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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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NEW DELHI

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Foreword

With a view to provide most accurate and sufficient information to the users, the financial reporting framework is continuously evolving. Keeping up such evolvement, Financial Statements which are prepared in accordance with the Generally Accepted Accounting Principles (GAAPs) are undergoing tremendous changes. In order to comprehend the various unique situations arising from these changes, members look up to well researched and impartial guidance.

To provide effective guidance to members faced with complex accounting situations, Expert Advisory Committee was constituted by the Council of the Institute in the year 1975. The Committee is constantly issuing comprehensive opinions after studying the specific facts in detail on the matters referred and an in-depth study of the relevant applicable accounting/auditing or legal requirements. The Committee is also regularly approached by the various Regulatory and Government authorities, such as, Ministry of Corporate Affairs (MCA), Security and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), etc. to seek guidance on accounting issues faced by them.

In order to make these opinions available to the members of the Institute, the opinions issued are regularly published as volumes of Compendium of Opinions. These Volumes act as a one-stop solution to major challenges faced while preparing or reviewing financials. I would like to congratulate CA. Babu Abraham Kallivayalil, Chairman, CA. M.P. Vijay Kumar, Vice-Chairman and all the other members of the Committee for coming up with yet another Volume, viz., Volume XXXIX (39) of the Compendium of Opinions.

I hope, this Volume will continue to benefit the members with the valuable guidance contained in the opinions and will prove to be of great assistance to the members.

New Delhi
February 02, 2021

CA. Atul Kumar Gupta
President

Preface

We feel elated to present the thirty-ninth (39) volume of the Compendium of Opinions containing all opinions finalised by the Expert Advisory Committee (EAC) during the Council year 2019-20 under the able chairmanship of CA. Tarun Jamnadas Ghia, Chairman of the Committee. It has been an extremely enriching experience to chair the EAC for the current Council Year, 2020-21.

We take great pride in mentioning that the queries issued by the Committee are well researched and deliberated in detail at the Committee. Gist of the prominent topics on which opinions issued contained in this volume are as follows:

- Accounting treatment under Ind AS for depreciation of 'enabling assets', amortization of leasehold land and project insurance in case of a new company formed for setting up of new urea plant which is under construction phase.
- Accounting treatment of PoS devices purchased out of accumulated payable amount of withheld retailer margin and installed at retailer's premises for sale of fertilizers under Direct Benefit Subsidy (DBS) Scheme.
- Consolidation of joint venture company (JVC) wherein the relevant economic activity and the purpose of formation of JVC got ceased.
- Company's policy on transfer price for segment revenue and segment results under segment reporting.
- Revenue recognition of real estate units under construction under Ind AS 115.
- Accounting for Embedded Derivatives in Non-Financial Host Contracts as per Ind AS 109.
- Presentation of gain or loss on account of mark to market valuation of the derivative contracts resulting from movements in exchange rates and interest rates of the underlying currencies.
- Presentation of the grant receivable from the Government of India (under SEIS) in the statement of profit and loss.
- Accounting for Concession Agreement.
- Disclosure/classification of late payment interest charges collected from customers in the statement of cash flows.
- Cash basis of accounting by Alternative Investment Fund (AIF).

The opinions issued by the Committee are based on the specific facts and circumstances of the query, considering the legal requirements (if any) and applicable accounting/auditing principles prevailing on the date on which a particular opinion is finalised. Therefore, the date of finalisation of each opinion is given in 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.

It may be noted that although the Council of the Institute of Chartered Accountants of India (ICAI) has constituted Expert Advisory Committee, an opinion or views expressed by the Committee represents the opinion or view of the EAC only and not the official opinion of the Council.

We would also like to apprise the readers that EAC answers the queries as per the Advisory Service Rules framed by the Council of the Institute. These Rules are available on the website (https://www.icai.org/post/advisory-service-rules-of-the-expert-advisory-committee) of the Institute and have also been published in all the volumes of the Compendium of Opinions.

We are pleased to inform you that for the convenience of members, all the Volumes of the Compendium viz, volumes I to XXXVIII released by the Committee so far, have also been hosted on Digital Learning Hub on the website (https://learning.icai.org/iDH/icai/) of the ICAI.

We wish to place on record my sincere gratitude towards CA. Atul Kumar Gupta, President, ICAI and CA. Nihar N. Jambusaria Vice-President, ICAI for their continuous support to the Committee. I would also like to recognize the great contribution and valuable guidance provided by CA. M. P. Vijay Kumar Vice-Chairman EAC in finalisation of the opinions. I appreciate the expertise and devotion contributed by all the members and special invitees of the Expert Advisory Committee both past and present in finalization of opinions. I wish to sincerely thank my Council Colleagues in the Committee, viz., Ms. Ritika Bhatia (Government Nominee), Shri Chandra Wadhwa (Government Nominee), CA. Tarun Jamnadas Ghia, CA. G. Sekar, CA. Anuj Goyal, CA. Dheeraj Kumar Khandelwal, CA. (Dr.) Debashis Mitra, CA. Prakash Sharma, CA. Prasanna Kumar D., CA. Satish Kumar Gupta, CA. Pramod Jain, CA. (Dr.) Sanjeev Kumar Singhal, CA. Hans Raj Chugh and CA. Dayaniwas Sharma.

We are also thankful to the Co-opted members of the Committee, namely, CA. Nilesh S. Vikamsey (Past President, ICAI), CA. (Dr.) Girish Ahuja, CA. Vivek Newatia, CA. Piyush Agrawal, CA. Venkateswarlu S. and CA. Siddharth Jain; and Special Invitees, namely, CA. Mohit Bhuteria, CA. Navneet Mehta, CA.

Venugopal C. Govind and CA. K. Vishwanath for their whole-hearted support and expertise contributed in the opinions of the Committee.

I would also like to acknowledge the consistent efforts and committed support of CA. Parul Gupta - Secretary EAC for formulating and presenting drafts for consideration of the Committee in timely manner with outstanding support of CA. Khushboo Bansal, Sr. Executive Officer and thereafter finalising the same as per the decisions of the Committee.

We sincerely hope that this volume will also be of great significance and value for our members and other stakeholders.

New Delhi
February 02, 2021

CA. Babu Abraham Kallivayalil
Chairman
Expert Advisory Committee

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PART I:
Opinions on
Indian Accounting Standards

Query No. 1

Subject: Accounting treatment under Ind AS for depreciation of 'enabling assets', amortization of leasehold land and project insurance in case of a new company formed for setting up of new urea plant which is under construction phase.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a joint venture company promoted by two fertilizer manufacturing companies (X Ltd. and Y Ltd.) and an engineering consultancy PSU, Z Ltd. The company was incorporated on 17th February, 2015 in terms of the mandate of the Government of India (GoI) of setting up of new gas based ammonia-urea complex at the closed ABC unit of Y Ltd. in terms of nomination by the Cabinet Committee of Economic Affairs (CCEA), GoI decision dated 4th August, 2011 for revival of closed fertilizers units of Y Ltd., which includes ABC unit.

2. The querist has informed that as per the process of revival of closed ABC unit of Y Ltd., the old plant was dismantled and sold off by Y Ltd. and the company is setting up a new state of art gas based ammonia-urea complex with production capacity of 2200 MTPD of ammonia and 3850 MTPD of urea (1.27 million MT urea per annum) at fertilizer city, ABC. For setting up urea plant, the company opened its project office at New Delhi for execution of the project on 1st October, 2015 and subsequently with the commencement of construction activities at ABC, site office was made operational.

3. As per the querist, shareholding of the company as on 31st March 2018 is as under:

S.No.	Particulars	% of Shareholding
1.	X Ltd.	26
2.	Y Ltd.	11
3.	Z Ltd.	26
4.	State Government	11
5.	Others (Un-tied)*	26

* Tie up of balance equity is under process and shall be completed in the current financial year 2018-19.

4. Abridged statement of affairs of the company as on 31st March 2018 is as under:

[1] Opinion finalised by the Committee on 9.4.2019.

Particulars	**Amount INR**
Equity Share Capital	602.12 Crore
Outstanding Term Loan from Consortium of Banks	1104.52 Crore
Capital Work in Progress	1341.83 Crore
Reserve & Surplus	(4.41 Crore)

5. As further stated by the querist, the project is being executed on Engineering Procurement & Construction Management (EPCM) route. The company after entering into contracts with technology suppliers and licensors for ammonia & urea and engaging Z Ltd. as EPCM Consultant, declared zero date of the project on 25th September, 2015 and the project is anticipated to be completed in the first quarter of financial year 2019-20. The project is in the advanced stage of construction and achieved physical progress of 85.5% as on 15th June, 2018. The total project cost envisaged is Rs. 5254.28 crores with debt-equity ratio of 75:25. Total debt of Rs. 3940.71 crores has been lined up and loan agreement has been entered into with consortium of 6 banks led by the State Bank of India.

6. Since the date of incorporation of the company, i.e., 17th February 2015, its first annual accounts were prepared for the period of 17th February 2015 to 31st March 2016 as per Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006. Annual accounts for the financial year 2016-17 were prepared in terms of Indian Accounting Standards (Ind ASs) in terms of the Companies Act, 2013. Comptroller and Auditor General of India (C&AG) decided not to conduct the supplementary audit of the financial statements of the company for the year ended 31st March, 2017 under section 143(6)(a) of the Act. Annual accounts for the financial year 2017-18 (duly audited by statutory auditor appointed by C&AG) have been prepared in terms of Ind ASs, which have been adopted and approved by the board at its last meeting held on 28th April 2018 (copy of the accounting policies has been supplied separately by the querist for the perusal of the Committee). The audited accounts were submitted to C&AG on 3rd May, 2018.

7. The querist has stated that the audited accounts of the company for the financial year 2017-18 were selected by the C&AG under section 143(6)(a) of the Companies Act, 2013 for supplementary audit. C&AG has raised provisional comments which are given below:

C&AG Provisional Comments:

"Balance sheet
Non-current assets
Capital work-in-progress

The above includes an amount of Rs. 47.36 crore (Rs. 28.95 crore for the financial year 2017-18) being expenses incurred and taken to capital work-in-progress (CWIP) for capitalisation by the company. The said expenses were of revenue nature and were not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating. Through these expenses mainly represented the overheads costs, but not charged as expenses and taken to CWIP for capitalisation which is not in line with provisions of Ind AS 16.

This has resulted in overstatement of capital work in progress (Note 4) by Rs. 47.36 crore, 'Reserve and Surplus' by Rs 18.41 crore and understatement of loss for the year by Rs. 28.95 crore."

8. Management had submitted reply with justification of inclusion of these expenditure in CWIP. (The reply of the company to C&AG has been separately supplied by the querist for the perusal of the Committee.) Based on the reply of the company and discussions held, C&AG dropped all its observations except recording of insurance, amortisation on lease hold land and depreciation in CWIP.

9. During deliberations, C&AG stated that insurance and depreciation & amortization expenses should be expensed in the statement of profit and loss and should not be capitalised. The company maintained its stand that these expenditure are directly attributable to the project and accordingly capitalized as CWIP. Thereafter, it was agreed that the company shall refer the matter to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for its opinion. Subsequently, C&AG issued Nil comments on the company's financial statements for the financial year 2017-18.

10. The company's submission is given as below:

a) *The accounting policy at Note No. 1(h) of the financial statements* - Expenditure incurred during the construction period and directly attributable to the construction activity has been capitalised as capital work in progress and will be allocated to the fixed assets at the time of capitalisation of the project (Notes to the financial statements for the year ended March 31, 2018 have been supplied by the querist for the perusal of the Committee). Accounting treatment is in line with accounting policy of the company.

b) *Depreciation and amortisation expenses – capitalised to CWIP* **–** This represents amortisation of leasehold land from Y Ltd. at project site, ABC and depreciation expenses on project enabling assets. The break-up of depreciation and amortisation expenses is as under:

(Rs. in lakhs)

Financial Year	Depreciation	Amortization	Total
2016-17	69.25	-	69.25
2017-18	185.44	342.18	527.62
	254.69	**342.18**	**596.87**

As per paragraph 16(b) of Ind AS 16, 'Property, Plant and Equipment', "The cost of an item of property, plant and equipment comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management."

Further paragraph 49 of Ind AS 16 states as follows:

"49 The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see Ind AS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with Ind AS 38, *Intangible Assets*."

The company is of the view that the intent of paragraphs 49 and 16 (b) of Ind AS 16 is that allocated costs of fixed assets which are used in the construction of other fixed assets must be included in the cost of those assets. Since, land is an essential asset on which project related activities are undertaken for construction of a fertilizer plant, its amortisation cost up to the date of completion of project is to be included in the cost of construction of the fertilizer plant.

11. The querist has stated that one of the object of the approval of the Cabinet Committee on Economic Affairs (CCEA) dated 4th August, 2011 (the letter has been separately provided by the querist for the perusal of the Committee) was to increase the urea production capacity in the country and therefore approved award of closed fertilizer units of Y Ltd. to selected parties on concession basis. As per paragraph 6.2 of CCEA approval, land shall be provided to concessionaire (the company) on right to use basis for the period of concession and during the concession period, Y Ltd. would retain a board seat in

the Special Purpose Vehicle (SPV) (the company) to safeguard its rights in the land. Therefore, the company has no choice but to construct plant on leasehold land and amortise the same in accordance with Ind AS.

12. Similarly, the company has charged depreciation in respect of project enabling assets which are required for execution of project and same has been disclosed as depreciation and amortisation in Note 4 relating to 'Capital Work in Progress'. Further it is submitted that these costs are unavoidable and essential to be incurred to execute the project. Land is acquired by the company for executing project on leasehold basis as per terms of agreement as specified above.

13. *Insurance Expenses – Capitalised to CWIP*– The company has taken marine cum erection insurance policy for coverage of all its equipments, storage and erection and commissioning of the equipment which also includes other project related insurance for associated costs for delayed commencement of project due to insured perils. All these policies shall expire immediately upon commissioning of project. The expense of Rs. 6.38 crore (Rs. 2.23 crore for F.Y. 2016-17 and Rs. 4.15 crore for F.Y. 2017-18) was charged to CWIP.

14. In this regard, the querist has stated that setting up of a project of such a magnitude and bringing property, plant and equipment to its present location without taking insurance policy for coverage is not considered commercially feasible. Hence, insurance policy is an integral part of project activities. The secured handling of project goods, whether in transit or during erection is an utmost project activity for timely completion of project without additional costs towards contingencies. To ensure this, all critical project equipments are inspected / surveyed at loading / unloading points. All these critical items with other project goods are got covered under the insurance policy. The premium paid under the insurance policy is directly attributable to project.

15. This Policy covers the risk of marine and erection of plant under construction. In case, the company had not taken this policy, then individual supplier and contractor would have taken the specific policy for marine as well as erection and had included this cost in their quoted price. Thus, as per the querist, the insurance cost is an essential cost to be incurred for successful execution of project and the same is to be included in the project cost eligible for capitalisation as per paragraph 16 (b) of Ind AS 16.

16. Reference to legal cases -While capitalising the insurance cost, landmark decision on actual cost by the Supreme Court in case of Challapalli Sugars Ltd. vs CIT [98 ITR 167 (SC) (1975)] was kept in mind. (Copy of the same has been separately supplied by the querist for the perusal of the Committee.) In this case, according to the querist, the apex Court has held that interest paid before the commencement of production on amounts borrowed for acquisition and

installation of plant and machinery form part of the actual cost of the assets.

In arriving at the above decision, the Supreme Court has laid down the following important principles for determination of actual cost:

(i) As the expression 'Actual Cost' has not been defined, it should be construed in the sense which no commercial man would misunderstand. For this purpose, it would be necessary to ascertain the connotation of the expression in accordance with the normal rules of accountancy prevailing in commerce and industry.

(ii) The accepted accountancy rule for determining cost of fixed assets is to include all expenditure necessary to bring such assets into existence and to put them in working condition.

Other cases settled where directly attributable cost including insurance cost is to be capitalized –

- CIT vs New Central Jute Mills [135 ITR 736 (Cal) (1982)]
- CIT vs Polychem Ltd [98 ITR 574 (Bom) (1975)]
- Madras Fertilizers Ltd vs CIT [209 ITR 174 (Mad)]
- Hotel Bombay Complex vs CIT [198 ITR 361 (Kar) (1992)]

17. The querist has also separately provided certain additional information which is as follows:

(i) *With regard to marine-cum-erection insurance policy:* The company has placed various orders for project equipments including orders on foreign suppliers. Further, the company has entered into various package contracts which involve supply, installation and erection of equipment as well as various civil and erection contracts. For protection from transportation, erection and commissioning risks, taking of insurance policy is either included in the scope of suppliers and contractors and cost of insurance becomes part of cost of supply of equipment/ contract value or composite insurance is taken by project owner. The company has taken composite marine-cum-erection insurance policy for all project equipments and contracts; and accordingly the purchase orders and contracts placed by the company are exclusive of insurance cost.

The project is funded from debt and equity in debt equity ratio of 75:25. For entering into loan agreements with banks, one of the pre-commitment condition as per loan sanction letter of banks (copy of the letter has been supplied by the querist for the perusal of the Committee) was appointment of Lenders' Insurance Advisor (LIA). The scope of services of LIA is to

advise on the insurance policy to be taken by the project owner and if policy has been already taken, to examine and see the adequacy of the insurance policy. Thus, without insurance policy in place, the company could not have arranged the debt and project had to be closed.

Further, in case of imports, the company is required to establish Letter of Credits (LCs). Establishment of LCs is governed by Uniform Customs and Practice (UCP) for Documentary Credits, issued by International Chamber of Commerce. UCP are rules that apply to any documentary credits (including letter of credit) and binding on all parties unless expressly modified or excluded from credit. For issuance of LCs by bank, it has to be UCP compliant. Presently, UCP 600 is in force and Article-28(iii) of UCP 600 provides as follows:

> "The insurance document must indicate that risks are covered at least between the place of taking in charge or shipment and the place of discharge or final destination as stated in the credit."

The insurance policy taken by the company covers transit risk of domestic goods, risks associated with storage of project goods waiting for use, risks arising out of erection of equipment and other incidental risks. Therefore, incurrence of insurance cost is directly attributable to project cost as it is unavoidable and has to be incurred for execution of the project. (Copy of UCP 600 and copy of a LC issued by bank has been supplied by the querist for the perusal of the Committee.)

In the instant case, the company has taken insurance policy and disclosed insurance cost separately in financial statements. Alternately, insurance cost would have been taken by all the suppliers to cover their risk in case of any loss in supply of goods. Similarly, the contractors would have also covered their risk in execution of contract, and this cost would have been a part in their consolidated contract / supply price. The company has taken insurance policy of its own to ensure that in case of any eventuality, insurance claim can be made by the company and also to ensure that all possible risks from movement of goods till its complete erection are covered, instead of piecemeal approach for insurance covers.

As per the querist, the execution of the project of such a magnitude is not possible unless the associated risks of the project are duly mitigated. Lenders do not extend the loan facility unless and until adequate insurance cover has been taken by the project owner and the insurance policy is monitored by LIA for lenders. For opening of letter of credits, insurance policy is mandatory under UCP 600.

Thus, various insurance policies taken by the company are an integral part of the project. (Copies of four insurance policies have been supplied by the querist for the perusal of the Committee.)

(ii) *With regard to leasehold land:* Cabinet Committee on Economic Affairs at the meeting held on 4th August, 2011, mandated revival of ABC unit of Y Ltd. by forming a Special Purpose Vehicle (SPV)/Joint Venture (JV) between X Ltd., Y Ltd. and Z Ltd. As per the concession agreement between the company and Y Ltd., approved by the Government, leasehold rights of the land (owned by Y Ltd.) have been given to the company for a period of 99 years. The lease, according to the querist, is a finance lease and has been capitalised by the company.

