corporation Limited, approving the amendments in the Shareholder's Agreement as well as in Articles of Association). The querist has also informed that under normal circumstances, the funds provided by Trust as per approval of the Cabinet Committee in respect of investment in XYZ-ABC Project Corporation Limited to XYZ Corporation Limited and which have been utilised accordingly for making investment in XYZ-ABC Project Corporation Limited, are not refundable except when XYZ-ABC Project Corporation Limited goes into liquidation, the proceeds therefrom together with the balance of interest, dividend and any other income lying with XYZ Corporation Limited on account of XYZ-ABC Project Corporation Limited will become refundable to the Trust and XYZ Corporation Limited or its shareholders will not have any claim.

11. *Accounting Treatment*

A. In the books of account of Industrial Corridor Project Implementation Trust Fund:

The amount of Rs. 13.00 crore was released to XYZ Corporation Limited for onward investment in the equity shares of XYZ-ABC Project Corporation Limited. The amount was released out of corpus of Industrial Corridor Trust.

The same was shown as a deduction from the corpus of the Industrial Corridor Trust accompanied by a clarificatory note in the financial statements of Industrial Corridor Trust.

The querist has supplied a copy of the audited financial statements of Industrial Corridor Trust for the financial years 2013-14 and 2014-15 for the perusal of the Committee.

B. In the books of account of XYZ Corporation Limited:

The amount of Rs. 13.00 crore received out of corpus of Industrial Corridor Trust was recorded as 'Project Implementation Funds' under 'Capital Reserves' as Reserves and Surplus of the company as per Accounting Standard (AS) 12, 'Accounting for Government Grants'.

The investment in shares of XYZ-ABC Project Corporation Limited is shown under investments under Non-Current Assets in the financial statements of XYZ Corporation Limited.

The querist has given a copy of the audited financial statements of XYZ Corporation Limited for the financial years 2013-14 and 2014-15 for the perusal of the Committee.

C. In the books of account of XYZ-ABC Project Corporation Limited:

1.3 crore equity shares were issued in the name of XYZ Corporation Limited and the same was reflected accordingly in the financial statement of XYZ-ABC Project Corporation Limited.

The querist has supplied a copy of the audited financial statements of XYZ-ABC Project Corporation Limited for the first financial year starting from 18.03.2014 to 31.03.2015 for the perusal of the Committee.

12. *Audit*

In accordance with the provisions of the Trust Deed, the Comptroller and Auditor General of India (C&AG) has been entrusted the audit of annual accounts of Industrial Corridor Trust for five years starting from the financial year 2012-13 to 2016-17.The audit team deployed from the Office of C&AG during the conduct of annual accounts audit of Industrial Corridor Trust for the financial year 2013-14 observed the following:

"Cabinet Committee on Economic Affairs approved constitution of a Special Purpose Vehicle for implementation and operation of ABC Model Solar Power Project, Rajasthan as a 100 per cent subsidiary of XYZ Corporation Limited on 20th January, 2014. However, the approval does not contain any direction on release of equity contribution of Rs. 13 crore from Corpus/Capital Account of Industrial Corridor Trust Fund. Further, as the Industrial Corridor Trust has earmarked funds specifically established for passing on to XYZ Corporation Limited as grant-in-aid, to enable XYZ Corporation Limited to carry out the project development activities for implementation of Industrial Corridor projects, including forming project specific SPVs and sectoral holding companies but the equity contribution for subsidiary of XYZ Corporation Limited was adjusted from Corpus/Capital Account of Trust, the clarification on this regard was not provided to Audit. The clarification on this regard may

> be obtained from appropriate authority and necessary accounting entry or disclosure may be made in the accounts for the year 2014-15."

The querist has supplied a copy of the management letter issued by the office of C&AG and the reply of the management for the perusal of the Committee. The same query was raised again by the audit team during annual accounts audit of Industrial Corporation Trust for the financial year 2014-15 in the form of half-margin. The same is reproduced as under:

> *"Audit of accounts of Industrial Corridor Trust Fund for the year 2014-15*
>
> The Cabinet Committee on Economic Affairs approved constitution of a Special Purpose Vehicle for implementation and operation of ABC Model Solar Power Project as a 100 per cent subsidiary of XYZ Corporation Limited on 20th January, 2014. However, the approval does not contain any direction on release of equity contribution of Rs. 13.00 crore from Corpus/Capital account of Industrial Corridor Trust Fund. As per para 6.1 and 7.1 of the Trust Deed of Industrial Corridor Trust, the corpus of Industrial Corridor Trust includes Rs. 1000 crore as additional corpus meant for grants-in-aid to XYZ Corporation Limited. The above funds were released to XYZ Corporation Limited but instead of adjusting the same from additional corpus, the contribution was adjusted from main corpus/capital account of Trust.
>
> This issue was raised last year through management letter and Industrial Corridor Trust Fund was requested to obtain a clarification in this regard from appropriate authority and to pass necessary accounting entry or disclosure to this effect in the accounts for the year 2014-15.
>
> However, the same has not been complied with by Industrial Corridor Trust Fund for the accounts for the year 2014-15.
>
> The above facts and figures may please be confirmed and reply may be furnished within two days."

The copy of the reply submitted to the Office of C&AG has been provided by the querist for the perusal of the Committee.

13. The querist has also separately informed that the equity investment released from the project implementation funds, i.e., corpus funds, to XYZ Corporation Limited for making onward investment in XYZ-ABC Project

Corporation Limited is in accordance with the approval of 'Financial and Institutional Structure of the Industrial Corridor project' approved by the Union Cabinet on 15th September, 2011 and Cabinet Committee on Economic Affairs approval dated 20.01.2014 for formation of special purpose vehicle for implementation and operation of ABC Model solar power project at Rajasthan.

B. Query

14. On the basis of the above, the querist has sought an opinion from the Expert Advisory Committee on the correctness of the accounting treatment given in the books of account of Industrial Corridor Trust by showing the funds amounting to Rs. 13.00 crore released by Industrial Corridor Trust from the Corpus to XYZ Corporation Limited for making onward investment in XYZ-ABC Project Corporation Limited.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to the treatment of release of funds amounting to Rs. 13 crore by Industrial Corridor Trust (hereinafter also referred to as the 'Trust') from the Trust Corpus of Rs. 17,500 crore (which is also referred to as the 'main corpus' in the Facts of the Case) to XYZ Corporation Limited for making onward investment in XYZ-ABC Project Corporation Limited in the books of account of Industrial Corridor Trust (hereinafter referred to as the 'Trust'). The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting in the books of account of XYZ Corporation Ltd. or XYZ-ABC Project Corporation Limited. Further, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various orders/approvals by Cabinet/Cabinet Committee on Economic Affairs, trust deed, etc. At the outset, the Committee presumes that the release of funds from the corpus of Rs. 17,500 crore is appropriate and in accordance with the Trust Deed and approval of the Cabinet Committee on Economic Affairs.

16. In the context of accounting for the release of funds, the Committee notes from the Facts of the Case and the relevant extracts from the Cabinet Approval Note (copy of which has been supplied by the querist for the perusal of the Committee) that the funds have been released to XYZ Corporation Ltd. for onward investment in 100% equity of XYZ-ABC Project

Corporation Ltd. and that any upsides from such investment will flow back to the Trust. The Committee further notes that such upsides include dividend and surplus from XYZ-ABC Project Corporation Limited as well as recovery of investments on liquidation/cessation of the operations of XYZ-ABC Project Corporation Limited, however, no equity or debt instrument is issued to the Trust in respect of such a release of funds. In this regard, the Committee also notes the definition of the terms, 'asset' and 'investment' from the Framework for the Preparation and Presentation of Financial Statements' and Accounting Standard (AS) 13, 'Accounting for Investments', issued by the Institute of Chartered Accountants of India, which provide as follows:

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

> ***"<u>Investments</u> are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. ..."***

17. The Committee notes from the Facts of the Case that the release of funds gives a right to the Trust to receive any upsides that may arise from the investment in SPV (XYZ-ABC Project Corporation Ltd.) formed for implementation of solar power project. Thus, the Committee is of the view that that such release of funds results into a resource controlled in the form of the right and from such resource, future economic benefits are also expected to flow to the Trust and therefore, it meets the definition of asset. Further, with regard to the nature of such asset, the Committee is of the view that in substance, such asset is held by the Trust for earning income and therefore, considering the principle of 'Substance over form', it is of the nature of 'investment' for the Trust. Accordingly, the Committee is of the view that the release of funds should be recognised as investment in the financial statements of the Trust rather than as a reduction from the 'corpus'. Moreover, an appropriate disclosure of the fact that the shares in XYZ-ABC Project Corporation Ltd. are held through XYZ Corporation Ltd. should be given in the notes to accounts. Further, since apparently, such investment is intended to be held for more than one year from the date on which such investment is made, it is a long-term investment and therefore should be recognised at 'cost' in accordance with paragraph 17 of AS 13, which provides as follows:

"17. Long-term investments are usually carried at cost. However, when there is decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment."

D. Opinion

18. From the above, the Committee is of the opinion that the accounting treatment given in the books of account of Industrial Corridor Trust by showing the funds amounting to Rs. 13.00 crore released by Industrial Corridor Trust from the Corpus to XYZ Corporation Limited is not correct. The same should be recognised as 'investment' in the financial statements of the Trust, as discussed in paragraph 17 above.

Query No. 22

Subject: Accounting treatment of expenditure relating to cost of utility diversions, environmental protection, road diversions/ restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. which are compulsorily required to be incurred for construction of Mass Rapid Transit System (MRTS) project.[1]

A. Facts of the Case

1. The opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) is being sought on accounting treatment of expenditure relating to cost of utility diversions, environmental protection,

[1] Opinion finalised by the Committee on 16.1.2017.

road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. which are compulsorily required to be incurred for construction of Mass Rapid Transit System (MRTS) project. According to the querist, these are the directly related expenditure without incurrence of which construction of MRTS project could not have taken place.

Background

2. Ministry of Urban Development (MoUD) vide sanction Order dated 26.09.2011 has given an investment approval of the Union Cabinet for Mass Rapid Transit System (MRTS) Phase III project based on detailed project report (DPR). The capital cost of the project as stated in the DPR includes civil engineering works, depot, utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement, traction and power supply, signaling and telecommunication works etc. According to the Querist, for the total cost of the project including utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc, funds have been arranged by the Government of India (GoI) and Government of National Capital Territory of Delhi (GNCTD). In view of the above arrangement, the cost incurred on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. was considered as part of the cost of the MRTS project. This practice is continuously followed since inception in Phase I and Phase II also.

Observation raised by Resident Audit Party of Comptroller and Auditor General (C&AG):

3. The querist has informed that on the above accounting treatment during the year 2014-15, Resident Audit Party of C&AG has issued half margins which are reproduced below along with the management reply:

> "Balance sheet
>
> Fixed assets- Capital work-in-progress – Rs. 11,410.61 crores
>
> The above includes Rs. 78.40 crores (46.78 crores during 2014-15 and previous years Rs. 31.62 crores) being expenditure incurred towards road diversion works, renovation work of drains, strengthening/

upgradation of existing road, provision of new/temporary works, road renovation works and utility shifting on temporary land. The same should have been charged off to revenue in the year of incurrence for the following reasons:

- As per Accounting Policy No. 6.7 of the company- *"Expenditure on the items, ownership of which is not with the company is charged off to revenue in the year of incurrence of such expenditure"*. As per the nature of expenses incurred towards road diversion works, renovation works of drains, strengthening/ upgradation of existing roads, provision of new /temporary works, road renovation works and utility shifting on temporary land are incurred on land not owned by the company. Hence, classifying the same as capital works in progress as against expenditure is not in accordance with the stated accounting policy of the company.

- As per paragraph 49 of the Framework for Preparation and Presentation of Financial Statements, "*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"*. Further, as per the provisions of Accounting Standard (AS) 26, 'Intangible Assets', *"An asset is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise".* Hence, though the expenditure incurred on the said items are incidental to construction, since the company does not have exclusive rights over the use of such assets and also cannot restrict the access of general public for use of such assets, these expenses do not qualify as an 'asset'.

- In Query No. 2 of Volume XXX of Compendium of Opinions, the Expert Advisory Committee of the Institute of Chartered Accountants of India had opined on the accounting treatment relating to 'enabling assets' which comprise accounting treatment of expenditure on items like roads, railway sidings etc., which are incurred to facilitate the construction of a project and subsequently to facilitate its operations and the ownership of which does not vest with the company. The Committee opined that *since the ownership of the 'enabling assets' does not vest*

with the company, the assets are available for general public use; hence, although the company is entitled to use these assets for the purpose of completing its own projects and subsequently for operational purposes, it has no say on the use of such assets by others. Thus, 'enabling assets' are not resources controlled by the company and, therefore, the expenditure incurred by the company on such 'enabling assets' cannot be capitalised as a separate tangible asset. The EAC opinion also stipulated that *expenditure on 'enabling assets' was not a directly attributable cost, and accordingly, the same cannot be capitalised as a fixed asset*. Hence as per EAC opinion, the expenditure on 'enabling assets' should be expensed by way of charge to the profit and loss account of the period in which the same is incurred.

- The EAC Opinion also further stated that expenditure on such assets not owned by the company appearing as CWIP, being an error should be rectified and disclosed as a 'prior period item' as per the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' in the financial statements of the period in which such rectification is carried out.

Hence, classifying the same under CWIP is not in compliance of the stated accounting policy of the company, the definition of 'control' embodied in the definition of asset and also an EAC opinion in this regard.

This has resulted in overstatement of CWIP, understatement of expenditure and consequent understatement of loss to the extent of Rs.78.40 crores (46.78 crores during 2014-15 and Rs. 31.62 crores for the prior period)."

Management Reply

4. The management reply to CAG is as follows:

"Ministry of Urban Development (MoUD) vide sanction order dated 26.9.2011 has given an investment approval of the Union Cabinet for MRTS Phase III project based on detailed project report (DPR). *The capital cost of the project as stated in the DPR includes civil engineering works, depot, utility diversions, environmental protection, other*

miscellaneous works including road diversions, road signages, rehabilitation and resettlement including road restoration, traction and power supply, signaling and telecommunication works etc.

As already explained that the total cost of the project including utility diversions, environmental protection, compensatory afforestation will be funded by the Government of India (GoI) and Government of National Capital Territory of Delhi (GNCTD) in equal proportions.

As per the above mandate, utility diversion work has been done which is essential activity before start and during execution of MRTS Phase III project. These are the expenditures without the incurrence of which, the construction of MRTS project could not have taken place and the project could not be brought to its working condition. Further, by incurring such expenditure, no separate asset item in the nature of enabling assets is created. Hence, the question of ownership of enabling assets, either with the company or not with the company, does not arise. Rather, these activities are ancillary type of activities which are required to be completed before completion of MRTS project. This is exactly in the nature of an attributable cost of bringing the MRTS project to its working condition for its intended use.

The company in turn raised demands from the respective Governments for financial assistance in line with the mandate of the total project cost which includes utility diversion, road diversion, renovation work of drains, strengthening/upgradation of existing road etc. Hence, the cost of these utility diversions are completely funded by the GOI and GNCTD in their respective shares as part of the total cost of MRTS project.

Further, in an opinion given by the Expert Advisory Committee (EAC) on 6.4.2013 in response of Query No. 6, Volume XXXIII of the Compendium of Opinions, on an issue raised in context of a metro rail project, the Committee considered the following contents of paragraphs 9.1, 9.2, 20 and 21 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and opined as below:

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

and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

(i) site preparation;

(ii) initial delivery and handling costs;

(iii) installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees of architects and engineers."

"9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset."

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

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

"From the above paragraphs of AS 10, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to a fixed asset under construction is that it should be directly attributable to the construction of the fixed asset for bringing it to its working condition for its intended use. These are the expenditures without the incurrence of which, the construction of fixed asset could not have taken place and the asset could not be brought to its working condition, such as, site preparation costs, installation costs, professional fees, etc."