The company has acquired this right to use of land as an intangible right from Y Ltd. Since the company is having right to use and it will derive future benefits from it, thereby it fulfils the capitalisation requirements of Ind AS 38; therefore, this right has got capitalised in books. (The copy of lease deed has been supplied by the querist for the perusal of the Committee.)

(iii) *With regard to enabling assets:* In order to commence, monitor and provide support in carrying out the construction activity, the company was required to create 'enabling assets', which are directly related to project activities, such as:

(a) Construction power system;

(b) Construction water network;

(c) Warehouse / stock yards;

(d) Security watch towers;

(e) Generators for power backups;

(f) Technical and other buildings at site;

(g) IT equipment / furniture and fixtures etc.

All the above activities are essential for commencement of project construction and are directly attributable to the project. Accordingly, the 'enabling assets' as above have been capitalised. Further, the querist has separately clarified that these enabling assets have been capitalized as separate individual items of property, plant and equipment and would be continued to be used by the company after the construction of the project is complete, for the operations of the project also.

B. Query

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

a) Whether expenses on account of project insurance consisting of marine-cum-erection insurance policy for coverage of all the equipments and site activities during construction and commissioning periods are directly attributable to the project activity and eligible for capitalisation.

b) Whether expenses on account of depreciation on enabling assets during construction period are directly attributable to the project activity and eligible for capitalisation.

c) Whether expenses on account of amortization of leasehold rights of the land which have been given by Y Ltd. (on finance lease) are directly attributable to the project activity and eligible for capitalisation.

C. Points considered by the Committee

19. The Committee notes that the basic issues raised in the query are whether expenses on account of project insurance (marine-cum-erection insurance policy) during the construction period, expenses on account of depreciation and amortisation of assets created for construction (referred to as 'enabling assets' by the querist) and 'right to use' of land in connection with the project, respectively, are directly attributable to project. 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 other expenses incurred during the construction period, accounting treatment of equity shares issued in lieu of the plant (including leasehold land) to Y Ltd., measurement of minimum lease rent, commencement of amortization, allocation of consideration of plant acquired by the company between consideration for land and for other plant facilities, manner of determination of depreciation on leasehold land, etc. Further, the Committee has expressed its opinion purely from the accounting perspective and not from tax perspective or from the perspective of legal interpretation of UCP 600 and various judgements of High Court/Supreme Court, as referred to by the querist. At the outset, the Committee notes from the Facts of the Case that certain assets have been created by the company in order to commence, monitor and provide support in carrying out the construction activity, which have been termed and capitalized as 'enabling assets' by the querist. In this connection, the Committee wishes to point out that the nature of these assets as 'enabling asset' has not been examined by the Committee. The Committee also wishes to state that it has not examined the accounting for 'enabling assets' as such and has presumed that the recognition and

measurement of the 'enabling assets' has been done correctly by the company considering the applicable accounting principles.

Expenses on account of project insurance (consisting of marine-cum-erection insurance)

20. The Committee notes that the company has taken marine-cum-erection insurance policy for coverage of all equipments and site activities during construction and commissioning period. In this regard, the Committee notes paragraph 16(b) and 17 of Ind AS 16, Property, Plant and Equipment, notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as the 'Rules'), which state as follows:

> "16 The cost of an item of property, plant and equipment comprises:
>
> …
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> …"

> "17 Examples of directly attributable costs are:
>
> (a) costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
>
> (b) costs of site preparation;
>
> (c) initial delivery and handling costs;
>
> (d) installation and assembly costs;
>
> (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
>
> (f) professional fees."

From the above, the Committee notes that the expenses that are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management should only be captalised. The Committee also notes the examples of directly attributable costs as given in paragraph 17 of Ind AS 16 above. Thus, in the extant case, the accounting treatment of expense on account of marine-cum-erection insurance

policy would depend upon whether or not the same is directly attributable to the construction/acquisition of the project/related asset(s).

The Committee notes that an insurance policy is normally taken to protect/safeguard against the loss that may arise in unforeseen future and may not be ordinarily essential for or will contribute to construction activity as such. Therefore, it cannot be considered as directly attributable to construction/acquisition of the project. In the extant case also, the Committee notes that the marine-cum-insurance policy has been taken to ensure that all the possible risks from supply/installation of goods/equipment till their complete erection are covered. Accordingly, considering the facts provided by the querist and considering the nature of directly attributable costs as per paragraphs 16 and 17 of Ind AS 16 reproduced above, the Committee is of the view that in the extant case, the expenses on account of project insurance cannot be considered as directly attributable costs and should accordingly be recognized in the statement of profit and loss.

In the above context, the Committee also wishes to mention that the fact that insurance is required to obtain loan/credit facilities does not make it directly attributable to the construction/acquisition of the project as in that case, these costs of insurance are incurred for obtaining loan and establishing letter of credit, i.e., for obtaining funds for the project as such and not for constructing/acquiring the project/equipments.

Depreciation *on assets used during construction (referred to as 'enabling asset' by the querist; the expression 'enabling asset' has been used in the discussion below only for reference to these assets).*

21. The Committee notes from the Facts of the Case that in order to commence, monitor and provide support in carrying out the construction activity, the company has acquired/constructed various assets, such as, power system, water network, warehouse, stock yard, security watch towers, generators for power back-ups, technical and other buildings at site, IT equipment/furniture and fixtures etc. These have been capitalised as separate individual items of property, plant and equipment and would be continued to be used by the company after the construction of the project is complete, for the operations of projects also. With regard to inclusion of depreciation on these assets during construction period in the cost of project/assets being capitalized (CWIP), the Committee notes paragraphs 48 and 49 of Ind AS 16, 'Property, Plant and Equipment', notified under the Rules, which state as follows:

> "**48 The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset.**

> 49 The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see Ind AS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with Ind AS 38, *Intangible Assets*."

From the above, the Committee notes that the depreciation charge for each period is recognized in the profit and loss unless it forms part of *another asset*. Thus, depreciation on an asset can only be capitalised with another asset if the future economic benefits embodied in that asset are absorbed in producing other asset. The Committee further notes that the querist has specifically stated in paragraph 12 above that these costs on 'enabling assets' under query are unavoidable and essential to be incurred to execute the project. Accordingly, the Committee is of the view that in the extant case, depreciation on such 'enabling assets' under query to the extent and till the time the future economic benefits embodied in the afore-mentioned assets are absorbed in construction of the project/other assets, should be capitalized along with the project/other assets under construction. The Committee is also of the view that the depreciation on such assets should be allocated appropriately and on a reasonable and systematic basis to other asset(s) or the project after ascertaining the benefit being obtained from these assets.

Expenses on account of amortisation of leasehold rights of the land

22. The Committee notes that the company has applied Ind AS 38, 'Intangible Assets' instead of Ind AS 17, 'Leases', which includes leases of land in its scope. In this context, the Committee also notes paragraph 3(c) of Ind AS 38, 'Intangible Assets', notified under the Rules, which states that "If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For Example, this Standard does not apply to: … (c) leases that are within the scope of Ind AS 17, *Leases*". The Committee also notes paragraph 3 of Ind AS 17, 'Leases', notified under the Rules, which states that "This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other". As in the extant case, right to use the land has been transferred by Y Ltd. to the company,

the Committee is of the view that accounting for the same will be governed by Ind AS 17, 'Leases' and not Ind AS 38, 'Intangible Assets'.

23 Further, the Committee is of the view that answer to the issue regarding inclusion of expenses on account of amortization of leasehold land would depend upon whether such lease is operating lease or finance lease. The Committee notes the following paragraphs of Ind AS 17, 'Leases', notified under the Rules:

> **"A *finance lease* is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.**
>
> **An *operating lease* is a lease other than a finance lease."**
>
> "10 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
>
> (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
>
> (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
>
> (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
>
> (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
>
> (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.
>
> 11 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
>
> (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
>
> (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent."

"15A When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life."

24. From the above, the Committee notes that a key criterion to determine the type of lease is whether or not it transfers substantially all the risks and rewards incidental to ownership of an asset. However, application of this criterion is subjective and depends on the substance of the transaction rather than the form of the contract and requires exercise of judgement considering various situations and indicators of situations, as prescribed in paragraphs 10 and 11 of Ind AS 17, such as, transfer of ownership of the asset by the end of lease term, option to purchase the asset at the end of the lease term at a price substantially lower than the fair value at the date the option becomes exercisable, economic life of the asset covered by the lease term, present value of minimum lease payments, conditions for cancellation and renewability, accrual of gains or losses from the fluctuation in the fair value of the residual etc.

25. The Committee notes the following relevant paragraphs of the lease deed:

"3. The absolute ownership, rights, title and interests of the Facility Area shall continue to remain with the Lessor only and the Lessee shall have right to enjoy the Facility Area for the Term of this Lease Deed and in accordance with the terms and conditions of this Lease Deed."

"5.2.1 In the event, the Concession Agreement is extended, the Parties agree that the Term of this Lease Deed shall be extended to the extended term of the Concession Agreement on mutually agreed terms and conditions. The Lessor agrees not to unreasonably object to such an extension of the Term."

"5.3 **Reversion**

On expiry of the Term or early termination of Lease Deed, for any reason whatsoever, the Lessee shall handover, the Facility Area,

Facility and Facility Capital Assets to the Lessor in accordance with the terms of the Concession Agreement."

"**7.**1 **By Lessee**

The Lessee shall obtain prior written consent of the Lessor with respect to Clause nos. 7.1.1 and 7.1.4

7.1.1 assign, mortgage (including equitable mortgage), charge, deal with, sub-license or otherwise grant rights in the Lease Deed, or any of its obligations or liabilities under this Lease Deed;

7.1.2 cause or permit any person, firm or company (other than any department of Government of India/Relevant Authorities) at any time to use (except for the purpose of construction of the Facility) any part of the Facility Area;

7.1.3 assign its rights to any payment(s) hereunder by way of security for its obligation in relation, directly or in directly, to any Borrowings;"

"12.6 The Lessor assures and represents to the Lessee that the lease granted in terms of this Lease Deed is irrevocable for the term, except in accordance with the provisions of this Lease Deed and/or the Concession Agreement."

26. The Committee notes that the lease, in the extant case, is an irrevocable lease for a period of 99 years. Further, the Committee notes from the lease deed that the absolute ownership, rights, title and interests of the facility area shall continue to remain with lessor and the lessee shall have the right to enjoy the facility area for the terms of the lease deed. It is also stated in the lease deed that the lease can be extended on mutually agreed terms and lessor will not unreasonably object to such extension. The lease deed also states that on expiry of the term or early termination, the lessee shall handover the Facility Area, Facility and Facility Capital Assets to the Lessor in accordance with the terms of the Concession Agreement. The Committee also notes that the lessee needs to obtain written consent of the lessor to assign/mortgage, charge, deal with, sub-licensing or otherwise grant rights in the lease deed or permit anyone (other than Government department) to use any part of facility area, assign its rights to any payment etc.

However, the Committee notes that various other factors for determining the type of lease, such as, the fair value of land, transfer of ownership at the end of lease term, option to purchase, cancellation of lease etc. have not been explicitly provided in the facts of the case and the lease agreement. Accordingly, the Committee is of the view that in the extant case, for a lease of land for 99 years,

if it is likely that at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset (viz., land), then, such lease will be classified as 'finance lease'. It may also be, however, noted that land normally has an indefinite economic life. Therefore, where in substance there is no transfer of risks and rewards, it should be considered as an operating lease. Some of the indicators to consider in the overall context of whether there is transfer of risks and rewards incidental to ownership include the lessee's ability to renew lease for another term at substantially below market rent, lessee's option to purchase at price significantly below fair value, etc. Accordingly, classification as operating or finance lease requires exercise of judgement based on evaluation of facts and circumstances in each case, by considering the indicators enumerated above.

27. On the basis of the above, the Committee is of the view that if the company after a detailed evaluation, concludes that the lease is an operating lease, the lease payments should be capitalised along with the capital work-in-progress till the time the asset/project is ready for the intended use as the same can be considered as directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management as per paragraph 16(b) of Ind AS 16, Property, Plant and Equipment. When the asset/project is ready for its intended use, the lease rent shall be recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit as given in paragraph 33 of Ind AS 17, 'Leases', notified under the Rules, reproduced below:

> **"33 Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless either:**
>
> **(a) another systematic basis is more representative of the time pattern of the user's benefit even if the payments to the lessors are not on that basis; or**
>
> **…"**

If the company after detailed evaluation concludes that the land lease is a finance lease, then it will account for and present the asset as property, plant and equipment and provide depreciation considering useful life, limits on the use of the asset (including legal/contractual limits), whether there is any reasonable certainty that the lessee will obtain the ownership of the asset by the end of the lease term in accordance with the requirements of Ind AS 16, 'Property, Plant and Equipment' and Ind AS 17. Further, the depreciation so determined should be included in the cost of the capitalized asset/project as acquisition of the land is directly attributable to the construction of the project/related assets.

D. Opinion

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

(a) Considering the nature of directly attributable costs as per paragraphs 16 and 17 of Ind AS 16, in the extant case, the expenses on account of project insurance cannot be considered as directly attributable costs and should accordingly be charged to the statement of profit and loss, as discussed in paragraph 20 above.

(b) Depreciation expense on 'enabling assets' under query to the extent and till the time the future economic benefits embodied in these assets are absorbed in the construction of the project/other assets should be capitalised along with the project/other assets, as discussed in paragraph 21 above.

(c) With regard to inclusion of expenses on account of amortization of leasehold land in the cost of the project, the same would depend upon whether such lease is operating lease or finance lease, which should be determined by exercising judgement, considering various criterions/indicators of Ind AS 17, as discussed in paragraph 26 above. If the company after detailed evaluation concludes that the land lease is an operating lease, the lease payments should be capitalised along with the capital work-in-progress till the time the asset/project is ready for the intended use. When the asset/project is ready for its intended use, the lease rent shall be recognized as an expense in the statement of profit and loss. In case after detailed evaluation, it is concluded that land lease is a finance lease, the company should provide depreciation considering useful life, limits on the use of the asset (including legal/contractual limits), whether there is any reasonable certainty that the lessee will obtain the ownership of the asset by the end of the lease term in accordance with the requirements of Ind AS 16, 'Property, Plant and Equipment' and Ind AS 17, 'Leases'. Further, the depreciation so determined should be included in the cost of the capitalized asset/project as acquisition of the land is directly attributable to the construction of the project/related assets, as discussed in paragraph 27 above.

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Query No. 2

Subject: Accounting treatment of PoS devices purchased out of accumulated payable amount of withheld retailer margin and installed at retailers premises for sale of fertilizers under Direct Benefit Subsidy (DBS) Scheme.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a Schedule 'A' and a Mini Ratna (Category-I) company, and was incorporated on 23rd August 1974. It has an authorized capital of Rs. 1000 crore and a paid up capital of Rs. 490.58 crore out of which Government of India's (GoI) share is 74.71 % and 25.29 % is held by financial institutions and others.

2. The company has five gas based Ammonia-Urea plants in various parts of the country, viz., in Haryana and two plants in Madhya Pradesh. The company currently has a total annual installed capacity of 35.68 LMT (re-assessed capacity of 32.31 LMT) and is the second largest producer of urea with a share of about 16% of total urea production in the country.

3. The company is engaged in manufacturing and marketing of neem coated urea, three strains of bio-fertilizers (solid and liquid) and other allied industrial products like ammonia, nitric acid, ammonium nitrate, sodium nitrite and sodium nitrate.

4. Urea (fertilizer) is a controlled product and its price is controlled by the Government under its subsidy scheme. The maximum retail price (MRP) of urea is fixed by the Government and is same for all the companies. The company is also importing and trading various agro-inputs like non-urea fertilizers, certified seeds, agrochemicals, bentonite sulphur, city compost through its existing PAN India dealer's network under single window concept.

5. As per the Department of Fertilizers (DoF) Notification dated 12-10-2012, an incentive of Rs. 50 per metric tonne (PMT) is given to the retailer for acknowledging the receipt of fertilizers in mobile-Fertilizers Monitoring System (m-FMS) by increasing MRP of Urea. In view of DoF Notification dated 12.10.2012, the company has been collecting Rs. 50 PMT as retailer margin by increasing MRP of urea for release of retailer margin to dealer upon receipt of acknowledgment from dealer for receipt of urea through m-FMS.

6. Department of Fertilizers, GoI vide its letter dated 25.10.2012 notified modification in the procedure for release of fertilizer subsidy by DoF for supply of

[1] Opinion finalised by the Committee on 9.4.2019.

all fertilizers from the month of April 2012 onwards. The said procedure inter-alia contained the following relating to providing of incentive to retailers:

- An incentive of Rs. 50 PMT will be given to the retailer for acknowledging the receipt of fertilizer in the Mobile Fertilizer Monitoring System (m-FMS) for implementation of entire cash transfer scheme in future which may include network / SMS cost by increasing the MRP. The incentive for urea may be given in the following manner:

- The incentive of Rs. 50 PMT to the retailers will be provided by increasing the MRP of urea by Rs. 50 PMT which will be borne by the farmers. The retailer margin may be increased by Rs. 50 PMT which will be paid to retailer acknowledging the receipt and reporting the stock and for implementation of entire cash transfer scheme in future which may include network / SMS cost, as additional incentive in the retailer margin.

7. As informed by the querist, pursuant to the above guidelines, retailer margin of Rs. 50/MT recovered from dealer through the invoice is being withheld by the company and shown in the accounts as account payable (retailer margin) w.e.f. 01.11.2012. The withheld amount is periodically released to the dealer by credit to dealers' account as and when acknowledgment is received in m-FMS.

8. Department of Fertilizers introduced Direct Benefit Transfer (DBT) pilot project in a few districts across the country with a view to improve the quality of services delivered to the farmers and it was decided vide OM No. 12012/7/2012-FPP dated 20.10.2016 to install Point of Sale (POS) machines by 31-12-2016 with all retailers across the country under second phase to start acknowledgment by retailers on PoS devices with effect from 01.01.2017. DoF vide its Notification dated 22.09.2016 (copy of notification has been supplied separately by the querist for the perusal of the Committee) informed to all fertilizer manufacturing companies that IT related equipments, such as, PoS devices, etc. may be installed out of retailer margin of Rs. 50/MT.

9. As per the directives of GoI, the company being the lead fertilizer supplier (LFS) in seven states issued 'Notice Inviting Tender' for purchase of PoS devices during financial year (F.Y.) 2016-17 and F.Y. 2017-18. The procurement cost of PoS devices has been met by the company out of accumulated withheld amount of retailer margin and therefore, no cost has been borne by the company for the purchase of PoS devices. In other words, procurement of PoS devices is revenue neutral to the company. The querist has separately informed that as per the directions of GoI, the company being LFS in seven states was required to procure, test and install PoS devices on all retail locations in seven states. In other words, PoS devices are provided by the company even to the retailers who are not the dealers of the company in the seven states assigned to the company.

Similarly, other fertilizer companies who have been designated as LFS by DoF for a particular state are providing PoS devices to all fertilizer sellers/ retailers in that State. Further, cost of PoS devices supplied to non-dealer retailers is also adjustable against the amount (retailer margin) withheld by the company of their dealers.

10. As per the provisions of the work order, PoS devices have been directly supplied and installed by the suppliers at different retailers' points (premises). (Sample copy of Undertaking of retailer for installation of device has been supplied separately by the querist for the perusal of the Committee). The retailers to whom PoS devices have been provided by the company are using PoS devices in the business of sale of fertilizers of the company and also of other fertilizer companies. In the books of account for F.Y. 2017-18, the procurement cost of PoS devices supplied to retailers have been debited to payable accumulated retailer margin held by the company.

Government Audit observation on the annual accounts for F.Y. 2017-18

11. During the course of audit of annual accounts of the company for F.Y. 2017-18, Government audit issued the following Half Margin (HM) on the accounting treatment of PoS machines purchased and installed at retailers from the unpaid retailer margin held by the company under the head 'Current Liabilities' on the direction of the Department of Fertilizers (DOF).