"The Committee is further of the view that the above principles of capitalisation relating to a fixed asset are equally applicable to a

> group of assets including a project. Accordingly, the expenses incurred in the instant case are specifically incurred for the project and are directly attributable to it, hence capitalised as discussed in paragraph 9 above. Charging of such expenditure to the statement of profit and loss will be in contravention of the provisions of paragraph 9.1 of AS 10."

Further, the auditor commented that the accounting treatment of expenditure incurred by the company towards utility diversion including improvement/diversion of roads is not in consonance with the opinion of Expert Advisory Committee (EAC) in Query No. 2 of Volume XXX of the Compendium of Opinions as it is in the nature of 'enabling assets' which do not construe as directly attributable expenses. In this reference, it is to clarify that the referred opinion has been given by the EAC for a public sector undertaking (PSU) engaged in refining and marketing of petroleum products. In this opinion, the querist had clearly stated that for setting up of a new refinery, it had to incur expenditure on the construction/development of certain assets, like electricity, transmission line, railway siding, roads, culverts, bridges, etc. in order to facilitate construction of the project and subsequently to facilitate its operation. The ownership of such assets is referred to as 'enabling assets'. The nature of expenditure towards utility diversion including improvement/diversion of roads incurred by the company in the extant case is entirely different from the expenditure incurred by the querist company in that case because unlike the above PSU, the company is not going to create any such enabling asset by incurring such type of expenditure, rather these are the expenditures without the incurrence of which, the construction of MRTS project could not have taken place and the project could not be brought to its working condition.

In view of this, it is to mention here that the grounds raised by the querist in the aforesaid opinion are not similar as that of applicable to the company, as the nature of expenditure incurred by the company towards utility diversion including improvement/diversion of roads is different and not related to the category of enabling assets.

However, the company has an accounting policy No. 6.7 in place, which states that any expenditure which comes under the category for creation of enabling assets is charged off to revenue in the year of incurrence of such expenditure.

In true spirit, the above policy is approved for some special type of works, like creation of sub-station on behalf of Delhi Vidyut Board, drainage system on behalf of civic agencies, etc. which are very well covered under the definition of enabling assets as pointed out by audit. But this policy does not cover the cost, which is directly attributable to bringing the MRTS project to its working condition for its intended use. Hence, cost incurred by the company towards road diversion work, strengthening/upgradation of existing roads and other utility diversion works to the extent it requires to start-up the construction of MRTS project are not covered in accounting policy no. 6.7 of the company, rather these are directly attributable cost of bringing MRTS project to its working condition for its intended use in line with the provisions of AS 10[2].

In view of the facts mentioned above, it is clear that the grounds of reference as mentioned by the audit in the accounting policy no. 6.7 of the company, paragraph 49 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountant of India and EAC opinion in Query No. 2 of Volume XXX of the Compendium of Opinions are not in line with the nature of expenditure incurred by the company on utility diversion including improvement/diversion of road etc.

Since the grounds of reference of EAC opinion in Query No. 2 of Volume XXX of the Compendium of Opinions are different from the grounds of directly attributable cost incurred by the company for construction of MRTS Project, there is no question of error or omission incurred by the company as per the requirements of AS 5.

Further, it is not out of place to mention here that the accounting treatment of capitalisation of the cost/ expenditure incurred for construction of MRTS project is in accordance with the funding arrangement of the Government of India. The Expert Advisory Committee in another earlier opinion, published as Query No. 1 of Volume XXXIV of the Compendium of Opinions, raised by the company

[2] The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

also accepted the accounting treatment for capitalisation of interest paid on enhanced compensation as cost of land upto the date of the court's order whereas this interest element is charged to revenue in case of other companies as mentioned in EAC opinion on Query No. 28 of Volume XXV of the Compendium of Opinions.

The company has been consistently following the same practice since inception.

In view of above submission, the audit is requested to drop the preliminary audit observation."

(Emphasis supplied by the querist.)

Assurance given by the company to C&AG

5. The querist has informed that the company has given assurance to the Principal Director (Commercial Audit), Member Audit Board-I, Delhi which is reproduced below:

"Regarding expenditure of Rs. 76.46 crores incurred on compensatory plantation and Rs. 78.40 crores towards road diversions/renovation work etc. during construction phase, it is assured that the complete accounting treatment on the above expenditure shall be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India."

Points for consideration of the Expert Advisory Committee

6. In this whole issue, the querist has submitted the following for consideration of the Expert Advisory Committee before issue of an expert opinion:

(i) The funding of capital cost of MRTS project of Phase III as stated in the detailed project report (DPR) is fully arranged by the Government of India and Government of National Capital Territory of Delhi which also includes the part cost relating to utility diversions, environmental protection, road diversions/ restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc.

(ii) These are the expenditure without incurrence of which the construction of MRTS project could not have taken place and the project could not be brought to its working condition.

(iii) These expenses are directly attributable to MRTS project and required to be incurred only in case of execution of the MRTS project *otherwise not*.

(iv) Further, it is not out of place to again mention here that accounting treatment of capitalisation of the cost/expenditure incurred for construction of MRTS project is in accordance with the funding arrangement made by the Government of India.

(v) The company is consistently following the same practice since inception in Phase I and Phase II also of MRTS project.

(vi) The relevant paragraphs of AS 10 defining components of cost of an item of fixed asset which, in the view of the querist, also covers the direct cost of utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. required to be incurred for construction of MRTS project are reproduced below:

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

(i) site preparation;

(ii) initial delivery and handling costs;

(iii) Installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees of architects and engineers."

"9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and

experimental production, is usually capitalized as an indirect element of the construction cost. ..."

"10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

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

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

B. Query

7. In view of the facts explained above, opinion of the Expert Advisory Committee has been sought on the following queries:

(i) Whether the company's accounting treatment to capitalise cost of utility diversions, environmental protection, road diversions/ restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. is in line with the provisions of Accounting Standard 10.

(ii) If no, what is the alternative accounting treatment available with the company regarding:

(a) treatment of such expenditure relating to utility diversions, environmental protection, road diversions/restoration/ signages, renovation work of drainage system, rehabilitation and resettlement etc. and also

(b) treatment of funds received by the company from the GOI and GNCTD towards financing of such expenditure.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting treatment of expenditure incurred on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement. Accordingly, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of expenditure other than stated above. At the outset, the Committee wishes to point out that the issue raised in the extant case is with regard to accounting treatment of the aforementioned expenditure and not whether the same are of the nature of 'enabling asset'. Accordingly, the Committee has not examined the issue as to whether the expenditure incurred can be considered as 'enabling asset'. Moreover, it may be mentioned that the term 'enabling asset' is not an accounting term and the accounting for an item of expenditure essentially depends on the nature of such item. The Committee, while expressing its opinion, has presumed that the MRTS project is owned and controlled by the company and the company is not acting only as an implementing/executing agency of the Government. Further, the Committee wishes to point out that since the query refers to the financial year 2014-15, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

9. At the outset, the Committee wishes to mention that in the absence of specific details regarding nature of activities undertaken on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement etc. and nexus/ relation of the expenditure incurred with the construction activity of the MRTS project, the Committee has, hereinafter laid down only the principles to be followed while accounting for such kind of expenditure. In this context, the Committee notes paragraphs 9.1, 9.2, 10.1, 20 and 21 of AS 10 as reproduced in paragraphs 4 and 6 above. From a holistic reading of the above paragraphs of AS 10, the Committee notes that an item of cost should be capitalised with the cost of a fixed asset/project under construction only when it is directly attributable to the construction of the project/fixed

asset for bringing it to its working condition for its intended use. The Committee is of the view that the costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are *generally* those directly related costs without the incurrence of which, the project/ fixed asset could not be brought to its working condition for its intended use, such as, site preparation costs, installation costs, profession fees, etc. Thus, the accounting for each of the item of expenditure depends on the nature thereof and the same can be capitalized as a part of the cost of the project/fixed asset(s) only if it can be considered to be directly attributable to the construction activity of MRTS project/fixed asset(s). The Committee is further of the view that in the extant case, for qualifying an item of expenditure to be capitalised as a part of the MRTS project cost, it should not merely be incidental to the construction activity or only agreed to be incurred as a part of the MOU or agreement or understanding with the Government while approving the construction project. For example, if an expenditure, say, on renovation of existing road/environmental protection is being incurred only as a part of the understanding with the Government to be incurred while approving the project and not because it is directly attributable to the construction activity of the MRTS project/fixed asset, the same should not be capitalised. On the other hand, if an expenditure, say on road diversion/utility diversion, the diversion work is in the nature of site preparation activity of the MRTS project/fixed asset(s), the same can be considered to be directly attributable to the construction of the MRTS project/ fixed asset(s) and therefore, capitalised as a part of the cost of MRTS project/fixed asset(s). Accordingly, the Committee is of the view that considering the above-mentioned factors, the company in the extant case, should evaluate the nature of each item of expenditure, as raised in the query as to whether the same is directly attributable to construction of MRTS project/fixed asset(s) or not and on that basis, decide whether the same needs to be capitalized or not with the cost of the project/fixed asset(s) concerned.

D. Opinion

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

(i) Whether the treatment made by the company to capitalise the expenditure incurred on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement which is

compulsorily required to be incurred for the construction of MRTS project is in accordance with AS 10 or not would depend upon the nature of each item of expenditure and whether such expenditure can be considered to be directly attributable to the construction of MRTS project/fixed asset(s), considering various factors, as discussed in paragraph 9 above.

(ii) In case, considering the nature of the expenditure incurred and other factors, as discussed in paragraph 9 above, an item of expenditure is not considered to be directly attributable to the construction of MRTS project/fixed asset(s) and therefore, not capitalised, the same should be charged to the statement of profit and loss in the year of incurrence of such expenditure. Further, the treatment of funds received by the company from the GOI and GNTCD towards financing of such expenditure would depend upon whether the funds received are of the nature of equity contribution or in the form of Government grant or debt to the company. In the absence of specific details with respect to that, the Committee has not expressed its views in respect of the same.

Query No. 23

***Subject: Capitalisation of interest cost.*[1]**

A. Facts of the Case

1. A company has set up a new plant to manufacture auto components in which it has incurred capital expenditure of around Rs. 415 million on new plant and equipment and other infrastructural facilities as per details mentioned below:

[1] Opinion finalised by the Committee on 16.1.2017.

Particulars	**Amount (INR- Mil)**
Building- Improvement	8.88
Furniture & Fixtures	6.13
Office Equipment	5.83
Plant & Machinery	393.73
Software	0.08
Vehicles	1.21
Total – A	415.86
Capital Work in Process – Others	1.19
Capital Work in Process – Plant & Machinery	0.72
Total – B	1.92
Grand Total	417.78

2. The querist has informed that in wiring harness industry, plant set-up involves setting up of cutting and crimping machine, conveyor, and assembly line for wiring harness and plant utilities such as air handling unit (AHU), compressor, floor painting, etc. after the building is completed and handed over, followed by customer trial and audit. The lead time for procurement of equipments is around 6 to 8 months from the date of order and the entire set-up including customer audit takes around 9-10 months. Normal time period taken from ordering the machines to installation and commissioning including customer audit to make the plant ready for manufacturing is around 8-10 months. With regard to building improvement, the querist has separately informed that the cost incurred for building improvement is mainly in the nature of air handling unit, epoxy flooring, plant electrification and networking and landscaping. The electrical work is done for the manual process of wiring harness maintaining 500 lux. Air handling units are installed for maintaining the internal temperature for easiness of operator's working.

3. The querist has referred to paragraph 3.2 of Accounting Standard (AS) 16, 'Borrowing Costs', which states as follows:

> ***"3.2 A <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.***

Explanation:

> ***What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered."***

4. Based on facts and circumstances of the industry, the querist is of the opinion that standard time of 8-10 months taken to set up a plant to manufacture wiring harness should be considered to meet the criteria of qualifying assets as per AS 16. Further, the plant has been set up in a factory building that was built by a third party (landlord) to suit as per the company's specifications. The company had taken this customised building on lease from the landlord for a period of nine years, with a lock-in period of 5 years. The landlord had incurred an amount of around Rs. 147 million in the construction of this building. With regard to the factory building, the querist has separately informed that the landlord had constructed the factory building on a vacant piece of land. The company contacted the landlord and he was interested to construct the building as per the requirements of the company and let out on rent. The company did not pay any customization cost separately; it was included in agreed rent. The building design, specifications and layout were specified by the company to suit wiring harness manufacturing. Some of the specific customisations done to suit the requirements of the company are as follows:

1. Production floor, shed height, utility, all support departments were built to suit the company's needs.
2. Roads were designed as per the requirements of the company.
3. Creche, employee gate, material gate constructed as per the requirements of the company.

The aforesaid customisation was done for the company specifically at the instance of the company, however, the landlord had acted independently. The construction was carried out under the supervision of architects, nominated by the company. The company had entered into a 9 years rental

agreement with 5 years lock in period that covers the entire cost of construction.

5. The company had entered into a Memorandum of Understanding (MOU) with the landlord to construct this customised building on 5th September, 2014. The landlord had taken a period of 12 months to complete the construction and handed over the building to the company after a period of 14 months. Thereafter, the company installed its equipment and created other infrastructure to make the plant operational. The key milestones and dates for creation of this plant are as follows:

i. Date of MOU with landlord for construction of customised factory building: 5th September, 2014

ii. Date of completion and handover of the building by the landlord: October 2015

iii. Date of signing of lease agreement with landlord: August 2015

iv. Date of first order for plant and equipment: June 2015

v. Date of installation and capitalisation of the plant: 1st March, 2016

vi. Date of audit by the company's customer and clearance for manufacturing and supply from the plant: 8th March, 2016

6. The querist has further stated that this is a major manufacturing project that the company has undertaken during the previous year and the entire capital expenditure that is incurred is funded through a term loan from bank. During the construction period, the company had incurred an amount of Rs. 420 million on the term loan taken to fund the project. Considering the aforesaid facts, the company is of the opinion that the assets installed in the said plant can be treated as 'qualifying assets' under Accounting Standard 16 and, therefore, the interest of Rs. 4.9 million incurred during the pre-operative period needs to be capitalised on the assets that it has procured and installed.

B. Query

7. On the basis of above, the querist has sought an opinion from the Expert Advisory Committee as to whether considering the fact that the overall project (including the construction of the building) has taken a period of 18

months for completion, the assets procured and installed in the said plant would be treated as 'qualifying assets' under the Accounting Standard 16 and whether the interest of Rs. 4.9 million incurred during the pre-operative period in procurement of the assets needs to be capitalised.

C. Points considered by the Committee

8. The Committee notes that the basic issues raised in the query relate to whether the assets procured and installed in the said plant would be treated as 'qualifying assets' and whether the interest of Rs. 4.9 million incurred during the pre-operative period in procurement of the assets needs to be capitalised. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for lease of building, whether the building is acquired on 'operating lease' or 'finance lease', accounting for lease rent paid during the period when the plant is getting ready for its intended use, accounting for capital expenditure incurred on building improvements, etc.

9. At the outset, the Committee notes that the company has incurred an expenditure on the new plant which is the entire set-up including building improvements, furniture and fixtures, office equipment, software, vehicles etc. apart from the plant and machinery and the issue now being raised is whether the assets installed in the said plant can be treated as a 'qualifying asset' under AS 16 and therefore, the interest of Rs. 4.9 million incurred during the pre-operative period needs to be capitalised on the assets that it has procured and installed. It appears that the company is treating the plant/entire set-up as a single qualifying asset for capitalisation of borrowing costs. Now the question that arises is whether the entire plant consisting of various assets can be considered as a 'qualifying asset' viz., the asset that necessarily takes a substantial period of time to get ready for its intended use. In this context, the Committee notes that the plant in the extant case consists of various assets, which are acquired by the company at different points of time. Therefore, the Committee is of the view that the company should evaluate whether these assets can be considered to be ready for their intended use only when the entire plant is ready for its intended use. In case, any of the assets of the plant can be considered to be ready for its intended use before the plant is ready, it should be considered as a separate qualifying asset provided it meets the definition of 'qualifying asset' as per the requirements of AS 16 and the considerations discussed in paragraph 10 below.