> Half Margin No.5
>
> As per Department of Fertilizers (DoF) notification dated 12.10.2012, an incentive of Rs. 50 PMT was proposed to be given to the retailer for acknowledging the receipt of fertilizers in the mobile Fertilizers Monitoring system (m-FMS) by increasing the MRP of Urea. Accordingly, the company was collecting Rs. 50 per MT as retailer incentive for making payment to retailer on receipt of acknowledgment from retailer for receipt of Urea through m-FMS. However, the actual acknowledgment for receipt of fertilizers in m-FMS was only 0.01% during 2015-16, which was insignificant. Further DoF has introduced Direct Benefit Transfer (DBT) system for fertilizer subsidy payments. Under this system 100% subsidy on fertilizers should be released to the manufacturer and importer on the basis of actual sale made through Point of Sale (PoS) device by the retailer to the beneficiaries. The fertilizer companies were responsible for purchase and installation of PoS devices. The Lead Fertilizer Suppliers (LFS) of each state were required to procure, test and install devices on all retail locations. In case of closure of the shop/ business or expiry of the license, the retailer should return the PoS device in working condition to the LFS. Accordingly, the company has obtained undertaking from retailers at the time of installation of PoS machine that the company has

right to withdraw PoS devices from the retailers. Further, as per Ministry Circular dated 31 July 2017, sale of fertilizers through PoS devices became mandatory with the condition to cancel the license if he/she refuses/fails to make sale transactions through PoS devices.

The company being Lead Fertilizer Supplier in seven states issued Notice Inviting Tender (NIT) on 04.10.2016 for purchase of PoS devices. As per clause of NIT, the supplier has to provide three years warrantee for PoS devices. The company procured and installed 13222 nos of PoS devices amounting to Rs. 22.35 crores till 31st March, 2018. The company has not shown PoS devices as an asset in its balance sheet as on 31.03.2018. However, Ind AS 16 defines 'property, plant and equipment' as tangible items that: (i) are held for use in the production or supply of goods or services, for rental to others, or for administrative purpose, and (ii) are expected to be used during more than one period. The company should have considered PoS machine as an asset in its balance sheet in accordance with Ind AS 16.

The above has resulted in understatement of property, plant and equipment by Rs. 22.35 crore as well as understatement of liability/fund created for procurement of PoS by the same amount.

Reply submitted by the company to Government Audit for Half Margin:

12. The company submitted the following reply:

As per Department of Fertilizers (DOF) Notification dated 12-10-2012, an incentive of Rs 50 PMT is to be given to the retailer for acknowledging the receipt of fertilizers in mobile Fertilizers Monitoring system (m-FMS) by increasing MRP of urea. In view of DoF Notification dated 12.10.2012, the company has been collecting Rs 50 PMT as retailer incentive by increasing MRP for release of retailer incentive to dealer on receipt of acknowledgement from dealer for receipt of urea through m-FMS.

Pursuant to above guidelines, retailer margin of Rs. 50/MT recovered from dealers through the invoice has been kept in the books of account as Account Payable (Retailer Margin) w.e.f. 01.11.2012. The withheld amounts are periodically released to the dealers as and when acknowledgement is received in m-FMS.

The details of account payable (retailer margin) in the books of the company as on 31-03-2017 and 31-03-2018 are as under:

1. As on 31-03-2017 – Rs. 36.11 crore
2. As on 31-03-2018 – Rs. 21.97 crore

During F.Y. 2016-17, retailer margin of Rs 19.86 crore was withheld, Rs. 13.25 crore was adjusted for purchase of PoS devices and Rs 3.10 crore was credited to Dealer Account. Similarly during F.Y. 2017-18, retailer margin of Rs. 21.53 crore was withheld, Rs 3.04 crore was adjusted for purchase of PoS devices and Rs. 22.43 crore was credited to Dealer Account.

Department of Fertilizers introduced Direct Benefit Transfer (DBT) pilot project in a few districts across the country with a view to improve the quality of services delivered to the farmers and it was decided vide OM No. 12012/7/2012-FPP dated 20.10.2016 to install Point of Sale (PoS) machines by 31-12-2016 with all retailers across the country under Second Phase to start acknowledgements by retailers on PoS devices with effect from 1.1.2017. DoF vide their Notification dated 22.09.2016 informed that IT related equipments such as PoS devices etc. may be installed out of Retailer Margin of Rs. 50/MT.

The procurement cost of PoS devices of Rs. 22.35 crore has been met by the company out of accumulation withheld out of retailer margin and therefore no cost has been borne by the company for the purchase of PoS devices. Accordingly, Rs. 16.29 crore has been adjusted from withheld retailer margin for payment towards PoS devices during F.Y. 2016-17 and F.Y. 2017-18.

Payment of Rs. 16.29 crore has been made, the balance payment of Rs. 6.06 crore is to be released as per the terms of Purchase Order and the same will be adjusted from the withheld amount of dealers.

Paragraph 7 of Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' states as under:

> **"The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:**
>
> **(a) it is probable that future economic benefits associated with the item will flow to the entity; and**
>
> **(b) the cost of the item can be measured reliably."**

Paragraph 6 of Indian Accounting Standard (Ind AS) 16 defines the term cost used in this standard as under:

> "***Cost* is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of**

other Indian Accounting Standards, e.g. Ind AS 102, *Share-based Payment*."

In view of the fact that no cost has been incurred by the company for procurement of PoS devices given to retailer for use in their business operation, the payment made out of retailer margin against PoS machines is not eligible for capitalisation in the books of account of the company.

Government Audit Supplementary Observation through Provisional Comment No.1:

13. Government audit after considering the above reply has further pursued their observation of HM and has issued Provisional Comment on the above issue as given below:

The Property Plant and Equipment does not include an amount of Rs. 22.35 crore being PoS machines purchased and installed at retailers from the unpaid retailers margin held by the company under the head Current Liabilities on the direction of Department of Fertilizers (DoF).

DoF vide notification dated 12.10.2012 introduced a scheme wherein an incentive of Rs. 50 PMT was proposed to be given to the retailer for acknowledging the receipt of fertilizer in the mobile Fertilizer Monitoring System (m-FMS) by increasing MRP of Urea. The collected amount of retailers margin could not be distributed and held by the company due to non-acknowledgement of the same by retailers. Subsequently DoF has introduced Direct Benefit Transfer (DBT) system for fertilizer subsidy payments wherein fertilizer companies were responsible for purchase and installation of PoS devices at retailers' location from the unpaid retailers' margin. Accordingly, the company purchased and installed 13222 PoS devices amounting to Rs. 22.35 crore. The company has also obtained undertaking from retailer that the company has right to withdraw PoS devices from the retailers. However, the company has not shown PoS devices as an asset in its balance sheet as on 31.03.2018.

As per Ind AS 16, **"The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if: (a) it is probable that future economic benefits associated with the item will flow to the entity; and (b) the cost of the item can be measured reliably."**

In view of the above, PoS machines qualify to be recognized as an asset since it is responsible for future economic benefit (e.g. subsidy) that would flow to the entity. This has resulted in understatement of property, plant and equipment by Rs. 22.35 crore.

Management Reply to Provisional Comment:

14. The company submitted the following reply to the Government audit in respect of aforesaid provisional comment:

1. As per Department of Fertilizers (DOF) Notification dated 12-10-2012, an incentive of Rs. 50 PMT is to be given to the retailer for acknowledging the receipt of fertilizers in mobile Fertilizers Monitoring System (m-FMS) by increasing MRP of urea. In view of DoF Notification dated 12.10.2012, the company has been collecting Rs. 50 PMT as retailer incentive by increasing MRP and incentive is released to dealer on receipt of acknowledgement from dealer for receipt of urea through m-FMS.

2. Pursuant to above guidelines, retailer margin of Rs. 50/MT recovered from dealers through the invoice has been withheld and kept in the books of account as account payable (retailer margin) w.e.f. 01.11.2012. The withheld amounts are periodically released to the dealers as and when acknowledgement for receipt of urea is received in m-FMS.

3. Department of Fertilizers introduced Direct Benefit Transfer (DBT) Pilot Project in a few districts across the country with a view to improve the quality of services delivered to the farmers and it was decided by DOF vide OM No. 12012/7/2012-FPP dated 20.10.2016 to install Point of Sale (PoS) devices by 31-12-2016 with all retailers across the country under Second Phase to start acknowledgements by retailers on PoS devices with effect from 1.1.2017. DoF vide their Notification dated 22.09.2016 also informed that IT related equipments such as PoS devices etc. may be installed out of retailer margin of Rs. 50/MT.

4. Pursuant to above, the company issued e-tender for supply, installation and maintenance of PoS device for retailers under Direct Benefit Transfer Scheme of GoI. As per e-tender, the suppliers of PoS device have obtained an undertaking from the dealers to the effect that PoS devices have been installed at retailer's point and a copy thereof has been furnished to the company.

5. The retailers to whom PoS devices have been provided by the company are using PoS devices in the business of sale of fertilizers of the company and also of other fertilizer companies, therefore, future economic benefits from use of PoS device shall accrue to the dealer.

6. The retailers shall return the device to the company in cases where dealership is cancelled by the company, or fertilizer selling license of retailer expires, or is revoked by the competent authority, or as per company's demand and in such cases the returned PoS device shall be issued by the company to some other retailers. In this connection, it may be mentioned that PoS devices issued on 4.05.2017 to a dealer (M/s A in Distt. Chamba (HP) was returned which was reissued on 7.06.2018 to another dealer M/s B in Chamba (HP). Requisite documents in support of reissue have been supplied by the querist for perusal of the Committee.

   Thus, ownership and property in PoS belong to dealer and not to the company.

   (Emphasis supplied by the querist.)

7. The company has purchased and installed 13222 no. of PoS devices with retailers. The procurement cost of these *PoS devices of Rs. 22.35 crores has been met by the company out of withheld amount of retailer margin and therefore no cost has been borne by the company for the purchase of PoS devices.* (Emphasis supplied by the querist.)

8. Paragraph 7 of Indian Accounting Standard (Ind AS) 16 relating to Property, Plant and Equipment states as under:

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

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

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

15. Paragraph 6 of Indian Accounting Standard (Ind AS) 16 defines the term 'cost' used in this standard as under:

> **"*Cost* is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, eg Ind AS 102, *Share-based Payment*."**

In view of above, the procurement cost of PoS device met by the company out of retailer margin is not eligible for capitalisation in the books of account of the company and, therefore, management of the company replies that there is no understatement of property, plant and Equipment by Rs. 22.35 crore.

16. The querist has separately informed the following:

i. With regard to ownership of the PoS devices, though, the legal ownership lies with the company, beneficial ownership of PoS devices lies with the dealer as retailers to whom PoS devices have been provided by the company are using PoS devices in the business of sale of fertilizers of the company and also of other fertilizer companies, therefore, future economic benefits from the use of PoS device shall accrue to the dealer.

ii. With regard to the 'control' of the PoS devices, the querist has informed that the PoS devices are controlled by the dealer/ retailer. All fertilizers of the company and other fertilizer companies have to be mandatory sold through PoS devices only. In case, sale is not effected through PoS devices, the fertilizer license will be cancelled. The PoS devices cannot be sold by the dealer to third party. The same will be returned to the company which will in turn handover the same to some other retailer. The querist has also informed that in case, the amount withheld by the company in respect of dealer's margin has been used to provide the devices to the dealers, no amount is refundable to the retailer on receipt/use of devices (or on any other condition). Further, PoS devices need not be returned if the retailer/ dealer gives up the dealership of the company but continues to sell fertilizers of other companies. However, the retailer shall return the PoS device to the company in case where fertilizer selling license of retailer expires or is revoked by the Competent Authority. In such a case, the returned PoS devices shall be issued by the company to some other retailer.

iii. With regard to surrender of PoS device by the retailer, the querist has informed that in cases, the retailer returns the PoS device, the company does not have to return any amount in respect of cost of PoS device which has been purchased by the company out of withheld retailer margin. The fertilizer companies have been directed by the Government to purchase PoS devices and get the same installed by supplier at different retailers' points (premises). The company had been directed to provide PoS device in seven (7) states. In other states, the PoS devices are being made available by other fertilizer manufacturing companies. The retailers to whom PoS devices are being provided by the company are using PoS devices in the business of sale of fertilizers of other fertilizer companies also.

iv. With regard to some of the issues, such as, whether the retailer's margin no longer due are required to be deposited with the relevant authorities or transferred to the profit and loss account of the

company, or who is responsible for replacing PoS device at the end of useful life, the querist has informed that there are no specific guidelines available.

v. There is no one to one relationship/link between the amount of retailer's margin withheld by the company in respect of a dealer and the cost of PoS device provided to such dealer. In case the amount used to buy the device in a particular case of retailer is less than the amount withheld by the company in respect of such dealer, the querist has informed that as per the existing guidelines, withheld amount is to be used for purchase of PoS devices and that there are no further guidelines on refund.

vi. The company in the past has not faced a situation wherein retailer's margin is required to be paid back to the dealer/retailer or refunded to the Government. Further, it has also been informed that there are no cases in the past wherein the retailer margin became income of the company on the ground that it is not required to be paid back to the Government/dealer/retailer.

vii. With regard to useful life of the PoS device, it is informed that the PoS device is under three years comprehensive warranty.

viii. With regard to the issue as to whether there is any time limit within which the acknowledgement for receipt of fertilisers in m-FMS has to be made, the querist has stated that in terms of Guidelines issued by DoF, the acknowledgement for receipt of fertilizers is first done by wholesaler, thereafter it is acknowledged by retailer upon receipt of stock and final acknowledgement is done by retailer in PoS devices before sale to farmers. As per the guidelines (vide e-mail dated 28.11.2017), the acknowledgement for the quarter will have to be completed by the end of 1st month of next quarter.

B. Query

17. On the basis 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 by debiting the procurement cost of PoS devices to Accounts Payable (Retailer Margin) withheld by the company is correct.

(ii) In the event the accounting treatment as at (i) above is not found correct, then whether PoS devices are to be capitalised in the books of account as observed by the Government audit.

(iii) Further as the cost of PoS devices has not been borne by the company, what will be the basis for accounting treatment for capitalisation of PoS devices in the books of account, i.e., the cost for debiting of assets and its corresponding head of accounts for credit in the books of account?

C. Points considered by the Committee

18. The Committee notes that the basic issues raised in the query relate to accounting treatment of PoS devices purchased by the company out of the retailers' margin and installed at retailer's premises. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for the retailer's margin, accounting for subsidy receivable, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various Notifications and orders of DoF.

19. With regard to the issue raised by the CAG as to whether PoS device can be considered as an 'asset' of the company, the Committee notes the definition of the term 'asset' from the 'Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards', issued by the Institute of Chartered Accountants of India:

> "An asset is a *resource controlled* by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." (Emphasis supplied by the Committee.)

From the above, the Committee notes that an important consideration while recognizing an asset is that the entity should have control over the underlying resource. With regard to determining whether the company has control over the asset, the company notes paragraph 13 of Ind AS 38, 'Intangible Assets', notified under the Companies (Indian Accounting Standards) Rules, 2015, which states as follows:

> "13. An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way."

From the above, the Committee notes that an entity controls an asset if it has the power or capacity to obtain future economic benefits flowing from the underlying resource, which would normally stem from legal rights that are enforceable in a court of law. In the extant case, the querist has specifically confirmed that legal ownership of the PoS devices lies with the company. Further, it is also noted that the retailers shall return the device to the company in cases where dealership is cancelled by the company or fertilizer selling license of retailer expires or is revoked by the competent authority or as per the company's demand. The dealer/ retailer also cannot sell the PoS device and no amount is refundable to the dealer/retailer on receipt/use of devices (or any other condition). All these facts also indicate that the company and not the dealer/retailer has 'control' over the PoS devices as envisaged in the Standards. Further, with regard to future economic benefits from PoS devices, the Committee notes from the Facts of the Case that under Direct Benefit Transfer (DBT) scheme, subsidy on fertilizer will be released to the manufacturer on the basis of actual sale made through PoS devices by the retailer to the beneficiaries (farmers). Thus, the benefit of the subsidy shall be available to the company only when the transaction is entered into the PoS devices and therefore, the future economic benefits from PoS devices also accrue to the company. Accordingly, the Committee is of the view that the PoS devices meet the definition of 'asset' for the company and should therefore be recognized in the financial statements of the company considering the requirements of Ind AS 16, 'Property Plant and Equipment'.

20. With regard to the contention of the querist that since the procurement cost of these PoS devices has been met by the company out of withheld amount of retailer margin and no cost has been borne by the company for the purchase of PoS devices, the same are not eligible for capitalization in the books of account of the company, the Committee notes paragraph 59 of the 'Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards', issued by the ICAI, which states as follows:

> "59 There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset."

From the above, the Committee notes that the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and from recognition in the balance sheet. Therefore, even though the company may not

have incurred any expenditure in respect of PoS devices but since it meets the definition of the asset for the company, as discussed in paragraph 19 above, the same should be recognized in the financial statements of the company. In this regard, the Committee wishes to point out that to meet the cost of PoS devices out of the retailers' margin should be considered as a funding mechanism of the Government for implementing the DBT scheme and m-FMS and therefore, the company should not reduce its liability in respect of retailer's margin.

21. Further, with regard to the querist's contention that the PoS devices are being utilized by the retailers for the sale of fertilizers of other companies as well, the Committee wishes to point out that the company being a lead fertilizer supplier in seven states, the PoS devices are being arranged by the company for the retailers /dealers of these states. Similarly, for other states, other lead fertilizer suppliers in those states are arranging for such PoS devices, which would also be used for selling the fertilizer of the company. Thus, it is only the mechanism of the Government to ensure use of PoS devices throughout the India.

D. Opinion

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

(i) and (ii) The PoS devices should be recognised as an 'asset' of the company, as discussed in paragraph 19 above and accordingly, accounting treatment followed by the company by debiting the procurement cost of PoS devices to Accounts Payable (Retailer Margin) withheld by the company is not correct.

(iii) The cost of PoS devices should not be debited to liability in respect of retailers' margin, as discussed in paragraph 20 above.

———————

Query No. 3

Subject: Accounting treatment of expenditure relating to employee benefits expenses, rent expenses, travelling expenses and house-keeping expenses which are compulsorily required to be incurred for construction of the project.[1]

A. Facts of the Case

1. The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on accounting treatment of expenditure relating to employee benefits expenses, rent expenses, travelling expenses and house-keeping expenses which are compulsorily required to be incurred for construction of High Speed Rail project by the company, which as per the querist, are directly related expenditure and without incurrence of which construction of rail project cannot take place.

2. The querist has informed that the project was approved by the Cabinet on 09.12.2015 and thereafter, a public limited company (hereinafter referred to as 'the company') was incorporated in India under the provisions of the Companies Act, 2013 on 12th February 2016, with the object to plan, design, develop, build, commission, maintain, operate and finance high speed rail services between the State of Maharashtra and State of Gujarat and/or any other area either on its own or by taking over or leasing or otherwise by any other model and build new transit route of any mode or a combination of mode with all attendant infrastructure facilities, as may be approved by Ministry of Railways (MoR) or Government of India (GoI) or any other such competent authority. The capital cost of the project is approximately Rs. 1.08 lakh crores. For the total cost of the project, funds have been arranged by the company in the form of equity from MoR, Government of Gujarat, Government of Maharashtra and in the form of soft loan from Japan International Cooperation Agency (JICA).

3. The querist has stated that as per Indian Accounting Standard (Ind AS) 101, 'First-time adoption of Indian Accounting Standards', the company being covered under phase-II of roadmap issued by the Ministry of Corporate Affairs (MCA) prepared its first Ind AS financials for the financial year (F.Y.) 2017-18 with the balance sheet as on 31.03.2017 for comparative period.