10. The Committee further notes the definition of the term 'qualifying asset' and paragraph 5 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), which are reproduced below:

> ***"3.2 A <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.***
>
> **Explanation:**
>
> > ***What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered."***
>
> "5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets."

11. The Committee notes from paragraph 3.2 of AS 16 that ordinarily twelve months is considered as substantial period of time. However, a shorter or longer period can be justified considering the peculiarities of the facts and circumstances of each case. In estimating this period, the time which an asset takes, technologically and commercially, to get ready for its intended use should be considered. Thus, the Standard does not specify the exact period which may be considered for determining what constitutes substantial period of time. Accordingly, the Committee is of the view that determination of 'substantial period of time' is a matter of judgement, which the management should exercise and the auditor should verify in the specific facts and circumstances of the case considering various factors, such as, nature of the asset, nature of the construction activity, normal time that the asset necessarily takes technologically and commercially to get ready for its intended use, etc. In this regard, the Committee also notes that the querist

has stated that the lead time for procurement of equipments is around 6 to 8 months from the date of order and the entire set-up including customer audit takes around 9-10 months. It is also mentioned that the normal period taken from ordering the machines to installation and commissioning including customer audit to make the plant ready for manufacturing is around 8-10 months. Thus, the time taken from the order till capitalisation of the plant is around 8-10 months which is shorter than 12 months. Therefore, the Committee is of the view that in the extant case, the company should itself evaluate its own facts and circumstances considering various factors, as aforementioned and determine whether the time taken by the plant in the extant case can constitute 'substantial period of time' and on that basis, whether the plant is a qualifying asset or not. In this regard, the Committee notes that the building has been customised for the purposes of the company. Whether the time taken in such customisation should be or not be considered for the purposes of determination of qualifying asset under AS 16 would depend on the specific facts and circumstances of the case considering various factors, for example, in case building is acquired on finance lease.

12. Further, the Committee notes from the Facts of the Case that various activities upto the customer trial and audit are undertaken for set up of the plant, which are financed through borrowed funds. In this regard, the Committee notes the following paragraphs of AS 16, notified under the 'Rules':

> ***"14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:***
>
> ***(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;***
>
> ***(b) borrowing costs are being incurred; and***
>
> ***(c) activities that are necessary to prepare the asset for its intended use or sale are in progress."***
>
> "16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the

> physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation."

The Committee notes from the Facts of the Case that the manufacture / construction of the plant and machinery, which is a significant component of the plant was performed by the vendor before it is commissioned at the construction site. The conditions for commencement of capitalisation are clearly laid down in paragraph 14 of AS 16. The Committee is of the view that though there are no restrictions for capitalising the borrowing costs incurred on assets manufactured at a vendor site, all the conditions of paragraph 14 above should be satisfied for capitalisation of borrowing costs. The expenditure on the qualifying asset and payment of borrowing costs are not sufficient enough to capitalise the borrowing costs. The activities that are necessary to prepare the asset for its intended use or sale should also be in progress so as to satisfy the conditions for capitalisation. The activities necessary to prepare the asset for its intended use or sale can vary depending on facts and circumstances of each case. The Committee is of the view that 'activities necessary to prepare the asset for its intended use or sale' are the activities which lead to any active development/construction of the asset that lead to change in the asset's condition/location. Accordingly, the various activities in the extant case, for example, customer trial and audit, should be carefully analysed to determine whether these meet the above-mentioned criteria considering various factors, such as, whether any modifications are required after customer trial and audit leading to change in the asset's condition, etc.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the company should itself evaluate in its own facts and circumstances considering various factors, as discussed in paragraph 10 above and determine whether the time taken by the plant in the extent case can constitute 'substantial period of time' and on that basis, whether the plant is a qualifying asset or not. Further, the interest incurred during the pre-operative period should be

capitalised only for the period when the activities that are necessary to prepare the asset for its intended use or sale are in progress and when other conditions for capitalisation of borrowing costs as per AS 16 are being fulfilled, as discussed in paragraph 12 above.

Query No. 24

Subject: Accounting treatment of dry development wells.[1]

A. Facts of the Case

1. A navaratna company in public sector, under the administrative control of the Ministry of Petroleum and Natural Gas, is engaged in exploration and development of oil fields; production, sale and transportation of crude oil and natural gas; production and sale of LPG and condensate; and transportation of finished petroleum products of other public sector undertaking (PSU) refineries to their marketing points. The company follows the Successful Efforts Method (SEM) of accounting for its oil and gas producing activities in accordance with the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised) 2013, issued by the Institute of Chartered Accountants of India (ICAI).

2. The company undertakes development of the oil fields, which amongst others include drilling of development wells, service wells like water/gas injection wells, water disposal wells, laying lease flow lines, setting up of oil and separators, heaters, pumps, storage tanks, artificial lift, advanced recovery systems etc. after techno-commercial viability of the exploration effort in the area is established.

3. The querist has informed that the company's accounting policy towards accounting for development cost is as under:

> "Costs that are attributable to development activities including production and processing plant and facilities, service wells including allocated

[1] Opinion finalised by the Committee on 16.1.2017.

> depreciation on support equipment and facilities are initially shown as tangible assets under capital work in progress as development cost till such time they are capitalised as producing properties upon determination of proved developed reserves."

Further, the company's accounting policy towards accounting for side-tracking expenditure is as under:

> "In case of development wells, the entire cost of abandoned portion and side-tracking is capitalised. ..."

4. Based on the above policies, the company capitalises development cost held in capital work in progress by transferring the same to the gross block of producing properties when proved developed reserves are established. Cost of any dry development well is also capitalised on completion of the well.

Views of the Comptroller and Auditor General (C&AG auditor) during the financial year 2015-16:

5. The querist has stated that as per the Guidance Note on Accounting for Oil and Gas Producing Activities (2013), the definition of development well is "a well drilled, deepened, completed or re-completed within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive". Therefore, the development wells are not supposed to fail. The querist has further informed that during the year 2015-16, three development wells were found dry and wells were booked under tangible assets as producing properties. In the opinion of the CAG auditor, the expenditure incurred on drilling of development wells declared dry does not meet the definition and recognition criteria of an 'asset', as defined in paragraphs 49 and 88 of the Framework for Preparation and Presentation of Financial Statements, issued by the ICAI and Accounting Standard (AS) 26, 'Intangible Assets'. Therefore, the expenditure incurred on dry development wells should have been written off. This has resulted in overstatement of producing properties and overstatement of profit for the year.

Views of the company:

6. The querist has referred to paragraph 20 of the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013), issued by the ICAI, which states that all development costs related to proved developed oil and gas reserves will be capitalised on completion of the same. Also, as

per paragraph 11(ii) of the Guidance Note referred above, development cost includes cost of successful and unsuccessful well cost. Hence, the treatment of the dry development wells is in line with the Guidance Note and industry practice. Accordingly, the cost of the dry wells has been capitalised to gross block of producing wells in the accounts for the financial year 2015-16.

7. Further, cost reflected in the statement of financial position of the company under the head producing wells corresponds to the proved developed reserves established by the company from which future economic benefit flows to the company. Development wells are drilled only after economic feasibility and commercial viability of the oil and gas reserves have been established. As a part of the development effort, if any development well is found to be dry, there is no change in the corresponding oil and gas reserves already found to be proved. Hence, cost of dry development well is a part of the total expenditure incurred to develop the reserves which are found to be proved.

B. Query

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

(i) Whether the accounting treatment followed by the company in respect of development wells including dry development wells is in line with the requirements of the Guidance Note.

(ii) What should be the correct accounting treatment of dry development well if the policy and practice of the company are not in line with the requirements of the Guidance Note?

(iii) Whether there is any violation by the company of requirements of paragraphs 49 and 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI while following the aforesaid accounting treatment as contended by CAG auditor.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting treatment in respect of dry development wells (which are part of the cost centre). Therefore, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the

Case, such as, propriety of determination of exploratory and development dry wells, accounting for exploratory wells, producing properties, propriety of accounting policy of the company in respect of other items of costs, such as, side-tracking, etc. At the outset, the Committee wishes to point out that in the absence of details pertaining to the costs of other development activities apart from the cost of dry development wells, such as nature of these activities, whether these are directly attributable or not to development activities, etc., the Committee has not examined the accounting treatment in respect of other development activities as whole. The Committee also wishes to point out that since the query has been raised in the context of financial year 2015-16, the opinion has been expressed considering the requirements of the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013), which was relevant and applicable during that financial year and not the requirements of the Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable).