4. The company is incorporated and engaged in one and the only activity of creation of self-constructed asset, i.e., Bullet Train Project between the State of Maharashtra and State of Gujarat. The Project includes activities from acquisition

[1] Opinion finalised by the Committee on 9.4.2019

of land, earth work, laying tracks, station building, signalling & telecommunication, overhead electric, bridge, tunnels, station, training institute etc. During the financial year 2017-18, the registered office/head office of company at New Delhi and site offices in the states of Gujarat and Maharashtra have been taken on rent; and all the project executing team including directors are sitting at the head office and site offices and executing their work from respective locations.

5. During the financial year 2017-18, the company has spent Rs. 1964.44 lakh as employee benefit expenses and other expenses for corporate and project site office which are specifically related to the creation of the Project. Out of these, details for Rs. 1720.98 lakh, as given below, has been referred for the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI):

Expense Head	Amount (Rs. in lakh)
Employee Benefit Expenses	999.52
Rent Expenses	332.27
Travelling Expenses	261.57
Housekeeping Expenses	127.62
Total	1720.98

Details of Employee Benefit Expenses:

S.No.	Department	No. of Employees	Amount (Rs. in lakh)	Role/Responsibilities
1	Managing Director	1	49.09	Managing Director of the company is engaged in managing all day to day activities related to the construction of the project by the company. He is fully involved in project related activities like co-ordinating with various government agencies at apex level for the purpose of land acquisition, utility shifting, environmental clearance and a host of other key activities critical for successful completion of the project. Besides this,

				his precious time is also spent on co-ordinating with JICA, Ministry of Finance, Ministry of Railways and National Institution for Transforming India (NITI Aayog) to resolve many important issues including raising of funds/loans as per the project requirement.
2	Company Law	2	12.70	The company secretary of the company is responsible for ensuring compliance with statutory and regulatory requirements of the company.
3	Finance department including director finance	7	79.38	The company has not started its operation and it is under the construction stage, which requires huge planning in terms of management of resources. Finance department is responsible for the following functions: ➢ Finalization of tender documents (Standard Biding Documents) ➢ Bid Process Management (including bid costing, tender evaluation and finalisation) ➢ Contract Management (including payments, variation and contract closing) ➢ Estimating and Costing including rate analysis ➢ Annual Budgeting ➢ Taxation ➢ All aspects related to corporate financing ➢ Financial aspects of service matters etc.
4	Human Resource (HR) Department	4	37.67	HR Department is involved to look after various functions of human resource management, such as, recruitment, training & development, compensation management, performance management & employee welfare etc. For the purpose of executing the project and its monitoring, various

				levels of technical/non-technical executives are required to be deployed in various site offices. The entire process of recruitment, their training and development in India as well as overseas is being coordinated by Human Resource Department. The compensation system and other welfare measures are being dealt centrally for all the employees involved in the execution of the project. Since the requirement of manpower for the execution of the project and its O&M activities is huge, the recruitment process will be carried out continuously in a phased manner.
5	Project Associated Departments	82	820.68	Project Associated departments are responsible for following functions: ➢ Railway Civil /Pway/ Electrification/S&T/Rolling Stock /Mechanical and all associated works, i.e., supervision of design and build works related to bridges, viaducts, tunnels, traction sub-station, distribution sub-station, transmission lines, overhead equipment line, rolling stock etc. ➢ Land acquisition and environment clearance related matters. ➢ Construction, testing, commissioning and monitoring, safety and quality assurance. ➢ Contract management, tendering interface and other maintenance /field/specific special works.
	Total	96	999.52	

Details of rent expenses, travelling expenses and housekeeping expenses

During the financial year 2017-18, the company has taken three offices on rent, i.e., head office in New Delhi and site offices in the states of Gujarat and Maharashtra.

- The company has incurred Rs. 332.27 lakhs as rent expenses out of which Rs. 270.51 lakhs is related to the head office where project executing team including directors are sitting, Rs. 12.98 lakhs is related to the Gujarat site office and Rs. 48.77 lakhs is related to the Maharashtra site office of the company.
- Project executing team including directors are sitting at the head office and site offices and executing their work from respective locations.
- Rent expenses incurred for the site offices are directly related to the project. Rent expenses of head office, travelling expenses and housekeeping expenses have been bifurcated into different departments as given below:

S. No.	Department	Rent Expenses	Travelling Expenses	Housekeeping Expenses
		Amount in Lakhs (Amount allocated based on no. of Employees)		
1	Managing Director	2.82	2.39	1.33
2	Company Law	5.64	4.78	2.66
3	Finance department including director finance	19.73	16.73	9.31
4	Human Resource Department	11.27	9.56	5.32
5	Project Department	231.06	228.11	109.01
		270.51	261.57	127.62

6. The querist has further informed that the company has capitalised the expenses given above as incidental project expenditure under the head capital work in progress (CWIP) in Note No. 4 of the financial statements. The same is also stated in accounting policy No.2.6 which is reproduced below:

> "Expenditure which can be directly identified with the Project undertaken by the company is debited to 'Capital Work in Progress' under 'Direct Project Expenditure'. Indirect expenditure in the nature of employee

benefits and indirect expenditure directly related to the project has been charged to project."

Observations made by Comptroller and Auditor General (C&AG)

7. The Comptroller and Auditor General of India (C&AG) has made some observations that, as per Indian Accounting Standard (Ind AS 16), 'Property, Plant and Equipment', paragraph 19 (d), CWIP should not include administrative costs and other general overhead costs. As per balance sheet, CWIP includes an amount of Rs. 1964.44 lakh (Rs. 999.52 lakh for employee benefit expense + Rs. 964.92 lakh for other expenses) which should have been charged to the statement of profit and loss. This has resulted in overstatement of CWIP by Rs. 1964.44 lakh and overstatement of profits to the same extent.

Management Reply

8. The management reply to CAG is as follows:

Paragraph 19(d) of Ind AS 16 is applicable in the case of a company already operating and now going for expansion, either by new facility (paragraph 19(a)) or new products or service (paragraph 19(b)) or business in new location (paragraph 19(c)). In these three situations, paragraph 19(d) becomes relevant that does not allow administrative costs and general overhead costs to be added in CWIP. In the case of the company, none of the sub-clauses of paragraph 19 from (a) to (c) are applicable and, therefore, sub-clause (d) as referred in the CAG observation is not applicable.

Since the company is engaged in self-construction of the asset, i.e., 'Bullet Train Project' (project), paragraph 22 of Ind AS 16 is relevant, which is reproduced hereunder:

> "22 The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see Ind AS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self- constructing an asset is not included in the cost of the asset. ..."

Since the company is self-constructing assets, therefore as paragraph 22 states, its cost of assets will be recognised as in case of assets being constructed for sale. Paragraph 22 mentions Ind AS 2, which means

costs that are taken to measure inventory, will be taken in case of self-constructed assets.

As per paragraph 10 of Ind AS 2, 'Inventories', the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Paragraph 15 of Ind AS 2, 'Inventories' states that other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

As per paragraph 16 of Ind AS 16, elements of cost are as follows:

> "16 The cost of an item of property, plant and equipment comprises:
>
> (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period."

Paragraph 16 of Ind AS 2 states as follows:

> "16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:
>
> (a) abnormal amounts of wasted materials, labour or other production costs;
>
> (b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

(d) selling costs."

Further, Question 10 of Educational Material on Ind AS 16, issued by the erstwhile Ind AS Implementation Committee of the ICAI states that general overhead costs are not costs of an item of property, plant and equipment unless if it can be clearly demonstrated that they are directly attributable to construction.

The answer to Question 10 above envisages a situation that may demand inclusion of general overhead cost as part of the cost, which is the case of the company. In the case of the company, because of self-constructed assets, cost is to be recognised by inclusion of administrative costs and other general overhead costs. Therefore, administrative costs and other general overhead costs become directly attributable to be part of self-constructed assets of the company.

Specifically, in respect of the cost mentioned in CAG observation;

• Rs. 999.52 lakh for employee benefit expense:

As per paragraph 17 (a) of Ind AS 16, costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment is an example of directly attributable costs.

In the case of the company, no employees would have been employed if the assets under construction, for which CWIP is recognized was not the objective; since the company is for creation of one asset, that is, Bullet Train, it has no other activities, employees are not required except for this project.

• Rs. 964.92 lakh for other expenses: (Query for EAC opinion is raised for Rs. 721.46 lakh for three major expenses)

Paragraph 22 of Ind AS 16 states that the cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see Ind AS 2). Paragraph 16 of Ind AS 2 states that administrative overheads should be excluded from the cost of inventories that do not contribute to bringing inventories to their present location and condition.

Other expenses like rent, maintenance of head office, travels, training all are only for one project, i.e., bullet train project; there are no other activities of the company. These expenses would not have been incurred if bullet train project was not the objective of the company.

Therefore, in view of the requirements of paragraph 22 of Ind AS 16, the company has rightly charged general and administrative overheads to the CWIP.

Assurance given by the company to C&AG

9. The company has given assurance to the Principal Director (Commercial Audit), Member Audit Board-I, Delhi which is reproduced below:

> "Regarding expenditure of Rs. 1964.44 incurred for employee benefit expense and for other expenses (administrative and other general costs) 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

10. In this whole issue, the company also submits the following for consideration of the Expert Advisory Committee:

(i) Rail Project is the only project, the company is presently executing and all the functions of the company at corporate office /site offices are related to this single project only.

(ii) These are the expenditure without incurrence of which the construction of the rail project cannot take place and the project cannot be brought to its working condition.

(iii) These expenses are directly attributable to rail project and are required to be incurred only for execution of the rail project and not otherwise.

B. Query

11. Accordingly, the opinion of the Expert Advisory Committee of the ICAI has been sought as to whether the accounting treatment of the said employee benefits expenses Rs. 999.52 lakhs, rent expenses Rs. 332.27 lakhs, travelling expenses Rs. 261.57 lakhs and house-keeping expenses Rs. 127.62 lakhs which are incurred for rail project, as disclosed by company, is correct. If not, what should be the treatment in the opinion of the Committee as per Ind AS 16, Property, Plant and Equipment and other applicable Indian Accounting Standards?

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to accounting treatment of employee benefits expenses, rent expenses, travelling expenses and house-keeping expenses incurred for the rail project. The Committee has, therefore, considered only these issues and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting of any other expense incurred by the company in relation to the project, allocation of expenses to various departments, accounting treatment of soft loan and equity received by the company, etc. Further, the Committee, while expressing its opinion, has not examined the accuracy of numerical data/figures of various items of cost/expenditure presented by the querist.

13. At the outset, the Committee wishes to point out that various expenses are incurred during construction period. However, it is not necessary that all expenses incurred during construction are eligible to be capitalised to the project/asset being constructed. The capitalisation of an item of cost to a fixed asset/project depends upon the nature of such expenses in relation to the construction/ acquisition activity in the context of requirements in this regard laid down in the applicable Indian Accounting Standards. Further, the Committee also wishes to state that just because the only activity being undertaken by the company at present is the construction of the rail project does not mean that all the costs incurred by the company are directly attributable costs of rail project in accordance with the requirements of Ind AS 16.

14. With regard to the issues raised in paragraph 11 above, the Committee notes the following paragraphs of Ind AS 16, Property, Plant and Equipment, notified under the Companies (Indian Accounting Standards) Rules, 2015:

> "16 The cost of an item of property, plant and equipment comprises:
>
> (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17 Examples of directly attributable costs are:

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

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

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

(f) professional fees."

"19 Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

20 Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) initial operating losses, such as those incurred while demand for the item's output builds up; and

(c) costs of relocating or reorganising part or all of an entity's operations."

From the above, the Committee notes that the basic principle to be applied while capitalising an item of cost to a property, plant and equipment (PPE) is that it is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The Committee is of the view that 'directly attributable' costs are generally such costs which are necessary to enable the construction activity, i.e. these costs are directly related to the construction activity and without the incurrence of which the asset cannot be brought to the location and condition necessary for it to be capable of operating in the manner intended by management. Accordingly, the Committee is of the view that the expenditure on employee benefits, rent expenses, travelling expenses and house-keeping expenses incurred by the company can be capitalised only if these can be considered as directly attributable cost to bringing the bullet train project or the related asset(s) to the location and condition necessary for it (them) to be capable of operating in the manner intended by the management.

15. The Committee further notes that paragraph 19 of Ind AS 16, as reproduced above states that administration and other general overhead costs are examples of the costs that are not costs of an item of property, plant and equipment. In this connection, the Committee wishes to point out that the contention of the querist relating to applicability of paragraph 19(d) of Ind AS 16 is not correct. Paragraph 19 (d) is applicable to all the entities irrespective of whether it is a new one or an existing one.

16. The Committee also notes that the querist has contended in the Facts of the Case that since paragraph 22 of Ind AS 16 (that deals with the cost of a self-constructed asset) mentions Ind AS 2, costs that are taken to measure inventory, will be taken in case of self-constructed assets. In this regard, the Committee wishes to state that paragraph 22 of Ind AS 16 is applicable when the self-constructed asset is also produced/made by the company for sale in its normal course of business and therefore, only in such cases, principles of Ind AS 2 can be applied. Thus, principles of Ind AS 2 cannot be applied in all cases of self-constructed assets. In this context, the Committee also wishes to mention that considering the requirements of Ind AS 16, administrative and general overhead expenses should, ordinarily, not be capitalised with the item of PPE, however in certain exceptional cases where it can be clearly demonstrated that these are directly attributable to construction (as discussed above), such costs can be capitalised.

17. With regard to employee benefit expenses, the Committee notes that paragraph 17 of Ind AS 16 gives examples of directly attributable costs and it includes costs of employee benefits (as defined in Ind AS 19, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment. Therefore, the Committee is of the view that

the employee benefit expenses arising directly from the construction or acquisition of the project should only be capitalised and rest should be charged to the statement of profit and loss as and when incurred. Considering the details of expenses provided, the Committee is of the view that employee benefit expenses in respect of project associated departments are apparently directly attributable costs (as discussed in paragraph 14 above) and can accordingly be capitalised with the cost of the project. In respect of employee benefit expenses of finance department, the Committee is of the view that normally the costs incurred by finance department are not directly attributable costs, but are considered as administration and general overheads and therefore, should not be capitalised. However, in certain rare/exceptional circumstances, where and to the extent, the finance department is engaged in the construction activities, the same may be considered as directly attributable costs and can accordingly be capitalised. Similarly, employee benefit expenses of Managing Director are normally of the nature of administration and general overheads and should, ordinarily, not be capitalised with the item of PPE, however in certain exceptional cases where it can be clearly demonstrated that these are directly attributable to construction, these can be capitalised. Further, the employee benefit expenses of HR department and company law department cannot be considered as directly attributable costs.

18. With regard to rent expenses, the Committee notes that it includes rent of site offices (2 offices) and head office. The Committee is of the view that generally there is direct relation between the site office and the construction activity and thus the rent expense in relation to site offices may be considered as directly attributable cost and therefore, can be capitalised to CWIP till the time the item of property, plant and equipment is in the location and condition necessary for it to be capable of operating in the manner intended by the management. With regard to rent of head office, the Committee is of the view that head office is generally used for the overall supervision, strategic planning and other related activities which are not directly related to construction as such and therefore, the rent expense of head office should not be considered as cost of the project. However, if the project execution related activities are also being performed at head office resulting into 'directly attributable costs' as discussed in paragraph 14 above, and these can be ascertained on a reasonable and reliable basis, then only to that extent, rent should be capitalised as the cost of the project.

19. With regard to travelling expenses, the Committee is of the view that these are required to be examined keeping in view the nature and purpose of such expenses and the extent to which these expenses are directly attributable to the construction of the train project. For example, travel expenses of Managing Director, are normally for general and administration purposes and ordinarily,

should not be capitalised, however in certain exceptional cases where it can be clearly demonstrated that these are directly attributable to construction, these can be capitalised. Thus, in the extant case, the accounting treatment of travelling expense would depend upon whether or not the same is directly attributable to the construction of the project for bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

20. With regard to housekeeping expenses, the Committee is of the view that these expenses are purely in the nature of administration expenses, as given in paragraph 19(d) of Ind AS 16, which cannot be considered as 'directly attributable cost' of construction of the rail project and therefore, these cannot be capitalised as cost of an item of property, plant and equipment.

D. Opinion

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

(a) As discussed in paragraph 17 above, employee benefit expenses in respect of project associated departments are apparently directly attributable costs (as discussed in paragraph 14 above) and can accordingly be capitalised with the cost of the project. In respect of employee benefit expenses of finance department, normally the costs incurred by finance department are not directly attributable costs, but are considered as administration and general overheads and therefore, should not be capitalised. However, in certain rare/exceptional circumstances, where and to the extent, the finance department is engaged in the construction activities, the same may be considered as directly attributable cost and can accordingly be capitalised. Similarly, employee benefit expenses of Managing Director are normally of the nature of administration and general overheads and should, ordinarily, not be capitalised with the item of PPE, however in certain exceptional cases where it can be clearly demonstrated that these are directly attributable to construction, these can be capitalised. Further, the employee benefit expenses of HR department and company law department cannot be considered as directly attributable costs.

(b) The rent expense in relation to site offices may be considered as directly attributable cost and can be capitalised to CWIP till the time the item of property, plant and equipment is in the location and condition necessary for it to be capable of operating in the manner intended by the management, as discussed in paragraph 18 above. The rent expense of head office should not be

considered as cost of the project. However, if the project execution related activities are also being performed at head office resulting into 'directly attributable costs' as discussed in paragraph 14 above, and these can be ascertained on a reasonable and reliable basis, then only to that extent, rent should be capitalised as the cost of the project.

(c) As discussed in paragraph 19 above, travelling expenses are required to be examined keeping in view the nature and purpose of such expenses and the extent to which these expenses are directly attributable to the construction of the train project.

(d) As discussed in paragraph 20 above, the housekeeping expenses are purely in the nature of administration expenses as given in paragraph 19(d) of Ind AS 16, which cannot be considered as 'directly attributable cost' of construction of the rail project and therefore, these cannot be capitalised as cost of an item of property, plant and equipment.

———————

Query No. 4

Subject: Accounting treatment of security deposit under Rajiv Gandhi Gramin LPG Vitrak Yojana (RGGLVY).[1]

A. Facts of the Case

1. A company is a Government company (hereinafter referred to as the 'company' or the '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 corporation also has depots, installation and LPG plants across India, besides having administrative offices at Delhi, Chennai, Kolkata, Mumbai and other major cities.

2. The company at the time of releasing a new LPG connection to its consumers, issues cylinder and pressure regulator on returnable basis against a security deposit. The cylinders/pressure regulators are capital items, procured by the company and are shown as 'Property, Plant and Equipment' (PPE) in the balance sheet. The security deposit is refundable to consumer only at the time of surrender of connection along with cylinder and pressure regulator and till such

[1] Opinion finalised by the Committee on 9.4.2019.

time, the aforesaid security deposit amount is kept under 'Deposits for containers' under 'Other Current Financial Liabilities'.

3. The querist has informed that as a part of Vision 2015 of the Ministry of Petroleum and Natural Gas (MOP&NG) for the oil sector, 'Customer Satisfaction & Beyond' finalized on 26th June 2009, the scheme as given under has been formulated for increasing the coverage of LPG in the country by leveraging the corporate social responsibility (CSR) fund of oil public sector undertaking (PSUs):

a) Provision of common LPG kitchen facilities in villages.

b) Release of one time grant to BPL (below poverty line) families in the rural areas for release of new LPG connection under Rajiv Gandhi Gramin LPG Vitarak Yojana (RGGLVY).

Under the scheme mentioned above:

a) One-time financial assistance will be given from the CSR pool account to meet the cost of security deposit for a cylinder and pressure regulator. These connections will be issued under Rajiv Gandhi Gramin LPG Vitrak Yojana (RGGLVY) scheme to BPL families. Contribution in CSR pool has been done by oil public sector undertakings.

b) The company will receive the amount of security deposit (against the issue of LPG cylinder and regulator issued to BPL families) from the pool account managed for this purpose.

These connections are issued without deposit from BPL families which otherwise would have been collected from a normal customer; however the security deposit amount is being received from the pool account.