10. With regard to development wells, the Committee notes the definition of the terms, 'cost centre' and 'development wells', as per paragraph 4 of the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013). These definitions and other relevant matters contained in other paragraphs of the Guidance Note are reproduced below:

> "*Cost Centre*: Cost centre is a unit identified to capture costs based on suitable criteria such as geographical or geological factors. Cost centre is not larger than a field in case of Successful Efforts Method and under Full Cost Method, the cost centre is not normally smaller than a country except where warranted by major difference in economic, fiscal or other factors in the country."
>
> "*Development Well:* A well drilled, deepened, completed or re-completed within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive."
>
> "11. Development costs cover all the directly attributable expenditure incurred in respect of the development activities including costs incurred to:
>
> (i) gain access to and prepare well locations for drilling, including surveying well locations for the purpose of determining specific development drilling sites, … to the extent necessary in developing the proved oil and gas reserves;

(ii) drill and equip development wells *(whether successful or unsuccessful)*, development-type stratigraphic test wells and service wells including the cost of platforms and of well materials and equipment such as casing, tubing, pumping equipment and the wellhead assembly;

…"

(Emphasis supplied by the Committee.)

"18. Under the successful efforts method, in respect of a cost centre, the following costs should be treated as capital work-in-progress or intangible asset under development, as the case may be (refer paragraphs 46 and 47) when incurred:

i. All acquisition costs;

ii. Exploration costs referred to in paragraph 9 (iv) and (v); and

iii. All development costs."

"20. When a well is ready to commence commercial production, the costs referred to in paragraph 18 (ii) and (iii) corresponding to proved developed oil and gas reserves should be capitalised as 'completed wells/producing wells' from capital work-in-progress/intangible assets under development to the gross block of assets. With respect to costs referred to in paragraph 18 (i), the entire costs should be capitalised from capital work-in-progress/intangible asset under development to the gross block of assets. Normally, a well is ready to commence commercial production on establishment of proved developed oil and gas reserves."

"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."

"42. … In case of development wells, the entire costs of abandoned portion and side-tracking should be capitalised…"

11. From the definition of the term 'development well', the Committee notes that the said wells are drilled and developed in the proved area of oil

or gas reserves and, therefore, are different from the exploration wells in respect of which the area is still to be considered to have proved oil reserves. The Committee further notes that the development cost covers all directly attributable expenditure incurred in respect of the development activities and includes cost incurred to drill and equip development wells (whether successful or unsuccessful). The Committee further notes from paragraphs 37 and 42 of the Guidance Note that gain or loss should not be recognised only if an individual well is abandoned as long as remaining wells in the cost centre continue to produce oil and gas and that in case of development wells, the entire costs of abandoned portion should be capitalised. Thus, the Committee notes that the Guidance Note requires the development costs to be considered in the context of proved area of oil and gas reserves and not individual wells, which might be successful or unsuccessful. The Committee is of the view that the expenditure incurred on developing dry wells is like a normal loss/ expenditure during construction or creation of an asset and, therefore, should be capitalised. Accordingly, in the extant case, the Committee is of the view that there is no need to expense off the expenditure incurred on dry development wells and the same should be capitalised unless the entire cost centre is abandoned. Therefore, the accounting treatment followed by the company to capitalise the costs incurred in respect of dry development wells to the gross block of assets/producing wells appears to be appropriate and in line with the requirements of the Guidance Note.

12. With regard to the contention of the C&AG auditor relating to future economic benefits considering the definition of 'asset' and the requirements of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, the Committee wishes to point out that under Successful Efforts Method, the future economic benefits are considered in the context of the oil and gas reserves in the cost centre instead of individual wells which are part of that cost centre. Accordingly, the aforesaid accounting treatment is in accordance with the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI.

D. Opinion

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

(i) Subject to paragraph 9 above, the accounting treatment followed by the company in respect of dry development wells appears to

be in line with the requirements of the Guidance Note, as discussed in paragraph 11 above.

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

(iii) As discussed in paragraph 12 above, there would be no violation by the company of the requirements of paragraphs 49 and 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI while following the aforesaid accounting treatment with regard to the dry development wells.

Query No. 25

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

A. Facts of the Case

1. A public sector company (hereinafter referred to as 'the company') is engaged in the manufacture of steel products from five integrated steel plants and three special steel plants. The company also has a number of iron ore, limestone and dolomite mines in various parts of the country. The annual turnover of the company during the financial year 2015-16 was Rs. 43,367 crore.

2. The company has been granted mining lease of an iron ore mine at a remote location. In order to transport ore from the mine, the company has entered into a Memorandum of Understanding (MoU) with Indian Railways, State Government and another public sector company for construction of a railway line in two phases – Phase I for 95 kms and Phase II for 140 kms.

3. The MoU states that the company will pay the entire cost of constructing Phase I, and a part of the cost of the Phase II. In turn, Railways will pay the

[1] Opinion finalised by the Committee on 16.1.2017.

company 7% per annum of the cost of the project over 37 years from the time the freight traffic starts. The MoU also states that the company should ensure a minimum freight traffic of 4 million tonnes per annum in the first two years, and 9 million tonnes per annum thereafter. The freight traffic is to be calculated over a period of 4 years, i.e., 36 million tonnes in a period of 4 years. In case of shortfall in traffic, the payment of the 4th year shall be kept on hold till the shortfall is made up.

4. The issue of accounting for these payments was earlier referred to the Expert Advisory Committee (EAC), who opined (published as Query No. 20 of Volume XXXI of Compendium of Opinions) that:

a. The amount paid to Railways is, in substance, interest-bearing advance, and it is irrelevant how the amount is being utilised by the Railways.

b. The amount paid in cash is to be treated as advance, and the amount paid in kind (steel) is to be recognised as revenue at the time the material is supplied to Railways and disclosed as 'Sundry Debtors'

c. On receipt of each instalment, the interest element is to be recognised as 'Other Income'. The company has followed the accounting treatment suggested by the EAC. However, according to the querist, as far as the accounting for interest is concerned, it appears that the EAC has proposed cash based accounting, although Accounting Standard (AS) 9, 'Revenue Recognition' stipulates that "revenue should be recognised when no significant uncertainty as to measurability or collectability exists". Therefore, it needs to be reviewed whether any 'significant uncertainty' exists as regards realisation of the amount from the Railways. The following facts may be noted:

(i) The construction work of the railway line is going on in full swing. With the posting of almost 5,000 paramilitary forces along the rail-route and mining area, the insurgency threat (endemic to that region) has been effectively contained. The first 17 kms has already been completed and train movement has started. Work is now going on in the 17- 45 km stretch. There is no reason to believe that the project will not be completed by 2021-22.

(ii) The company has floated a tender for engaging a Mines Developer-cum-Operator (MDO) for operating the mine. The MDO will do the mining and will despatch ore to the company, and will be paid on a per-tonne basis. The contract with the MDO stipulates a minimum ore despatch of 14 million tonnes per annum, below which liquidated damages (LD) are levied. The minimum railway freight traffic of 9 million tonnes per annum is 40% less than the minimum ore despatch quantity. The quantity needs to be seen in the context of the company's annual ore requirement of 14 million tonnes. Therefore, there is no uncertainty, whatsoever, in fulfilment of the freight target.

(iii) The 9 million tonnes freight traffic is to be calculated over a period of 4 years, i.e. 36 million tonnes to be transported in 4 years. A shortfall in one year can be made up in the next year. Even assuming, as a worst-case scenario, that steel plant of the company is unable to transport 36 million tonnes in 4 years, it would only mean that the payment of the 4th year will be kept on hold till the shortfall is made up. The payment for the first 3 years will be paid as usual.

5. It can be seen from the above facts that there exists absolutely no uncertainty in realisation of money from the Railways and therefore, the company is of the opinion that in accordance with AS 9, the accrued interest needs to be accounted for. The company has paid Rs. 270 crore to the Railways during the period 2006-07 to 2015-16.

6. The criteria set by AS 9, i.e. 'collectability' and 'measurability' have also been examined by the querist as follows:

Collectability: Railways will repay the advance @ 7% per annum. This is an annuity payment in which both the principal and interest components are embedded. It is not possible to treat one component as doubtful and the other component as certain. If the interest is considered doubtful, one must also treat the principal as doubtful (because both will be repaid together in the same annuity). In that case, the whole investment in the railway line must be provided for as doubtful asset, and every payment made hereafter should be immediately provided for. Since there is no reason to doubt the recovery

of the principal, it follows that there can be no reason to doubt the collectability of interest either.

Measurability: The MoU stipulates that Railways will repay the advance at the rate of 7% per annum over 37 years, which works out to 259% (including repayment of principal). Therefore, the interest component is 159% of investment payable over 37 years. Interest needs to be calculated on time-proportion basis on the outstanding amounts. The annual rate of interest is not given in the MoU, but can be derived by calculation, depending on the year-wise phasing of expenditure and the year-wise repayment over 37 years from the expected date of commissioning of the railway line.

7. Since all the conditions of AS 9 are met, the querist is of the opinion that the interest accruing on the advance and debtors should be recognised on time proportion basis, as and when payment is made to Railways without waiting for actual repayment to start.

B. Query

8. A clarification is required from the Expert Advisory Committee whether the interest accruing on advance to the Railways can be accounted for immediately without waiting for actual repayment to start.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised is with regard to timing of recognition of interest viz., whether on accrual basis or on receipt basis. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case such as, calculation of interest on advance, accounting for component of interest on debtors/receivable portion, apportionment of the recovery amount towards principal portion and interest, etc. The opinion expressed hereinafter is from the perspective of the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not from the perspective of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee presumes from the Facts of the Case that the freight rate charged by the Railways from the company on completion of railway line and after start of freight traffic is not different from the rate charged by the Railways from other customers.

10. At the outset, the Committee notes that in the earlier opinion referred to by the querist, the issue of recognition of interest on accrual basis was not specifically raised and, therefore, was not specifically examined by the Committee. Further, the term 'recovery' or 'receipt' in the earlier opinion was used more in the context of bifurcation of principal and interest portion at the time of recovery, as was specifically raised by the querist and not in the overall context. Moreover, the requirements of Accounting Standard (AS) 9, 'Revenue Recognition' had also been referred to in the earlier EAC opinion and therefore, the opinion should be read considering the requirements of AS 9.

11. With regard to the issue of timing of recognition of interest on advance payments, the Committee notes the following paragraphs of Accounting Standard (AS) 9, Revenue Recognition, notified under the Companies (Accounting Standards) Rules, 2006:

> ***"4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."***
>
> "8.1 The use by others of such enterprise resources gives rise to:
>
> (i) interest—charges for the use of cash resources or amounts due to the enterprise;
>
> ...
>
> 8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity."
>
> "9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments."

"9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed."

"13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: On a time proportion basis taking into account the amount outstanding and the rate applicable.

..."

12. From the above, the Committee notes that interest arising from the use of resources by others is considered as revenue and governed by the principles of AS 9. The Committee further notes from the above-reproduced requirements of AS 9 that the basic condition for recognition of revenue under AS 9 is that no significant uncertainty should exist regarding collectability and measurability of revenue. The Committee is of the view that whether there is uncertainty or not regarding these two aspects is a matter of judgement, which should be applied by the company itself, considering various factors affecting the certainty of revenue to the company, in its own facts and circumstances. However, considering the Facts of the Case, the Committee presumes that the measurement and collection of interest on advances to Railways is not significantly uncertain in the extant case. Further, from the above-reproduced requirements of AS 9, the Committee notes that the revenue arising from the use by others of enterprise's resources yielding interest, accrues from the time these resources are transferred for use by others and should be recognised on a

time proportion basis taking into account the amount outstanding and the rate applicable, provided no significant uncertainty as to measurability or collectability exists. Accordingly, the Committee is of the view that in the extant case also, the company should recognise the interest income accruing on advances given to Railways on a time proportion basis and not when the same is received/ recovered, as per the requirements of AS 9.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the interest accruing on advance to Railways should be recognised on a time proportion basis, provided no significant uncertainty as to measurability or collectability exists, as per the requirements of AS 9, as discussed in paragraph 12 above.

Query No. 26

Subject: ***Accounting treatment for 'Duty Credit Entitlement Certificates' issued under 'Served from India Scheme' (SFIS).[1]***

A. Facts of the Case

1. This is in reference to an earlier opinion issued by the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) (published as query No. 21 in volume XXXIII of the Compendium of Opinions) on the above subject to a company (hereinafter referred to as the 'company'). The querist has stated that the EAC of the ICAI has opined as follows:

a) Duty credit entitlement under 'Served from India Scheme' (SFIS) does not fall under 'revenue', as defined in Accounting Standard (AS) 9, 'Revenue Recognition'.

b) Duty credit entitlement under SFIS is a government grant/subsidy/ assistance as defined in Accounting Standard (AS) 12, 'Accounting for Government Grants'.

[1] Opinion finalised by the Committee on 3.2.2017.

c) Duty credit entitlement under SFIS should be treated as a grant related to revenue. Therefore, adjustment against gross value of the assets concerned does not arise.

However, the company still differs with the opinion given by the EAC of the ICAI considering the duty credit entitlement under SFIS as grant related to revenue.

2. The company is of the opinion that:

A. AS 12 does not specifically refer to grants in the nature of duty credit entitlement scrips but it states the following general propositions which may be noted:

a. Two broad approaches may be followed for the accounting treatment of government grants: the 'capital approach', under which a grant is treated as part of shareholders' funds, and the 'income approach', under which a grant is taken to income over one or more periods. (Paragraph 5.1 of AS 12)

b. It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants. (Paragraph 5.4 of AS 12)

c. Government grants available to an enterprise are recognised in the financial statements at the time:

i. when there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

ii. when such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made. *Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled and the benefits therefrom are availed or will be availed with certainty.* (Paragraph 6.1 of AS 12)

d. *Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.* Other conditions may also be attached restricting the type or location of the asset or the periods during which they are to be acquired or held. (Paragraph 8.1 of AS 12)

e. Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives. (Paragraph 8.2 of AS 12)

   i. Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value. (Paragraph 8.3 of AS 12)

   ii. Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systemic and rational basis over the useful life of the asset. ... (Paragraph 8.4 of AS 12)

B. In applying the general principles outlined above, according to the querist, the following features of the SFIS scheme should be noted :

a. The government grant under SFIS is *not a subsidy receivable in cash but is in the form of a duty credit scrip which can be utilised with and in certain conditions.*

b. The duty credit entitlement scrip *can only be utilised by the enterprise which has export earnings* through rendering of service or by 'Group companies' who are service providers.

c. The duty credit entitlement scrip *can only be used to make payment of import duty on import of capital goods or consumables.*

d. The capital goods or consumables whether imported by the exporting enterprise or the 'Group company' *can only be used in the service sector business of the enterprise or the 'Group company'.*

e. The duty credit entitlement scrip *cannot be transferred except to a 'Group company'.* It does not therefore have a market value.

f. If the duty credit *scrip is not utilised within two years of its issue, it lapses.*

g. There is *no grant available for exporters who do not import capital goods or consumables.*

h. The usage of duty credit entitlement scrips is for specific assets. For what is specific asset, the following points need to be considered:

   (i) the term 'specific' as defined in Concise Oxford Dictionary gives the following meaning:

   - clearly defined; definite;
   - relating to a particular subject; peculiar;
   - (a) of or concerning a species;

     (b) possessing or concerned with the properties that characterise a species;
   - (of a duty or a tax) assessed by quantity or amount, not by value of goods.

   (ii) when the literal meaning of the term 'specific' is applied to the words, 'specific asset', it means an individual asset, an individual asset forming part of a group or class of assets or a group or classes of assets.