4. The querist has informed that presently, the following accounting treatment is being adopted:

a) *At the time of issuance of LPG connection with one LPG cylinder and regulator to eligible BPL family:*

The funds received from pool accounts represent as security deposit against the LPG cylinders and pressure regulators issued to the consumers. The amount is refundable/adjustable by issuing new connection to another eligible customer when the customer surrenders the connection along with the cylinder/pressure regulator and represents obligation endowed on the company. As per extracts given

below from Indian Accounting Standard (Ind AS) 32 'Financial Instruments',

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

Security deposit received from customers for cylinder and pressure regulator is being shown as 'Security Deposit' under Other Current Financial liabilities.

Accordingly, the amount received from the pool account also representing as security deposit has been treated as financial liability and shown under other current financial liabilities.

b) *At the time of surrender of connection by surrendering the LPG cylinder and regulator:*

At the time of issue of LPG cylinder, the company takes security deposit from the customer against the LPG cylinder (financial asset). In case of LPG connections issued to BPL families under Rajiv Gandhi Gramin LPG Vitarak Yojana (RGGLVY) scheme, at the time of surrender of cylinder and regulator, the company is supposed to issue one more connection to eligible BPL family and the existing security deposit is to be treated as security deposit for the new consumer.

c) *At the time of surrender of connection without surrender of cylinders/ regulator:*

In case any of the equipment (cylinder or pressure regulator) is lost, then consumer has to pay tariff/penal rate as applicable. Thus, loss of cylinder/ regulator is recovered from the consumers or adjusted with the security deposit held by the company and no loss is borne by the company on this account. This tariff or penal rate is recognised as income after adjusting the PPE value in the books of account for the cylinder/regulator and value of PPE will be reduced accordingly. The recoverable amount will be adjusted with the security deposit held with

the company and accordingly, the other current financial liabilities will be reduced.

B. Query

5. In view of the facts explained above, opinion of the Expert Advisory Committee has been sought on the following issues:

(i) Is there any separate disclosure requirement as per Ind ASs for connections issued under Rajiv Gandhi Gramin LPG Vitarak Yojana (RGGLVY) scheme and the amount received from Pool account representing as security deposits under other current financial liabilities?

(ii) Whether accounting treatment given for security deposits received from Pool account for connections issued under Rajiv Gandhi Gramin LPG Vitarak Yojana (RGGLVY) scheme is appropriate as per Ind ASs. If not, what is the appropriate accounting treatment?

(iii) In case of surrender of connection without returning the LPG cylinder by Rajiv Gandhi Gramin LPG Vitarak Yojana (RGGLVY) customer, whether the accounting treatment as mentioned in para 4(c) above is appropriate.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to accounting treatment followed by the company in relation to LPG connections issued under Rajiv Gandhi Gramin LPG Vitarak Yojana (RGGLVY) Scheme. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of cylinder and regulators as property, plant and equipment, accounting for CSR funds or adjustment, if any, required therein due to granting of connection to the customer or on surrender of connection, accounting for equipments, such as stoves, etc. provided under RGGVY Scheme, accounting treatment of penal charges collected from customers, measurement and consequential discounting, if any, in respect of the security deposits received and any other related matters. Further, the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective, such as, legal interpretation of RGGLVY scheme or any related circular of Ministry/GoI in this regard.

7. With regard to the classification of security deposits received in connection with LPG connection issued under RGGLVY, as current financial liabilities, the Committee notes the following definition of 'Current Liability' as per paragraph 69 of Ind AS 1, 'Presentation of Financial Statements', notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as the 'Rules'):

> **"69 An entity shall classify a liability as current when:**
>
> **(a) it expects to settle the liability in its normal operating cycle;**
>
> **(b) it holds the liability primarily for the purpose of trading;**
>
> **(c) the liability is due to be settled within twelve months after the reporting period; or**
>
> **(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.**
>
> **An entity shall classify all other liabilities as non-current."**

Form the above, the Committee notes that, paragraph 69(d) specifically states that if the entity does not have an unconditional right to defer the settlement of liability beyond 12 months, then the same shall be classified as current liability. The Committee also notes that paragraph 3 of General Instructions for Preparation of Balance Sheet Under Division II - Ind AS Schedule III to the Companies Act, 2013 provides similar definition of the current liability. In the extant case, the Committee notes that the querist has specifically stated in paragraph 4 above that the security deposit against LPG cylinders and pressure regulators is refundable/adjustable by issuing new connection to another eligible customer when the customer surrenders the connection. Further, the Committee notes following clauses from RGGLVY (a copy of which has been supplied by the querist for the perusal of the Committee):

> "6 … no refund of security amount will become due on surrender of the connection, as the connection would be released against one time grant by the Government."
>
> "13.(g) Surrender of LPG connection released under this scheme:

> If a LPG connection released under this scheme is surrendered by a beneficiary, the CSR fund (security deposit amount) so available, will be utilized by OMCs towards subsiding another eligible beneficiary."

On a reading of the above clauses, it appears that on surrender of connection by the customer, security deposit amount becomes refundable by the company; although same is not refunded in cash to the customers rather used for providing new connection to another customer. Thus, the Committee is of the view that as far as the company is concerned, due to the fact that security deposit amount is received from Pooled CSR fund of oil PSUs does not change the right to defer settlement of the liability for atleast twelve months after the reporting period. Accordingly, since the company in the extant case does not have an unconditional right to defer such settlement, the same should be classified as 'current liability' as per the aforesaid definition.

8. With reference to the classification of consumer deposits as a financial liability, the Committee notes the following paragraphs of Ind AS 32, 'Financial Instruments: Presentation', notified under the Rules:

> **"11 A *financial liability* is any liability that is:**
>
> **(a) a contractual obligation:**
>
> **(i) to deliver cash or another financial asset to another entity; or**
>
> **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or**
>
> **…"**
>
> "13 In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.
>
> 14 In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies."

With regard to the classification of the deposits collected as a financial liability, the Committee notes that since on surrender of connection, the deposits have to be refunded by the company by adjusting against new connection to another eligible customer as discussed in paragraph 7 above, there exists a contractual

obligation to exchange one financial liability with another in terms of paragraphs 11 and 13 of Ind AS 32, reproduced above. Accordingly, the same should be classified as 'financial liability'.

9. With regard to accounting treatment to be followed by the company in case of surrender of connection without returning the LPG cylinder, the Committee notes paragraph 67 of Ind AS 16, 'Property, Plant and Equipment' and paragraphs 3.3.1 and 3.3.3 of Ind AS 109, 'Financial Instruments', notified under the Rules, which state as follows:

Ind AS 16

> **"67 The carrying amount of an item of property, plant and equipment shall be derecognised:**
>
> **(a) on disposal; or**
>
> **(b) when no future economic benefits are expected from its use or disposal."**

Ind AS 109

> **"3.3.1 An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires."**
>
> **"3.3.3 The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss."**

From the above, the Committee notes an item of property, plant and equipment should be derecognised when no future economic benefits are expected from its use or disposal. In the extant case, in case cylinders and regulators are not returned by the consumers, no future economic benefits are expected from its use and disposal and therefore, the value of property, plant and equipment in respect of the same should be derecognised. Further, with regard to security deposit which is in the nature of financial liability, the Committee notes that paragraph 3.3.1 of Ind AS 109 states that a financial liability is to be removed when the obligation specified in the contract is dischsrged/cancelled/expires. Accordingly, in the extant case, when the cylinders are not returned, if the obligation of the company to refund such deposit expires, the security deposit in respect of such customers should also be derecognised in accordance with the requirements of Ind AS 109.

10. Incidentally, the Committee notes paragraph 61 of Ind AS 1, 'Presentation of Financial Statements', notified under the Rules, which states as follows:

> **"61 Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:**
>
> **(a) no more than twelve months after the reporting period, and**
>
> **(b) more than twelve months after the reporting period."**

From the above, the Committee is of the view that for better presentation and disclosure, for the current liability in respect of security deposit, the company should disclose the amount expected to be settled in no more than twelve months and more than twelve months after the reporting period.

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) and (ii) The classification made by the company for deposits received by it from its LPG consumers towards supply of cylinders and regulators as current financial liability is in accordance with the requirements of Ind ASs, as discussed in paragraphs 7 and 8 above. However, if there are any disclosure requirements arising from RGGLVY scheme, the same should also be complied with.

(iii) In case of surrender of connection without returning the LPG cylinder by the RGGLVY customer, the company should derecognise/reduce the value of PPE in respect of LPG cylinders for such customers as discussed in paragraph 9 above. Further, the security deposit in respect of such customers should also be derecognised if the obligation of the company to refund such deposits expires, in accordance with the requirements of Ind AS 109, as discussed in paragraph 9 above.

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Query No. 5

Subject: Consolidation of joint venture company (JVC) wherein the relevant economic activity and the purpose of formation of JVC got ceased.[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a wholly owned Government of India company under the Department of Atomic Energy. It was established in 1967 primarily to meet the control and instrumentation requirements of India's nuclear power program. The company has played a pioneering role in spurring the growth of indigenous electronic industry in the country. It is a multi-product, multi-disciplinary and multi-technology organisation providing cutting edge technology solutions to the strategic users in defence, atomic energy, aerospace, electronic security, information technology and e-Governance.

2. The company having net worth of more than Rs. 500 crore is required to adopt Indian Accounting Standards (Ind ASs) and accordingly, the company has adopted Ind ASs in accordance with Notification dated February 16, 2015 issued by the Ministry of Corporate Affairs (MCA), Government of India, with effect from April 01, 2016 with transition date on April 01, 2015.

3. A joint venture between M/s XYZ, an organisation under the laws of the State of California, U.S.A and the company, a corporation organised under the laws of India, was formed and incorporated as a company ('JVC') under the Companies Act, 1956 in May,1995. (Copy of the Joint Venture Agreement, Memorandum of Association and Articles of Association of the JVC have been furnished by the querist for the perusal of the Committee). The company is a shareholder in ABC Ltd., being the JVC, with 49% equity. Also, out of six directors on the Board of the JVC, two directors are nominated from the company.

4. The very purpose of setting up the JVC is to manufacture, assemble, test, market, sell and service the products, i.e., single and multi-energy X-ray baggage inspection systems, explosive detectors, walk-through metal detectors and related security products by the company on the technical know-how transferred by XYZ to the company. The said products will be sold to the joint venture and the JVC will market and sell the products to the ultimate customers. Since 2012-13 onwards, the said technology has become obsolete and the company is not manufacturing the above said products and is not selling to the JVC. However, the company is availing the services of the joint venture for execution of its

[1] Opinion finalised by the Committee on 9.4.2019.

projects based on its experience and is placing the purchase orders at arms' length price just like any other supplier (creditor). To this extent, the company has been disclosing the transactions with JVC in its related party disclosure requirements in the Notes forming part of the accounts.

5. The querist has stated that with the commencement of Companies Act, 2013 (hereinafter referred to as the 'Act'), joint venture is included in the provisions dealing with consolidation of subsidiaries and hence, the provisions of section 129(3) on consolidated financial statements have to be adhered to. However, on 14th October, 2014, the MCA had notified Companies (Accounts) Amendment Rules, 2014 and granted exemption to companies not having a subsidiary or subsidiaries but having one or more associate companies or joint ventures or both from consolidation of financial statements in respect of associate companies or joint ventures or both, as the case may be, for the financial year 2014-15 (copy of the exemption notification has been supplied by the querist for the perusal of the Committee).

6. The querist has further stated that owing to the cessation of envisaged economic activity due to obsolescence of the technology, the relevant activity i.e., supply of the single and multi energy X-ray baggage inspection systems, explosive detectors, walk-through metal detectors and related security products could not be made and hence, the subject matter of formation of JVC diminished over the years. Accordingly, the company is left with no power to exercise control on JVC. Also, the joint venture partner M/s XYZ has proposed for dissolution of the JVC. In this context, the company, in the annual reports for financial years 2015-16 and 2016-17, has disclosed the above-mentioned fact in its related party disclosure requirements and stated about the fact of non-consolidation of its accounts with that of JVC (copy of extracts of Annual Reports for F.Y. 2015-16 and 2016-17 have been provided by the querist for the perusal of the Committee).

7. Section 129(3) of the Act[2] states as follows:

> "(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statements under sub-section (2):
>
> …

[2] Section 129(3) of the Companies Act, 2013 has been since amended by the Companies (Amendment) Act, 2017. The amendment is effective from 7th May, 2018.

> *Explanation.*-For the purposes of this sub-section, the word "subsidiary" shall include associate company and joint venture."

The second proviso to section 129(3) states as follows:

> "Provided further that the Central Government may provide for consolidation of accounts of the companies in such manner as may be prescribed."

The manner of consolidation has been set out in Rule 6 of the Companies (Accounts) Rules, 2014[3] which reads as under:

> "The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards:
>
> Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.
>
> …"

Further, paragraphs 3 and 4 of Part III - General Instructions for the Preparation of Consolidated Financial Statements, contained in Division II of Schedule III to the Act read as under:

> "3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statement.
>
> 4. An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating."

8. As per paragraph 1 of Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements', the objective of the Standard is to establish the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. To meet the above objective, Ind AS 110 requires an entity (the parent) that controls one or more entities (subsidiaries) to present consolidated financial statements. The litmus test for an investor to prove that it can exercise control over the investee is set out in paragraphs 7, 8 and 9 of Ind AS 110, which are reproduced as below:

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[3] Rule 6 of the Companies (Accounts) Rules, 2014 has been since amended by the Companies (Accounts) Amendment Rules, 2014, the Companies (Accounts) Amendment Rules, 2015 and the Companies (Accounts) Amendment Rules, 2016, effective from 14th October 2014, 16th January 2015 and 27th July 2016 respectively.

" **7 Thus, an investor controls an investee if and only if the investor has *all* the following:**

(a) power over the investee (see paragraphs 10-14);

(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and

(c) the ability to use its power over the investee to affect the amount of the investor's return (see paragraphs 17 and 18).

8 An investor shall consider *all facts and circumstances when assessing whether it controls an investee.* The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80-B85)."

9 Two or more investors collectively control an investee when they must act together to direct the *relevant activities.* In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant Ind ASs, such as Ind AS 111, *Joint Arrangements*, Ind AS 28, *Investments in Associates and Joint Ventures*, or Ind AS 109, *Financial Instruments*."

Also, paragraph 10 of Ind AS 110 specifies about exercising the power by an investor. It states that "An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee's returns". Further, as per the querist, in accordance with paragraph 11 of Ind AS 110, existing cases/factors also have to be reckoned where the assessment of power will be more complex, one example being power resulting from one or more contractual arrangements.

(Emphasis supplied by the querist.)

9. As per the agreement between the investors of ABC Ltd. i.e., the company and M/s XYZ, the very purpose of establishing the joint venture is to organise and operate a limited liability company under the laws of India to manufacture, assemble, test, market, sell and service the 'products', i.e., single and multi-energy X-ray baggage inspection systems, explosive detectors, walk-through metal detectors and related security products. As per the querist, the aforesaid activity constitutes the *only economic activity* and the *relevant activity* that is the subject of the joint venture and it is the sole business purpose or the

sole economic activity of the joint venture. However, for the past five years, the envisaged *economic activity or the relevant activity* of the joint venture has ceased to exist due to obsolescence of the technology, and a proposal for dissolution of the joint venture has been proposed by the venture partner, M/s. XYZ. According to the querist, the company has no control on the current operations of ABC Ltd. for the past five years. The Board of Directors has decided to appoint a financial institution for conducting financial due diligence of the joint venture. ABC Ltd. has appointed a valuer of joint venture. Based on the valuation report, M/s XYZ has proposed an offer to take over 49% company's share in the joint venture. The Board of the company is yet to take a decision in this regard. Further, presently no products are being manufactured and sold by the company to the joint venture company as a part of joint venture agreement. (Emphasis supplied by the querist.)

10. As per the querist, from the above paragraphs, it can be demonstrated that there is no power over investee (ABC Ltd.) and hence, no control can be exercised. By virtue of above facts and circumstances, the very objective of Ind AS 110 cannot be met/sustained and, hence, presentation of consolidated financial statements may not be warranted. Further, section 129 (1) of the Companies Act reads as below:

> "(1) The financial statements shall give a true and fair view of the *state of affairs of the company or companies,* comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III:
>
> Provided that the items contained in such financial statements shall be in accordance with the accounting standards:
> …"
>
> (Emphasis supplied by the querist.)

Further, paragraph 35 of the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards (hereinafter referred to as the 'Framework'), issued by the Institute of Chartered Accountants of India, speaks about 'Substance over Form', as per which, if the information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. Also, paragraph 4 of 'Part III- General Instructions for the Preparation of Consolidated Financial Statements' contained in Division II of Schedule III to the Act states that "An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating."

11. Applying the ratio of above provisions of the Ind ASs, the Act (including Schedule III to the Act), 'Framework' and above all, the existing facts and circumstances at the end of reporting period, it was felt by the company that the consolidation of accounts of ABC Ltd. with that of the company would not present a true and fair view.

B. Query

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

(i) Whether the financial statements of the joint venture company (JVC), wherein the relevant economic activity and the purpose of formation of JVC has ceased, be consolidated with those of the company under section 129(3) of the Companies Act, 2013;

(OR)

(ii) Whether it is sufficient to disclose in its Notes to Accounts (in the financial statements of the company) that the company is not consolidating its financial statements with that of its JVC stating the reasons for not consolidating in line with paragraph 4 of Part III of Division II of Schedule III to the Companies Act, 2013.

C. Points considered by the Committee

13. The Committee notes from the Facts of the Case that the querist has mentioned that there is no control over the joint venture company (hereinafter referred to as 'the JVC') due to cessation of envisaged economic activity due to obsolescence of the technology related to single and multi-energy X-ray baggage inspection systems and other security products. In this context, the issue that has been raised by the querist in the extant case is whether the company should consolidate the financial statements of the JVC viz. M/s ABC Ltd., with those of the company under section 129(3) of the Companies Act, 2013 (hereinafter referred to as 'the Act'). 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, assessment of control/joint control on JVC, treatment of joint venture in the separate financial statements of the company, accounting for transactions between the company and the JVC, legal interpretation of the joint venture agreement, accounting in the books of JVC or M/s XYZ, accounting implications of transition to Ind ASs, accounting for impairment (if any) to be provided on investment in JVC, etc. The Committee wishes to mention that Accounting Standards and Indian Accounting Standards cited hereinafter refer to Standards notified under the Companies (Accounting Standards) Rules, 2006 and the Companies (Indian Accounting Standards) Rules, 2015 respectively. Further, since the querist has referred to financial years 2015-16 and 2016-17,

the Committee has expressed its views for these two years only, after considering annual reports for these two years available in the company's website. The Committee notes from the annual reports of the company for the financial years 2015-16 and 2016-17 that the investment in M/s ABC is classified as 'Investment in Joint Venture'. Further, the querist has referred to M/s ABC as joint venture company (JVC). Accordingly, in the absence of any information to the contrary, the Committee has proceeded on the premise that M/s ABC is neither a subsidiary of the company nor its associate but is a joint arrangement of the nature of joint venture (and not joint operation) as per Indian Accounting Standard (Ind AS) 111, 'Joint Arrangements' for the financial year 2016-17 and was a jointly controlled entity under Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'Rules, 2006') for the financial year 2015-16. It is also presumed that the company is not acting as an agent of the JVC.

The Committee also wishes to point out that in the extant case, the situation of classification of the investment in JVC as 'held for sale' is not considered by the Committee, since, the criteria for such classification are not met in the extant case having regard to paragraph 8 of Ind AS 105, 'Non-current Assets Held for Sale and Discontinued Operations'. This is because as per the Facts of the Case, the Board of Directors of the company is not yet committed to plan of sale of the investment in the JVC.

14. The Committee notes that section 129(3) of the Act[4] provides as follows:

> "(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2):
>
> Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed:
>
> Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.
>
> *Explanation.*—For the purposes of this sub-section, the word "subsidiary" shall include associate company and joint venture."

[4] Refer footnote 2.

Further, the manner of consolidation has been laid down in Rule 6 of the Companies (Accounts) Rules, 2014[5], which states as under:

> "**6. Manner of consolidation of accounts.**
>
> The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards:
>
> Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.
> …"

Further, the Committee notes paragraphs 3 and 4 of Part III of Division II of Schedule III to the Act, quoted by the querist in paragraph 7 above and notes that similar requirements are contained in Division I of Schedule III to the Act applicable for financial statements for F.Y. 2015-16.

From the above, the Committee notes that as per the provisions of the Act, a company is required to prepare consolidated financial statements for its associates and joint ventures, even if does not have subsidiaries, unless it is exempt from that requirement in accordance with law and applicable Accounting Standards. In this regard, the Committee wishes to clarify that 'consolidation' in the case of associates/joint ventures should not be understood as similar to consolidation of subsidiaries. Rather, it means 'equity method' accounting in accordance with Ind AS 28, 'Investments in Associates and Joint Ventures'. This is also evident from paragraph 7 of Ind AS 27, 'Separate Financial Statements', which states, "Financial statements in which the equity method is applied are not separate financial statements. These may be termed as *'consolidated financial statements'. …*" (Emphasis supplied by the Committee). Further, the Committee relies on 'Frequently Asked Questions (FAQs) regarding requirements to prepare Consolidated Financial Statements'[6], issued by the Accounting Standards Board of the Institute of Chartered Accountants of India in the context of the Companies

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[5] Refer footnote 3.

[6] Subsequent to the issuance of these FAQs, paragraph 9 of AS 21, Consolidated Financial Statements' has been revised vide MCA Notification dated 30.03.2016, which states that " Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively". Further, as per subsequent Announcement by ICAI, "amended Accounting Standards should be followed for accounting periods commencing on or after the date of publication of the notification in the Official Gazette".

(Accounting Standards) Rules, 2006, which, inter alia, states that a company not having subsidiaries is required to prepare consolidated financial statements for its associate and joint venture in accordance with the applicable Accounting Standards, viz, AS 23, 'Accounting for Investments in Associates in Consolidated Financial Statements' and AS 27 respectively. The Committee notes that having regard to the fact that the company itself is not a subsidiary and having regard to the nature of its operations, optional exemption from 'consolidation' in accordance with Ind AS 28 (i.e., equity method) given in paragraphs 17 to 19 thereof is not available to it. Further, for the financial year 2015-16, the two exceptions to consolidation in accordance with AS 27 (i.e., 'proportionate consolidation') given in paragraph 28 thereof (relating to an interest in a jointly controlled entity (a) which is acquired and held exclusively with a view to its subsequent disposal in the near future; and (b) which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer) are not relevant for the extant case. Further, since the company itself is not an intermediate parent, the exemption from preparation of consolidated financial statements given in the second proviso to Rule 6 of the Companies (Accounts) Rules, 2014 is not available to the company.

15. The Committee notes from the Facts of the Case that the only reason cited by the querist for losing 'control' over JVC and resultantly not consolidating the financial statements of JVC is the cessation of, or decline in, the activities of the JVC for the past 5 years. Therefore, the Committee has considered hereinafter only this issue as to whether the cessation of, or decline in, the activities of the JVC can be considered to result in the loss of 'control'/ 'joint control' over the JVC. The Committee also notes that the concept of 'joint control' involves concept of 'control' dealt with in detail in Ind AS 110, 'Consolidated Financial Statements'. Accordingly, the Committee examines the requirements of Ind AS 110 on the concept of control in the paragraph 16 below. (For F.Y. 2015-16, concepts of control and joint control were dealt with in AS 27, notified under Rules, 2006.)

16. The Committee notes the following paragraphs of Ind AS 110:

> **"6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.**
>
> **7 Thus, an investor controls an investee if and only if the investor has all the following:**
>
> **(a) power over the investee (see paragraphs 10–14);**

(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80–B85).

9 Two or more investors collectively control an investee when they must act together to direct the relevant activities. In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant Ind ASs, such as Ind AS 111, *Joint Arrangements*, Ind AS 28, *Investments in Associates and Joint Ventures,* or Ind AS 109, *Financial Instruments.*

10 An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee's returns."

Further, the Committee notes paragraph B11 of Ind AS 110, reproduced below, which provides examples of relevant activities:

"B11 For many investees, a range of operating and financing activities significantly affect their returns. Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:

(a) selling and purchasing of goods or services;

(b) managing financial assets during their life (including upon default);

(c) selecting, acquiring or disposing of assets;

(d) researching and developing new products or processes; and

(e) determining a funding structure or obtaining funding."

From the above, the Committee is of the view that the *ability* to direct relevant activities (and not mere presence of relevant activities *during the current reporting period)* is important for determining control of an investee. Therefore, the querist's contention that consolidation of the JVC is not appropriate because there are no relevant activities in recent years is not tenable. This is because disposal of the JVC may also be a relevant activity which may arise in future. In this regard, the Committee notes the example of 'disposing of assets' as a possible relevant activity cited in paragraph B11 of Ind AS 110 (reproduced above). Incidentally, the Committee notes from annual reports for the financial years 2015-16 and 2016-17 that the JVC has turnover from (i) sale of X-Ray Baggage Inspection Systems and Spares and (ii) servicing and other income. Selling goods and services could be relevant activities as per the example cited in paragraph B11 of Ind AS 110 (reproduced above). The Committee is of the view that size of operations/activities is not a determining factor for deciding presence of 'relevant activities'. Further, it is also noted from the annual reports of the company for the financial years 2015-16 and 2016-17 that the company has received dividend from JVC. The Committee is of the view that to take decisions regarding dividend itself can also be a relevant activity as per paragraph B11 above. Accordingly, the Committee is of the view that in the extant case, cessation/decline of activities in itself, does not result into loss of 'control'/'joint control'. Accordingly, the Committee is of the view that the company should 'consolidate' the JVC in its 'consolidated financial statements' in accordance with Ind AS 28 (i.e., by applying the 'equity method') for the financial year 2016-17.

17. Further, for the financial year 2015-16, the Committee notes the following definition given in AS 27:

> ***"Joint control is the contractually agreed sharing of control over an economic activity.***
>
> ***Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it."***

From the above provisions of AS 27, the Committee notes that it is the power or ability to govern the financial and operating policies of the economic activities being undertaken by the joint venture and not the presence/quantum of economic activities as such, which is relevant for determining 'control' and, consequently, joint control. Therefore, for the financial year 2015-16 also, the Committee is of the view that the company should 'consolidate' the JVC in its 'consolidated financial statements' in accordance with AS 27 (i.e., by applying the 'proportionate consolidation' method).

18. The Committee notes the requirement of paragraph 35 of the 'Framework for the Preparation and Presentation of Financial Statements in accordance with

Indian Accounting Standards' (hereinafter referred to as 'the Framework') cited by the querist in paragraph 10 above. The Committee wishes to point out that 'Framework' does not override any specific Ind AS (see paragraph 2 of the Framework). Further, the Committee notes that paragraphs 19-23 of Ind AS 1, 'Presentation of Financial Statements' deal with the course of action in extremely rare circumstances in which the management concludes that compliance with a requirement in an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework and paragraph 24 of Ind AS 1 gives guidance on making assessment in this regard. The course of action depends on whether the relevant regulatory framework requires, or otherwise does not prohibit, departure from that requirement or whether the relevant regulatory framework prohibits such departure. For the reasons given in paragraphs 16 and 17 above, the Committee is of the view that the extant case does not fall within the purview of paragraphs 19-24 of Ind AS 1. Consequently, the Committee does not further examine whether the departure from consolidation requirements in the extant case is permitted by the first proviso to Rule 6 of the Companies (Accounts) Rules, 2014. However, the Committee wishes to point out that it is for the Auditors to express their view on the management's conclusion in this regard considering the requirements of applicable Standards and submissions of the management and after ascertaining the legal position. Incidentally, the Committee notes that Notes to Accounts for the financial year 2016-17 contains minimum disclosure of the departure from consolidation of the JVC and not full disclosure requirements of Ind AS 1 in this regard. Further, Committee wishes to point out that the accounting requirements applicable for F.Y. 2015-16 does not provide for departure from a requirement of an Accounting Standard, unless such departure is in accordance with law.

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 12 above:

(i) (a) For financial year 2016-17, the company should consolidate the financial statements of the JVC with those of the company in accordance with the requirements of Ind AS 110.

(b) For financial year 2015-16, the company should consolidate the financial statements of JVC with those of the company in accordance with the requirements of AS 27.

(ii) This issue does not arise in view of (i) above.

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Query No. 6

Subject: Company's policy on transfer price for segment revenue and segment results under segment reporting.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a public sector enterprise under the administrative control of Ministry of Mines, Government of India and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power at Captive Power Plant (CPP) for use in Smelter, and selling of alumina and aluminium both in domestic and international market. Besides, the company is also engaged in generation of wind power with setting up of wind power plants at distinct locations in the country.

2. The company has four production units, details of which are furnished below:

(i) fully mechanised open cast bauxite mine having excavation capacity of 68,25,000 tonnes per annum

(ii) Aluminium refinery having production capacity of 22,75,000 tonnes per annum

(iii) Captive Power Plant having 10 units of 120 MW each to generate power and

(iv) Smelter Plant of 460,000 tonnes per annum capacity. In addition, there are 4 wind power plants of about 50MW each located in the states of Andhra Pradesh, Rajasthan and Maharashtra.

3. Mines division, which is located on hills, serves feed-stock to the alumina refinery located 16 KM downhill. The Refinery provides alumina to the company's Smelter Plant which is about 600 KM away by a specially designed alumina wagon by rail transport. For production of 1 MT of aluminium at smelter, 13,600 KWH of power is required, which is met by generation of power at Captive Power Plant situated at 4 KM away from the Smelter. Calcined alumina and thermal power are two important inputs for producing aluminium metal at Smelter Plant. The production process starting from bauxite mines to alumina refinery to Aluminium Smelter and Captive power plant is fully integrated.

4. Bauxite produced at mines is only meant for captive consumption at alumina refinery and not open to sale. Surplus alumina produced over and above Smelter requirement is sold in the open market through competitive bids either as long term contracts or spot tenders. The company has been registered with

[1] Opinion finalised by the Committee on 13.6.2019.

London Metal Exchange (LME). Export and domestic price for sale of aluminium metal is dependent upon LME price of Aluminium.

5. At present, the company has two reportable operating segments for the purpose of segment reporting as mandated under Ind AS 108, 'Operating Segments'.

a. Chemical segment

b. Aluminium segment

6. The company has considered chemicals and aluminium as the two primary operating business segments. Chemicals include calcined alumina, alumina hydrate and other related products. Aluminium includes aluminium ingots, wire rods, billets, strips, rolled and other related products. Bauxite produced for captive consumption for production of alumina is included under chemicals and power generated for captive consumption for production of aluminium is included under aluminium segment. Wind Power Plants have been commissioned primarily to meet the Renewable Purchase Obligation (RPO) as a mandatory compliance and included in the unallocated common segment.

7. The company is working in an ERP-SAP environment. Transfer of alumina from refinery (chemical segment) to aluminium Smelter (aluminium segment) is recorded in the books of account at moving average price based on inventory valuation in compliance to Ind AS 2. Similarly, thermal power from CPP (Aluminium Segment) as transferred to refinery, is recognised at monthly average price as per Ind AS 2.

8. For the purpose of inter segment transfer pricing of alumina, the company considers average sales realization from export of calcined alumina less in-land freight from refinery to Port at Vizag plus export incentive and captive power transferred from aluminium segment to chemical segment at average purchase price of power from state grid as the transfer price for disclosure of inter-segment revenue and segment results under segment reporting.

9. The facts stated at paragraph 7 indicate the method of accounting of alumina for inventory valuation based on moving average price which is at cost price. Facts stated at paragraph 8 indicate disclosure of segment report based on average export realisation of Alumina. From the above, it is evidently clear that price considered for inter segment transfer for the purpose of segment report is not the same as considered in the Accounts.

10. The querist has stated that the notified Indian Accounting Standard (Ind AS) 108, 'Operating Segments' does not specifically prescribe the basis of determination of transfer price of inter-segment transfer for segment reporting. It may be mentioned that Accounting Standard (AS) 17, 'Segment Reporting', at

paragraph 33 prescribes that "***Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.***"

11. According to the querist, as per the guidance provided in the Education Material on Indian Accounting Standard (Ind AS) 108, 'Operating Segments', issued by the erstwhile Ind AS Implementation Committee of the ICAI at page 54,

> "… Diversified Company accounts for intersegment sales and transfers as if the sales or transfers were to third parties, ie at current market prices."

The querist has mentioned that the company having, an integrated project of bauxite mining, alumina refinery and aluminium smelter is continuing its business model since inception without any diversification. In view of the above, the decision of the company to adopt a cost based intersegment transfer pricing for segment reporting confirms the provisions of the Accounting Standards in compliance to Ind AS 108.

12. With above backdrop, the company has decided to change its existing policy of inter-segment transfer price as below:

Existing Policy	Proposed Policy
Inter-segment transfer of calcined alumina is considered at average sales realization from export sales during the period less freight from refinery to Port at Vizag plus export incentive. Transfer of power from aluminium segment to chemical segment is considered at the annual / periodic average purchase price of power from State Grid at alumina refinery.	Inter-segment transfer of calcined alumina from chemical segment to aluminium segment and captive power from aluminium segment to chemical segment is considered at their respective cost price used for recording such transactions.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether inter-segment transfer price of alumina from chemical segment to aluminium segment and captive power from aluminium segment to chemical segment at cost price, as recorded in the books for determination of cost of production and inventory valuation, will be appropriate for segment reporting, in the absence of specific stipulation regarding transfer

pricing for inter-segment transfer in the notified Indian Accounting Standard (Ind AS) 108, 'Operating Segments'.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised in the query relates to measurement principles to be adopted for inter-segment transfer for presenting segment information as per Indian Accounting Standard (Ind AS) 108, 'Operating Segments', notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as 'the Rules, 2015'). The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, identification and aggregation of reportable segments, appropriateness of accounting policies and principles followed for preparing and presenting the financial statements including valuation of inventories and determining cost of production, etc.

15. The Committee notes the following paragraphs of Ind AS 108, notified under the Rules, 2015:

> "23 An entity shall report a measure of profit or loss for each reportable segment. An entity shall report a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to the chief operating decision maker. An entity shall also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker, or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:
>
> (a) revenues from external customers;
>
> *(b) revenues from transactions with other operating segments of the same entity;*
>
> (c) interest revenue;
>
> …"
>
> "*25 The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. …*
>
> 26 If the chief operating decision maker uses only one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities in assessing segment performance and deciding how to allocate resources, segment profit or loss, assets

and liabilities shall be reported at those measures. If the chief operating decision maker uses more than one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities, the reported measures shall be those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements.

27 An entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity shall disclose the following:

(a) the basis of accounting for any transactions between reportable segments.

(b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations (if not apparent from the reconciliations described in paragraph 28). Those differences could include accounting policies and policies for allocation of centrally incurred costs that are necessary for an understanding of the reported segment information.

(c) the nature of any differences between the measurements of the reportable segments' assets and the entity's assets (if not apparent from the reconciliations described in paragraph 28). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information.

(d) the nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities (if not apparent from the reconciliations described in paragraph 28). Those differences could include accounting policies and policies for allocation of jointly utilised liabilities that are necessary for an understanding of the reported segment information.

(e) the nature of any changes from prior periods in the measurement methods used to determine reported segment

profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

(f) the nature and effect of any asymmetrical allocations to reportable segments. For example, an entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment."

(Emphasis supplied by the Committee.)

16. From the above, the Committee notes that as per paragraph 25 of Ind AS 108, the amount of each segment item reported should be the measure reported to the chief operating decision maker (CODM) for the purposes of making decisions about allocating resources to the segment and assessing its performance. Thus, the Standard uses the 'management approach', under which, the information to be reported about each segment should be measured on the same basis as the information used by CODM for purposes of allocating resources to segments and assessing segments' performance rather than to be provided in accordance with the same generally accepted accounting principles (GAAP) used to prepare the financial statements. Thus, the measurement principles to be followed for presenting segment information could be different from the accounting principles and policies followed for preparing the general purpose financial statements.

17. The Committee also notes that the Standard is not specific as to how this measure should be calculated, nor does it require that the same accounting policies should be used as those used in preparing the financial statements. The measurement principles are also not required to be in accordance or consistent with those used in an Ind AS. In this context, the Committee notes that paragraph 27(b) of Ind AS 108 requires to disclose the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income. This, itself indicates that the Standard allows the company to have a non-GAAP presentation as long as the presentation is clear what constitutes the non-GAAP measure and there is a clear and detailed reconciliation of the disclosed measure to the respective GAAP amount.

18. The Committee also notes that Ind AS 108 does not define segment revenue, segment expense, segment results, segment assets and segment liabilities. It requires an explanation of how segment profit or loss, segment assets and liabilities are measured at each reportable segment as used by the CODM for decision-making purposes. The Standard also specifically requires to disclose as minimum, the basis of accounting for any transactions between reportable segments. Thus, the Standard only requires to disclose the basis of accounting for any inter-segment transactions and does not prescribe any

specific accounting/measure to be adopted for presenting segment information. Accordingly, the Committee is of the view that in the extant case, inter-segment transfer price of alumina from chemical segment to aluminium segment and captive power from aluminium segment to chemical segment should be at the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. However, in case CODM uses more than one measure of an operating segment's results/assets/liabilities, the reported measures should be those that the management believes are determined in accordance with the measurement principles most consistent with those used in the entity's financial statements as per the requirements of paragraph 26 of Ind AS 108.

19. Incidentally, the Committee wishes to point out that the extract of Educational Material on Ind AS 108 referred to by the querist in the Facts of the Case is an extract of only an example from the Guidance on Implementing Ind AS 108, that illustrates the disclosure to be made by a company regarding measurement of operating segment profit or loss, assets and liabilities as required under paragraph 27 of Ind AS 108 for the facts provided in the Example given thereunder. Therefore, it does not establish measurement principles.

D. Opinion

20. On the basis of above, the Committee is of the view that in the extant case, inter-segment transfer price of alumina from chemical segment to aluminium segment and captive power from aluminium segment to chemical segment should be at the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. However, in case CODM uses more than one measure of an operating segment's results/assets/liabilities, the reported measures should be those that the management believes are determined in accordance with the measurement principles most consistent with those used in the entity's financial statements as per the requirements of paragraph 26 of Ind AS 108.

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Query No. 7

Subject: Revenue recognition of real estate units under construction under Ind AS 115.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is primarily engaged in business of construction of residential, commercial, IT Park along with renting of immovable properties and providing project management services for managing and developing real estate projects.

2. The following is the revenue recognition policy of the company relating to sale of residential units as per annual report for the year ended 31st March 2018:

> "Revenue from real estate projects including integrated townships is recognised on the 'Percentage of Completion Method' of accounting. Revenue is recognized, in relation to the sold areas only, on the basis of percentage of actual cost incurred thereon including land as against the total estimated cost of the project under execution subject to construction costs being 25% or more of the total estimated cost. The estimates of saleable area and costs are revised periodically by the management. The effect of such changes to estimates is recognised in the period such changes are determined.
>
> In accordance with the Guidance Note on Accounting for Real Estate Transactions (for entities to whom Ind AS is applicable)[2], issued by the Institute of Chartered Accountants of India (ICAI), revenue is recognised on percentage of completion method if (a) actual construction and development cost (excluding land cost) incurred is 25% or more of the estimated cost, (b) at least 25% of the saleable project area is secured by contracts or agreements with buyers and (c) at least 10% of the total revenue as per sales agreement or any other legally enforceable document are realised as at the reporting date."