C. Having regard to the general considerations and the specific features noted in paragraph above, the following conclusions emerge:

a. The availability of the grant is dependent upon *two independent criteria,* both of which must be satisfied namely, (i) *a qualifying criteria that the service provider should have foreign exchange earnings and (ii) a utilisation criteria that the duty credit entitlement scrip must be utilised only for payment of import duty on import of a capital asset or consumables to be used in the service sector business of the exporter*. It is not sufficient if only one condition is satisfied; but it is necessary that both conditions must be satisfied. The nature of grant therefore is different from a normal grant for the promotion of exports. Thus, no grant is available to an exporter in the services sector, who does not, or does not need to, import capital goods or consumables.

b. It is also important to note that the duty credit entitlement scrip is not transferrable other than to group company and has no market value. Further, it lapses if it is not utilised through import within two years.

c. For the capital goods to be imported and to qualify for the utilisation of the duty credit entitlement scrip, its use is restricted in the service sector business of the enterprise or of the enterprise's 'Group company'.

i. Thus the duty credit entitlement *scrips can be used only for payment of customs duty on such capital goods which are imported for use in the service sector. These capital goods are therefore, clearly specific assets.*

ii. The duty credit entitlement scrips if utilised for such specific assets are therefore the grants related to specific assets within the meaning of paragraph 8.1 of AS 12.

d. *The company has utilised the duty credit entitlement scrips only for payment of customs duty on identifiable and specific*

> *capital goods imported for use in its service sector business. It has therefore availed of a grant related to specific fixed assets in terms of paragraph 8.1 of AS 12.*

Secondly, the EAC has stated that "the Committee notes that such duty credit entitlement under SFIS can be utilised not only for the payment of duty on import of capital goods but also for their spare parts or consumables which can be revenue in nature. Moreover, it is not necessary under the Scheme that its recipient should utilise the scrip for importing goods only. The recipient may transfer them to another company within the same group or managed hotels as per conditions of the Scheme resulting into an income for it. Thus, the amount of duty credit entitlement under SFIS should be considered to be generating income to the company."

e. The above view of the Committee also needs to be supplemented with the following:

   i. The duty credit entitlement *scrip is not transferable except to a 'Group Company' and that too only for use in the service sector businesses.* Therefore, if the exporting company is not part of a 'Group' or the 'Group' does not have an entity in the service sector, the scrip is completely non-transferable.

   ii. The duty credit scrip cannot be used for any type of import. *It must be used only for import of capital goods and consumables in the service sector.*

   iii. The capital goods and consumables for which the duty credit entitlement scrip is used cannot be transferred except to a 'Group company' for use in the service sector.

   iv. No income is generated when a duty credit scrip is awarded. *Income would be generated only if the duty credit scrip is transferred to a Group Company for consideration.*

D. It is also pertinent to note that in terms of the Foreign Trade Policy for 2015-2020 announced by the Government of India, SFIS has been replaced with the 'Service Export from India Scheme (SEIS)'. Under SEIS, the duty credit entitlement scrip "would no longer be with actual user condition and will no longer restrict the usage for specified types of goods but be freely transferrable and usable for all types of goods and services for debits on procurement of services/ goods. Debits would be eligible for CENVAT credit or drawback."

E. The above brings out the essential difference between the two Schemes and highlights the reasons why duty credit entitlement scrip under SEIS can be considered as income whereas duty credit entitlement scrip under SFIS being subject to actual user conditions cannot be considered as income.

(Emphasis supplied by the querist.)

Hence, according to the company, the grant becomes effective when two independent conditions, viz. (i) the earning of export income and (ii) the utilisation of the SFIS scrip for import of capital goods and consumables in the service sector are both satisfied. When it is used for payment of customs duty on import of capital goods it becomes a capital grant. Since the company has used SFIS scrip for payment of customs duty on import of capital goods, it is rightful to treat it as capital grant and not the grant in the nature of revenue.

3. The company has, therefore, submitted that:

(a) Mere issuance of duty credit entitlement scrips without their utilisation does not create any benefit in the hands of exporter; and

(b) If utilised in accordance with the conditions of issuance of scrips, the nature of grant, i.e. revenue grant or capital grant will be determined and accordingly accounted for the benefit.

B. Query

4. In view of the above, the querist has requested to the EAC of the ICAI to review its earlier opinion and issue necessary clarification / revision of its opinion on the basis of utilisation of SFIS scrips as mentioned above.

C. Points considered by the Committee

5. At the outset, the Committee wishes to point out that normally the Committee does not accept the request for review of its earlier opinion, except in certain situations, such as submission of certain additional facts which materially affect the opinion earlier issued by the Committee or omission of certain material facts while providing the opinion, etc. However, the Committee notes that in the extant case, although the querist has requested for review of its earlier opinion, the issue raised in the extant query relating to recognition of duty credit entitlement certificates (scrips) issued under the 'Served from India Scheme' based on their utilisation was not specifically raised in the earlier query and is, therefore, considered as a separate issue raised by the querist.

6. The Committee notes that the basic issue raised in the query relates to the nature of the grant related to duty credit entitlement certificates (scrips) issued under the 'Served from India Scheme', viz., whether the scrips utilised for payment of import duty on import of a capital asset should be treated as grant related to specific fixed asset and those utilised for payment of import duty on consumables as grant related to revenue, instead of treating the entire grant as grant related to revenue as opined in the earlier EAC Opinion to the querist. Therefore, the Committee has considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, presentation and disclosure of duty credit entitlement under SFIS in the financial statements, timing of recognition of the duty credit entitlement under SFIS, accounting for transfer of the duty credit entitlement to the group companies, etc.

7. With regard to the issue raised as to whether the duty credit entitlement can be treated as grant related to specific fixed asset in case it is utilised for payment of import duty on capital goods, the Committee notes paragraphs 5.4 and 8.1 of AS 12, notified under the Companies (Accounting Standards) Rules, 2006, which provide as below:

> "5.4 It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants."

> "8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held."

From the above, the Committee notes that accounting for grant should be based on the nature of relevant grant (based on the eligibility condition for availing the grant) rather than its actual utilisation, as being argued by the querist. Further, the Committee notes that grants related to specific fixed asset are the grants whose *primary condition* is that an enterprise qualifying for them should purchase, construct or otherwise acquire such specific assets. Thus, Committee is of the view that in case of such grants, specific fixed asset(s) is identified for which the grant is to be used. The Committee notes that in the extant case, the Scheme is applicable to various kind of service providers. To avail the benefit under SFIS the main eligibility condition is exports. Thus, the company would not be entitled to receive the duty credit unless this condition of exports is met. While the scheme entitles the scrips to be utilised for payment of import duty on the capital goods pertaining to the service sector in which those service providers deal (apart from other permitted forms of utilisation), it is only representative of one of the possible ways of the utilisation of the duty credit. In other words, the import of capital goods is not essential (or the primary condition) to be entitled to the benefit. The nexus of the entitlement to duty credit is with export of services. The substantive position is that once the export occurs, the entitlement to duty credit arises. The real trigger is the exports; the entitlement does not arise as a result of import of a specific fixed asset/specific type of fixed asset. If there is no such exports during the period, there would be no duty credit accruing to the company. Thus, this situation can be distinguished from those where an entity is entitled to a government grant if it purchases a specific type of asset, e.g. certain pollution control equipments or energy saving derives. In these cases, the nexus of the grant is with the purchase of the asset. However, in the extant case of duty credit entitlement, the nexus of entitlement is with exports, though the grant is not paid in cash and is instead usable for payment of customs duty on most types of imports (capital goods and consumables) relevant to the exporter in the normal course of business. Accordingly, the Committee is of the view that since the primary condition is neither related to any fixed asset nor are the benefits based on capital investment, in terms of the classification of government

grants under AS 12, the scrips are in the nature of grant related to revenue. The actual utilisation of scrips for a purpose, say for import of capital goods does not change the nature of the grant.

D. Opinion

8. On the basis of above, the Committee is of the opinion that the duty credit entitlement under SFIS should be treated as a grant related to revenue, as discussed in paragraph 7 above. The actual utilisation of scrips for a purpose, say for import of capital goods does not change the nature of the grant.

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.