3. The querist has stated that the Ministry of Corporate Affairs (MCA) has notified the new revenue recognition standard, viz., Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers' on 29th March 2018, which would be applicable for accounting periods beginning on or after 1 April 2018. Ind AS 115 replaces all existing Ind AS revenue recognition requirements.

4. The querist has provided the following summary of the sales process of

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[1] Opinion finalised by the Committee on 7.8.2019.

[2] This Guidance Note has been withdrawn from the date of Ind AS 115 becoming effective.

the company:

(a) After obtaining relevant approvals for construction plan and activities, the company launches a project.

(b) Customer selects a residential unit of his/her choice within the project, wherein the price of the residential unit plays a key role in determining the transaction, amongst various other factors. The prices of residential units do not remain constant and are market driven; and also impacted by factors such as floor rise, direction of the flat etc., and customer judgement (highly subjective). Once the residential unit to be purchased is finalized; the customer deposits the booking amount with the company. The booking amount is generally INR 100,000 or less (i.e. less than 5% of the residential unit's total sale value).

(c) Within the next 30 days, the customer pays 10% of the residential unit's total sale value and enters into an 'Agreement for Sale' with the company, generally much before the residential unit is completed (a copy of the model Agreement to Sell has been provided by the querist for the perusal of the Committee). This Agreement is registered with the property registrar.

(d) As per the terms of Agreement between the company and its customers, on achieving construction milestones, the company raises demand on customers and customers are required to make the payment.

(e) After the residential unit is ready in all respects, the company raises a demand for last installment. On receiving the final payment, the company hands over possession of residential units to customers.

5. In one of the projects of the company, the extracts of the key terms of Agreement with customers of residential units have been provided by the querist as under:

"3. Allotment and consideration

3.1 The Promoter shall construct the Building on the Project land in accordance with the Approvals and Plans. Provided that the Promoter shall obtain prior consent in writing of the Allottee in respect of variations or modifications which may adversely affect the Apartment of the Allottee and not otherwise if any alteration or addition is required by any Government Authorities or due to change in the Applicable Law then no consent of the Allottee shall be required to be sought.

3.2 Subject to the terms and conditions of this Agreement, the Promoter hereby agrees to sell to the Allottee and the Allottee hereby agree to purchase from the Promoter the Apartment together with the Internal Apartment Specifications at or for the consideration mentioned in Third Schedule hereunder written."

"4. Default in payment of consideration

4.1 The Allottee agrees to pay to the Promoter Allottee's Interest, defined above, on all the outstanding amounts which become due but remain unpaid by the Allottee to the Promoter under the terms of this Agreement. The Allottee's Interest shall be payable from the date the concerned payment becomes due and payable by the Allottee till the date of actual payment.

4.2 In addition to the liability of the Allottee to pay the Allottee's Interest, the Allottee shall also be liable to pay and reimburse to the Promoter, all the costs, charges and expenses whatsoever, which are borne, paid and/or incurred by the Promoter for the purpose of enforcing payment of and recovering from the Allottee any amount or dues whatsoever payable by the Allottee under this Agreement.

4.3 Without prejudice to right of the Promoter to charge interest in terms of this Agreement, on the Allottee committing default in payment on the due dates of any amount that becomes due and payable by the Allottee to the Promoter under this Agreement (including his/her/their proportionate share of taxes levied by concerned Local Authority and other outgoings), the Promoter shall be entitled at his own option, to terminate this Agreement in the event of the Allottee committing three such defaults of payment of instalments. The Promoter shall give notice of 15 (fifteen) days in writing to the Allottee and mail at the email address provided by the Allottee, of his intention to terminate this Agreement and of the specific breach/breaches of the terms and conditions in respect of which it is intended to terminate the Agreement. If the Allottee fails to rectify the breach/breaches mentioned by the Promoter within the period of notice then at the end of such notice period, the Promoter shall be entitled to terminate this Agreement. Upon termination of this Agreement as aforesaid, Allottee shall execute and register a Deed of Cancellation in favour of the Promoter. The Promoter shall refund to the Allottee within a period of 30 (thirty) days of the execution and registration of the Deed of Cancellation, the instalments of Consideration of the Apartment which may have

till then been paid by the Allottee to the Promoter subject to adjustment and recovery of any agreed liquidated damages i.e. deduction of 10% of the total consideration together with any other amount which may be payable to Promoter and subject to the adjustment/deduction related to the Government statutory dues and taxes, bank loan, brokerage if any that have been paid by the Promoter or to be paid by the Promoter."

"13. Termination

13.1 The occurrence, happening or existence of any of following events shall be considered as the **"Allottee's Event of Default"** –

(i) Failure on part of the Allottee to make payment of any installments/ outgoings/ payments under this Agreement; or

(ii) Failure on part of the Allottee to take possession of the Apartment within the time stipulated and in the manner set out hereinabove; or

(iii) Breach by the Allottee of any of the representations, warranties and covenants or failure to perform, comply and observe any of its obligations and responsibilities as set forth in this Agreement; or

(iv) Any other acts, deeds or things, which the Allottee may omit or fail to perform in terms of this Agreement, which in the opinion of the Promoter, amounts to an event of default. The Allottee hereby agrees and confirms that the decision of the Promoter in this regard shall be final and binding on the Allottee.

13.2 On the occurrence, happening or existence of any of the Allottee's Event of Default as stated above, the Promoter shall give notice of 15 (fifteen) days by letter in writing through RPAD to the Allottee or by email at the email address (**"Allottee's Default Notice"**) provided by the Allottee of its intention to terminate this Agreement and of the specific breach or breaches of terms and conditions in respect of which it is intended to terminate the Agreement. Upon failure of the Allottee to rectify/cure the Allottee's Event of Default within the time period stipulated in the Allottee's Default Notice, without prejudice to any other right or remedy available to the Promoter under the Applicable Laws or as envisaged in this Agreement. The Promoter shall have the right to terminate this Agreement without any further notice/intimation to the Allottee. The Allottee shall forthwith come forward and execute and register a Deed of Cancellation in favour of the Promoter.

13.3 On and from the date of such termination on account of Allottee's Event of Default as mentioned herein above, the Parties mutually agree that the Promoter shall refund to the Allottee (subject to adjustment and recovery of any agreed liquidated damages i.e. deduction of 10% of the total consideration together with any other amount which may be payable to Promoter and subject to the adjustment/deduction related to the Government statutory dues and taxes, bank loan, brokerage, if any) within a period of 30 (thirty) days from the date of execution and registration of the Deed of Cancellation, the Consideration or part thereof which may till then have been paid by the Allottee to the Promoter (excluding the amount/s paid by the Promoter to various Authorities as and by way of taxes, duties etc.) but the Promoter shall not be liable to pay to the Allottee any interest on the amount so refunded.

13.4 The Promoter may, at its sole discretion, condone the breach committed by Allottee and may revoke cancellation of the allotment provided that the Apartment has not been re-allotted to another person till such time and Allottee agrees to pay the unearned profits (difference between the Consideration and prevailing sales price) in proportion to total amount outstanding on the date of restoration and subject to such additional conditions/undertaking as may be decided by Promoter. The Promoter may at its sole discretion waive the breach by Allottee for not paying the aforesaid instalments but such waiver shall not mean any waiver in the interest amount and the Allottee will have to pay the full amount of interest due.

13.5 Upon the cancellation/termination, the Promoter shall be entitled to sell or otherwise dispose of the Apartment to any other person/party whomsoever, at such price, in such manner and on such terms and conditions as Promoter may in its sole discretion think fit and proper and the Allottee shall not be entitled to raise any objection or dispute in this regard. However, it is agreed between the Parties that the Promoter shall adjust the amount due from Allottee first towards the interest due then towards taxes and then towards the Consideration (including all outstanding amounts like bank loan, brokerage etc., if any, payable by the Allottee to the Promoter."

"13.11 The occurrence, happening or existence of any of following events shall be considered as the "**Promoter's Event of Default**" –

(i) Failure of the Promoter to give the Intimation to take Possession to the Allottee on or before [Date] (subject to Force Majeure); or

(ii) Breach by the Promoter of any of the representations, warranties and covenants or failure to perform, comply and observe any of its obligations and responsibilities as set forth in this Agreement.

13.12 Upon the cancellation/termination of this Agreement on account of the Promoter's Event of Default as mentioned hereinabove, the Allottee shall be entitled to recover all the amounts that have been paid by the Allottee to the Promoter under the terms of this Agreement (excluding taxes etc. that have been paid by the Promoter to the Government/Statutory Bodies/ Authorities and excluding bank loan, brokerage, if any). In such a case as provided under the Act, the Promoter shall refund the aforesaid amounts to the Allottee within a period of 30 (thirty) days or a mutually agreed date from the execution and registration of the Deed of Cancellation by the Allottee in favour of the Promoter."

"23. Creation of third party rights

…

23.2 By the allottee:

(i) The Allottee shall be entitled to transfer his/her/their right under this Agreement to any person or party provided however the Allottee and the new Allottee shall jointly inform the Promoter in respect thereof with a clear covenant on the part of the new Allottee undertaking to adhere to the terms and conditions of this Agreement and also the bye laws of the Organisation. The Allottee shall be entitled to effect such transfer only if the Allottee has till then not defaulted in making any payments payable to the Promoter.

(ii) However, the Allottee agrees and undertakes to cause the new Allottee to execute/register the deed, document, agreement or writing as may be requested by Promoter to record the transfer as mentioned hereinabove.

(iii) Stamp duty or other charges as may be applicable on any transfer/addition shall be paid by the transferor/transferee. The Allottee shall indemnify and keep indemnified the Promoter against any action, loss, damage or claim arising against Promoter for non-payment of such stamp duty and requisite charges.

(iv) The transfer shall be allowed only subject to clearing all the sums that shall be due and payable to the Promoter. The Allottee shall be solely responsible and liable for all legal, monetary or any other consequences that may arise from such nominations/transfer."

6. The company has obtained two legal opinions from reputed law firms (copies of which have been provided separately for the perusal of the Committee) relating to assessment of the enforceable right to payment under paragraph 35 (c) of Ind AS 115 and as per the applicable legal laws in the State of Maharashtra and in India.

Management view

7. Based on the facts, the relevant technical literature and legal opinions, the management of the company is of the view that the revenue from sale of under-construction residential unit would be recognised over a period of time (percentage of completion method) as the condition mentioned in para 35 (c) is met.

Management Analysis under Ind AS 115

8. The querist has stated that paragraph 35 of Ind AS 115 is the relevant paragraph and covers revenue recognition from contracts where control of goods and services are transferred to the customer over a period of time. Analysis of paragraph 35 and especially paragraph 35 (c) of Ind AS 115 is as under:

"35 An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

…

(c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37)."

Applying paragraph 35(c), the company shall be able to recognise revenue over time if:

(i) the asset created by the entity's performance does not have an alternative use to the entity; and

(ii) the entity has an enforceable right to payment for performance completed to date.

9. *Condition 1: The entity's performance does not create an asset with an alternative use to the entity*

Paragraph 36 of Ind AS 115 specifies that the asset created does not have an alternative use to an entity if the entity is restricted contractually from readily directing the asset for another use during the creation of that asset or limited practically from readily directing the asset in its completed state for another use. As stated in the sales process mentioned above, price of residential unit play a key role; and is dependent upon various factors include floor rise; direction /position of the flat, and subjectivity of the customer, and all these particulars are specified in the agreement to sell. Hence, the flats cannot be transferred at the will of the company alone. As per the agreement between the company and its customers, the company does not have a right to sell/ transfer the under construction residential unit to another customer, unless the agreement is terminated.

As per clause 13.5 of the agreement, the company is entitled to sell or otherwise dispose of the under-construction residential unit to any other person/party whomsoever, at such price, in such manner and on such terms and conditions as Promoter may in its sole discretion only at the time of termination of the contract.

10. As per paragraph B6 of Ind AS 115, the possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use. Hence, clause 13.5 of the agreement shall be ignored while evaluating the 'alternative use' criteria.

As per Basis for Conclusions (BC) 137 on IFRS 15 'Revenue from Contracts with Customers', the level of customisation is not a determinative factor for assessing alternative use in certain contracts including real estate contracts, where an asset may be standardised but may still not have an alternative use to an entity, as a result of substantive contractual restrictions that preclude the entity from readily directing the asset to another customer. Rather, this indicates that the customer controls the asset as it is created, because the customer has the present ability to restrict the entity from directing that asset to another customer.

According to the querist, as per the *Question 76 of* Educational Material on Indian Accounting Standard (Ind AS) 115, issued by the erstwhile Ind AS Implementation Group of the ICAI, an entity cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its rights to the unit if the entity sought to direct the asset for another use. Accordingly, the contractual restriction is substantive and the real estate unit does not have an alternative use to the entity.

11. Based on the evaluation of the agreement's terms and aforesaid technical guidance, the querist is of the view that there are contractual restrictions and practical limitations on the company's ability to readily direct that asset for another use. Hence, the first condition of paragraph 35 (c) is met.

12. *Condition 2: The entity has an enforceable right to payment for performance completed to date*

As per the clauses 13.1 to 13.6 of the agreement between the company and its customers, customer has the right of termination only on failure of the company to handover timely possession of the apartment, or on account of company's breach of its representations, warranties and covenants, or its failure to perform its obligations and responsibilities as set forth in the agreements. Customers do not have a right to terminate for any other cause/ without cause.

According to the querist, as per the Scenario C to Question 76 of the Educational material on Indian Accounting Standard (Ind AS) 115, issued by the erstwhile Ind AS Implementation Group of the ICAI, the company has a right to payment for performance completed to date because it could also choose to enforce its rights to proportionate payment under the contract. Consequently, the criterion in paragraph 35(c) of Ind AS 115 is met and the entity has a performance obligation that it satisfies over time. The fact that the company may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment, provided that the company's rights to require the customer to continue to perform as required under the contract (i.e., pay the promised consideration) are enforceable.

13. As per Press Release on Implementation of Ind AS 115, 'Revenue from Contract with Customers' for revenue recognition in context of Real Estate Sector, issued by the ICAI, the recognition of revenue as the construction progresses is possible considering the prevalent long established legal system/jurisprudence in India, and facts and circumstances of individual case/contract.

14. The querist has further stated that as per IFRIC Update of March 2018, if there is relevant legal precedent indicating that the entity is not entitled to an amount that at least compensates it for performance completed to date in the event of cancellation for reasons other than the entity's failure to perform as promised, such legal precedent is assumed to be sufficient evidence. Such legal precedent is relevant to the assessment of the entity's enforceable right to payment as described in paragraph 35(c). As per the fact pattern described in the IFRIC Update, in the event of the courts accepting requests to cancel contracts, the entity is entitled only to a termination penalty that does not compensate the entity for performance completed to date.

15. As per section 19 (6) of The Real Estate (Regulation and Development) Act, 2016 (RERA), "Every allottee, who has entered into an agreement for sale to take an apartment, plot or building as the case may be, under section 13, shall be responsible to make necessary payments in the manner and within the time as specified in the said agreement for sale and shall pay at the proper time and

place, the share of the registration charges, municipal taxes, water and electricity charges, maintenance charges, ground rent, and other charges, if any." It should be noted that the RERA does not just stipulate/mandate the allottee (customer) to make necessary payments; rather it also stipulates that the payment needs to be made in the manner and time as specified in the agreement to sell. In other words, the aforesaid section 19 (6) entitles the company to claim compensation from prospective buyers for their failure to pay the instalments due; whether on account of delay or on account of invalid termination of the Agreement to sell by buyers, in accordance with the provisions of RERA.

16. Also, as per the querist, paragraph BC 142 to IFRS 15 states that there is a link between the factors of no alternative use and right to payment since the asset which entity is creating has no alternative use to the entity, as the entity is effectively constructing at the direction of the customer. Consequently, the entity will want to be protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. This is established by requiring that if the contract is terminated, the customer must pay for the entity's performance completed to date. Consequently, the fact that the customer is obliged to pay for the entity's performance suggests that the customer has obtained the benefits from the entity's performance.

17. Based on the analysis of the agreement, technical guidance and the legal opinions, the company is of the view that it has an enforceable right to payment for performance completed to date. Hence, the second condition of paragraph 35 (c) is met. Further to the above evaluation, the company has also sought and obtained legal opinions from reputed law firms in regard to legal precedents currently supporting the company's view in recognizing the revenue in accordance with paragraph 35 (c) of Ind AS 115 and relevant provisions of RERA as referred above; and has received a view from the firms that there are no legal precedents currently in India which express or lay down a position of law which is contrary to company's proposed position. The legal opinions have also further confirmed a position, which is line with the company's conclusion. Hence, in the view of the company, both the conditions of paragraph 35 (c) of Ind AS 115 are met and the company must account for the sale of under-construction residential units as per percentage of completion method (POCM).

18. The querist has also provided separately as *Annexure A,* extracts from the following technical literature which have been referred to while arriving at a view on this query:

- Ind AS 115, 'Revenue from Contracts with Customers'
- Basis for Conclusions on IFRS 15
- IFRIC Update March 2018

- ICAI Press Release on Implementation of Ind AS 115, Revenue from Contracts with Customers in context of Real Estate Sector
- Educational Material on Indian Accounting Standard (Ind AS) 115, Revenue from Contracts with Customers
- The Real Estate (Regulation and Development) Act, 2016

B. Query

19. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to how should the company recognise revenue for such contracts under Ind AS 115 while the residential units sold is still under construction?

C. Points considered by the Committee

20. The Committee notes that the basic issue raised in the query relates to the revenue recognition in case of real estate unit (apartment) under construction under Ind AS 115. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, measurement of revenue, other aspects of Ind AS 115, including, whether there are multiple distinct performance obligations, variable consideration, measure of progress, accounting for the cost of obtaining the contracts, etc. Further, the Committee has restricted its opinion from accounting perspective and has not examined from legal perspective, such as, legal interpretation under the provisions of RERA, the Maharashtra Ownership Flats (Regulation of the Promotion of Construction, Sale, Management and Transfer) Act, 1963, Indian Contract Act and other laws. The Committee further wishes to point out that it has considered only the issue of fulfillment of the criteria laid down in paragraph 35 of Ind AS 115 and, since in the extant case, the querist has referred to only the criterion under paragraph 35 (c) of Ind AS 115 for recognizing revenue over time, the Committee has expressed the opinion only in that context and has not examined the other two criteria, viz., under paragraph 35(a) and 35(b) as the same have not been specifically raised by the querist. At the outset, the Committee also wishes to mention that the facts and circumstances of each real estate contract may vary and the regulatory framework and legal precedence in each jurisdiction/state may be different. Therefore, the facts and circumstances of each case should be appropriately examined under Ind AS 115 and this opinion should not be generalized for other real estate transactions.

21. The Committee notes that paragraph 35 of Ind AS 115 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if any one (or more) of the three criteria in paragraph 35 is met. Further, paragraph 32 of Ind AS 115 states that if an entity does not satisfy a performance obligation over time, it

satisfies the performance obligation at a point in time. Accordingly, the Committee notes that at contract inception for each performance obligation, an entity applies the criteria in paragraph 35 to determine whether it recognises revenue over time.

22. The Committee notes that while applying paragraph 35(c), an entity recognises revenue over time if:

(i) the asset created by the entity's performance does not have an alternative use to the entity; and

(ii) the entity has an enforceable right to payment for performance completed to date.

With regard to first condition relating to whether the asset has an alternative use to the entity, the Committee notes paragraphs 36, B6 and B7 of Ind AS 115 as follows:

"36. An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. ..."

"B6 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

B7 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could

> transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract."

The Committee notes that in the extant case, based on the legal precedents submitted, the company has taken a view that the asset, viz., real estate unit under construction, does not have an alternative use to the company since it is restricted contractually from readily directing the asset for another use during the creation of that asset. Based on the facts provided by the querist, the Committee notes that the real estate apartment/unit is clearly specified in the Agreement to Sale with the customer with regard to its location (floor, etc.) and the company cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its rights to the unit if the entity sought to direct the asset for another use. Accordingly, the contractual restriction is substantive and the real estate unit does not have an alternative use to the entity as described in paragraph 35(c).

23. As regards the second condition relating to whether the entity has an enforceable right to payment for performance completed to date, the Committee notes paragraphs 37, B9, B10, B11, B12 and B13 of Ind AS 115 as follows:

> "37 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. ..."

> "B9 In accordance with paragraph 37, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation

for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

(a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or

(b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

B10 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity shall consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

B11 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. *If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).*(Emphasis supplied by the Committee.)

B12 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that

could supplement or override those contractual terms. This would include an assessment of whether:

(a) legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer;

(b) relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; or

(c) an entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

B13 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract."

From the above, the Committee notes that paragraph 37 states that, to have an enforceable right to payment, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Further, paragraph B10 states that in assessing whether an entity has right to payment for performance completed to date, it shall consider whether it would have an *enforceable right to demand or retain payment* for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised. In this context, paragraph B12 states that in assessing the existence and enforceability of a right to payment, the entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual

terms. This would include an assessment of whether legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer. The Committee observes that the assessment of enforceable rights as described in paragraph 35(c) is focused on the existence of the right and its enforceability. The Committee also notes that an entity does not have an enforceable right to payment for performance completed to date as described in paragraph 35(c), if, based on contractual terms or relevant legal precedence, the entity is not entitled to an amount that at least compensates it for performance completed to date in the event of cancellation for reasons other than the entity's failure to perform as promised. This would be the case where, in the event of the courts accepting requests from the customers to cancel contracts, the entity is entitled only to a termination penalty that does not compensate the entity for performance completed to date.

24. Accordingly, the Committee is of the view that the assessment of enforceable right to payment requires an assessment of the particular facts and circumstances of the contract/Agreement taking into consideration the legal environment within which the contract is enforceable. In this context, the Committee notes that the Agreement to Sale in the extant case, provides the right to the customer to terminate the Agreement only on failure of the company to perform its obligations under the agreement as promised to the customer, such as, to give timely possession to the customer (allottee), or on breach by the company of any of the representations, warranties and covenants, etc. and not due to any other reason. Thus, the terms of Agreement are enforceable both on the company as well as the customer. Moreover, on the Allottee committing three defaults in payment of installments on the due dates, the promoter has the *option* to terminate the agreement. Thus, if the Promoter does not opt to terminate Agreement, the customer, by himself, apparently cannot terminate the Agreement and in that case, as per the Agreement, the Promoter may have the right to enforce the payment from the customer, which, although in view of the Committee, would again depend upon the legal enforceability of the same considering the legal position/precedents etc. The Committee further notes that as per clause 4.3 of the Agreement to Sale submitted by the querist, in the case of default in payment by the customer on the due dates, and if the company (promoter) opts to terminate the agreement with the customer, the company shall refund to the customer the instalments of consideration of the apartment/unit which may have till then been paid by the customer to the company subject to adjustment and recovery of any agreed liquidated damages, i.e., deduction of 10% of the total consideration, together with any other amount which may be payable to the company and subject to the adjustment/deduction related to the Government statutory dues and taxes, bank loan, brokerage if any that have been paid by the company. The Committee is of the view that this contractual

clause restricts the company's right to recover only 10% of the consideration in case it opts to terminate the agreement on default by the customer. However, the querist has mentioned that the contractual rights under the Agreement are without prejudice to other remedies available to the company under other law, notwithstanding the contractual terms to the contrary. Further, as per the requirements of Ind AS 115, entities are required to consider any laws, legislation or legal precedent that could supplement or override contractual terms in addition to contractual terms.

From the above, the Committee is of the view that since the Agreement with the customer is silent with regard to the promoter's (company's) right to require the customer to pay the consideration, the relevant law (s) and legal precedents, etc. have to be relied upon. As far as law is concerned in the context of real estate transaction, the Committee notes that the Real Estate (Regulation and Development) Act, 2016 (RERA) is the central and overriding law. Therefore, in this context, the Committee notes sections 19(6) and 19(7) of the Real Estate (Regulation and Development) Act, 2016, which states as follows:

> "Rights and Duties of Allottees
>
> **19.**
>
> …
>
> (6) Every allottee, who has entered into an agreement for sale to take an apartment, plot or building as the case may be, under section 13, shall be responsible to make necessary payments in the manner and within the time as specified in the said agreement for sale and shall pay at the proper time and place, the share of the registration charges, municipal taxes, water and electricity charges, maintenance charges, ground rent, and other charges, if any.
>
> (7) The allottee shall be liable to pay interest, at such rate as may be prescribed, for any delay in payment towards any amount or charges to be paid under sub-section (6)."

From the above, the Committee notes that the Act prescribes the allottee to make necessary payments in the manner and within the time as specified in the Agreement for sale and also prescribes interest for any delay in payments. Further, reading of paragraph B 12 of Ind AS 115 indicates high significance of legal environment and underlying legal jurisprudence in the country. The Committee also notes that the querist has also relied upon the legal opinion and judgement to derive on the point that till the contract is not terminated, it continues to be enforceable and on this basis, the company contends that it has complied with the condition under paragraph 35(c) of Ind AS 115. However, the Committee wishes to point out that considering its terms of reference, as a

matter of policy, it does not enter into legal interpretation of various enactments and legal issues involved and expresses opinions on accounting and auditing aspects. Since in the extant case, the impugned matter is substantially based on legal interpretation; under these circumstances, the Committee is of the opinion that based on legal interpretation, if the company is able to demonstrate compliance with the conditions under paragraph 35(c) of Ind AS 115, there is no adversity in recognising revenue over time on the basis of facts and circumstances submitted to it.

D. Opinion

25. In view of terms of reference, as a matter of policy, the Committee does not enter into legal interpretational issues and expresses opinions on accounting and auditing aspects. Accordingly, on the basis of the above, without evaluating the legal interpretation of various enactments and the issues involved, which, in the extant case, are substantially based on legal interpretation; under these circumstances, the Committee is of the opinion that based on legal interpretation, if the company is able to demonstrate compliance with the conditions under paragraph 35(c) of Ind AS 115, then the Committee does not find any adversity in recognising revenue over time on the basis of facts and circumstances submitted to it, as discussed in paragraphs 22 to 24 above.

Annexure A

Technical literature guidance:

Guidance for revenue recognition under Ind AS 115

1. As per paragraph 31 to 33 and 35 to 37 of Ind AS 115 provides the following guidance with respect to satisfaction of the performance obligations:

"**31 An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.**

32 For each performance obligation identified in accordance with paragraphs 22–30, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 35–37) or satisfies the performance obligation at a point in time (in accordance with paragraph 38). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

33 Goods and services are assets, even if only momentarily, when

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

(a) using the asset to produce goods or provide services (including public services);
(b) using the asset to enhance the value of other assets;
(c) using the asset to settle liabilities or reduce expenses;
(d) selling or exchanging the asset;
(e) pledging the asset to secure a loan; and
(f) holding the asset."

"35 An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3-B4);
(b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or
(c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

36 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation...

37 An entity shall consider the terms of the contract, as well as any

laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised…"

Guidance for alternative use under Basis for Conclusions on IFRS 15

"BC137 Although the level of customisation might be a helpful factor to consider when assessing whether an asset has an alternative use, the boards decided that it should not be a determinative factor. This is because in some cases (for example, some real estate contracts), an asset may be standardised but may still not have an alternative use to an entity, as a result of substantive contractual restrictions that preclude the entity from readily directing the asset to another customer. If a contract precludes an entity from transferring an asset to another customer and that restriction is substantive, the entity does not have an alternative use for that asset because it is legally obliged to direct the asset to the customer. Consequently, this indicates that the customer controls the asset as it is created, because the customer has the present ability to restrict the entity from directing that asset to another customer (an entity would also need to consider whether a right to payment exists to conclude that control of the asset transfers over time as it is created, see paragraphs BC142–BC148). The boards observed that contractual restrictions are often relevant in real estate contracts, but might also be relevant in other types of contracts."

BC138 The boards also noted that contractual restrictions that provide a protective right to the customer would not be sufficient to establish that an asset has no alternative use to the entity. The boards observed that a protective right typically results in the entity having the practical ability to physically substitute or redirect the asset without the customer being aware of or objecting to the change. For example, a contract might state that an entity cannot transfer a good because a customer has legal title to the goods in the contract. However, the customer's legal title to the goods is intended to protect the customer in the event of the entity's liquidation and the entity can physically substitute and redirect the

goods to another customer for little cost. In this example, the contractual restriction is merely a protective right and does not indicate that control of the goods have transferred to the customer."

Guidance for right to payment under Basis for Conclusions on IFRS 15

"BC142 The boards decided that there is a link between the assessment of control and the factors of no alternative use and a 'right to payment'. This is because if an asset that an entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring that if the contract is terminated, the customer must pay for the entity's performance completed to date. This is consistent with other exchange contracts in which a customer would typically be obliged to pay only if it has received control of goods or services in the exchange. Consequently, the fact that the customer is obliged to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance."

"BC144 The boards noted that the compensation to which the entity would be entitled upon termination by the customer might not always be the contract margin, because the value transferred to a customer in a prematurely terminated contract may not be proportional to the value if the contract was completed. However, the boards decided that to demonstrate compensation for performance completed to date, the compensation should be based on a reasonable proportion of the entity's expected profit margin or be a reasonable return on the entity's cost of capital. Furthermore, the boards noted that the focus should be on the amount to which the entity would be entitled upon termination rather than the amount to which the entity might ultimately be willing to settle for in a negotiation. Consequently, the boards clarified their intention about what a 'reasonable profit margin' is intended to represent in paragraph B9 of IFRS 15.

BC145 In addition, the boards clarified that an entity need not have a present unconditional right to payment but, instead, it must have an enforceable right to demand and/or retain payment for

performance completed to date if the customer were to terminate the contract without cause before completion…"

Guidance for right to payment in IFRIC Agenda Paper 2C March 2018

"…The assessment of whether an entity has an enforceable right to payment for performance completed to date requires an entity to consider the rights and obligations created by the contract, taking into account the legal environment within which the contract is enforceable. Accordingly, the Committee observed that the outcome of an entity's assessment depends on the particular facts and circumstances of the contract…

…The Committee observed that the principle in paragraph 31 of IFRS 15 for the recognition of revenue requires the customer to have obtained control of a promised good or service. Accordingly and as noted above, the underlying objective of the criterion in paragraph 35 (c) is to determine whether the entity is transferring control of goods or services to the customer as an asset is being created for that customer. In line with this objective, it is the payment the entity is entitled to receive under the existing contract with the customer relating to performance under that contract that is relevant in determining whether the entity has an enforceable right to payment for performance completed to date. The consideration received by the entity from the third party in the resale contract is consideration relating to that resale contract—it is not payment for performance under the existing contract with the customer

In the fact pattern described in the request, the payment to which the entity has a right under the existing contract with the customer is a payment for the difference between the resale price of the unit, if any, and its original purchase price (plus selling costs). That payment does not at all times throughout the duration of the contract entitle the entity to an amount that at least approximates the selling price of the part-constructed real estate unit and, thus, it does not compensate the entity for performance completed to date. Accordingly, the entity does not have an enforceable right to payment for performance completed to date as described in paragraph 35(c) of IFRS 15..."

Press Release for Revenue Recognition in context of real estate sector issued by ICAI

As per the Press Release on Implementation of Ind AS 115, Revenue from Contracts with Customers in context of Real Estate Sector issued by the Institute of Chartered Accountants of India ("ICAI"):

"…the ICAI would like to clarify that the Ind AS 115 does allow recognition of revenue using Percentage of Completion Method (POCM) and has

> explicit and specific requirements to recognise revenue, where performance obligation is satisfied over a period of time. It may be noted that paragraphs 35-37 of Ind AS 115 explicitly permit recognition of revenue using POCM, where the performance obligation is satisfied over time.
>
> …
>
> It may be noted that Paragraph 35(b) & (c) of Ind AS 115 are intended to address situations of real estate sector. In view of the above, recognition of revenue as the construction progresses is possible considering the prevalent long established legal system/jurisprudence in India, and facts and circumstances of individual case/contract"

Educational Material on Indian Accounting Standard (Ind AS 115)

As per the Educational Material on Ind AS 115, issued by the Ind AS Implementation Group of the ICAI, the revenue from real estate contracts would be recognised for the following scenarios:

"Scenario A: If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract, if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

Response to Scenario A: … P cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its rights to the unit if the entity sought to direct the asset for another use. Accordingly, the contractual restriction is substantive and the real estate unit does not have an alternative use to P.

P also has a right to payment for performance completed to date in accordance with paragraphs 37 and B9-B15. This is because if the customer were to default on its obligations, P would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised. Therefore, the terms of the contract and the legal precedent indicate that there is a right to payment for performance completed to date.

Consequently, the criteria in paragraph 35(c) are met, and P has a performance obligation that it satisfies over time. To recognise revenue for that performance obligation satisfied over time, P should measure its progress toward complete satisfaction of its performance obligation in accordance with paragraphs 39-45 and paragraph B14-B19.

Scenario B: If the customer defaults on the contract before completion of the unit, P Ltd. only has the right to retain the deposit.

Response to Scenario B: As discussed above, the entity applies paragraph 35(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The real estate unit does not have an alternative use to P. However, P does not have an enforceable right to payment for performance completed to date - until construction of the unit is complete, P only has a right to the deposit paid by the customer. Because P does not have a right to payment for work completed to date, P's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 35(c). Instead, P accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 38.

Scenario C: In the event of a default by the customer, P Ltd. shall serve the customer with a notice period to perform/pay. Either P Ltd. can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and be entitled to a penalty of a proportion of the contract price. In case of such cancellation, the P Ltd. shall be entitled to sell the unit to any other person if the customer does not fulfil his obligation within the notice period given by P Ltd.

Response to Scenario C: Notwithstanding that P Ltd. could cancel the contract (in which case the customer's obligation to P Ltd. would be limited to transferring control of the partially completed asset to it and paying the penalty prescribed), P Ltd. has a right to payment for performance completed to date because it could also choose to enforce its rights to proportionate payment under the contract. Consequently, the criterion in paragraph 35(c) of Ind AS 115 is met and the entity has a performance obligation that it satisfies over time. The fact that P Ltd. may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment, provided that P Ltd.'s rights to require the customer to continue to perform as required under the contract (i.e., pay the promised consideration) are enforceable.

…"

The Real Estate (Regulation and Development) Act, 2016

As per section 18 of The Real Estate (Regulation and Development) Act, 2016

"18. (1) If the promoter fails to complete or is unable to give possession of an apartment, plot or building,—

(a) in accordance with the terms of the agreement for sale or, as the case may be, duly completed by the date specified therein; or

(b) due to discontinuance of his business as a developer on account of suspension or revocation of the registration under this Act or for any other reason,

he shall be liable on demand to the allottees, in case the allottee wishes to withdraw from the project, without prejudice to any other remedy available, to return the amount received by him in respect of that apartment, plot, building, as the case may be, with interest at such rate as may be prescribed in this behalf including compensation in the manner as provided under this Act:

Provided that where an allottee does not intend to withdraw from the project, he shall be paid, by the promoter, interest for every month of delay, till the handing over of the possession, at such rate as may be prescribed.

(2) The promoter shall compensate the allottees in case of any loss caused to him due to defective title of the land, on which the project is being developed or has been developed, in the manner as provided under this Act, and the claim for compensation under this subsection shall not be barred by limitation provided under any law for the time being in force

(3) If the promoter fails to discharge any other obligations imposed on him under this Act or the rules or regulations made thereunder or in accordance with the terms and conditions of the agreement for sale, he shall be liable to pay such compensation to the allottees, in the manner as provided under this Act."

As per sub section (6) and (7) of section 19 of The Real Estate (Regulation and Development) Act, 2016

"(6) Every allottee, who has entered into an agreement for sale to take an apartment, plot or building as the case may be, under section 13, shall be responsible to make necessary payments in the manner and within the time as specified in the said agreement for sale and shall pay at the proper time and place, the share of the registration charges, municipal taxes, water and electricity charges, maintenance charges, ground rent, and other charges, if any.

(7) The allottee shall be liable to pay interest, at such rate as may be prescribed, for any delay in payment towards any amount or charges to be paid under sub-section (6)."

———————

Query No. 8

Subject: Accounting treatment of leasehold land.[1]

A. Facts of the Case

1. A company is a public limited company (hereinafter referred to as the 'company'), fully owned by the Ministry of Railways (MOR), Government of India (GoI) incorporated in India under the provisions of Companies Act, 1956 with the objective of fast track implementation of rail infrastructure projects and raising extra budgetary resources for project execution. The company is implementing various types of rail infrastructure projects assigned by the Ministry of Railways including doubling (including 3rd/4th lines), gauge conversion, new lines, railway electrification, major bridges, workshops, production units and extension of the Kolkata Metro Rail System.

2. The company is covered under phase-I of roadmap for implementation of Indian Accounting Standards (Ind ASs), issued by the Ministry of Corporate Affairs (MCA) and prepared its first Ind AS financials for the financial year 2016-17 and the balance sheet as on 31.03.2016 for comparative period as per Indian Accounting Standard (Ind AS) 101, 'First-time Adoption of Indian Accounting Standards'.

3. The company entered into a lease deed on 4th December 2017 to take on lease, a plot of land for setting up of premises for its official purpose under the 'Noida Open-ended Scheme for institutional plots-2015(02)' (copy of Noida Open-ended Scheme has been supplied by the querist for the perusal of the Committee). Lease deed contains the followings clauses:

i. As per clause 2 of the lease deed, the lessee was given the demised premises for a period of 90 years commencing from the due date or actual date of execution of lease deed whichever is earlier.
ii. As per clause 7 of the lease deed, the lessee will at their own cost construct a building on the demised plot as per the floor area ratio (FAR) provided under this Scheme and in accordance with the prescribed bye laws, plan and building regulations.
iii. As per clause 13 of the lease deed, the company can transfer plot after 5 years with consideration after payment of transfer charges as fixed from time to time.
iv. As per clause 14, the lessee may with the permission of the lessor (NOIDA authority) mortgage the demised plot to any government organisation or any institution recognized by the government and/or the Reserve Bank of India (RBI) for raising loans for purposes of

[1] Opinion finalised by the Committee on 7.8.2019.

construction of the building/functioning of the project subject to such charges & terms and conditions as decided by the lessor at the time of granting the permission.

4. The company has paid an amount of Rs. 23,548.36 lakhs for leasehold land which also includes one-time lease rent, stamp duty charges and GST payment; and capitalised the same under the property, plant and equipment (Note No. 3) in the financial statements. Leasehold land has been allotted to the company on 2nd May 2017, however title deed is dated 4th December 2017. During the year ended 31st March 2018, the company has not amortised the leasehold land in the financial statements and has disclosed it as leasehold land under 'Property, Plant & Equipment'.

5. The Comptroller and Auditor General of India (C&AG) while auditing the accounts of the company has raised an objection as follows:

"A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with Ind AS 16, 'Property, Plant and Equipment' and Ind AS 38, 'Intangible Assets'. If there is no reasonable certainty that the lessee will obtain the ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of lease term and its useful life. Further, as per Significant Accounting Policy No. 2.15: Leases (a)(v) of the company, finance lease is depreciated over the useful life of the asset. However, if there is no reasonable certainty to obtain ownership by the end of the lease term, the asset is depreciated over the shorter of the estimated useful life of the asset and the lease term.

The company entered a lease deed on 4th December 2017 to take on lease a plot of land for setting up of office. As per clause 2 of the lease deed, the lessee was given the demised premises for a period of 90 years commencing from the due date or actual date of execution of lease deed whichever is earlier. The company has shown the leasehold land under the property, plant and equipment (Note No. 3) with an amount of Rs. 23,548.36 lakhs which also includes the one-time leasehold rent, stamp duty charges and GST payment in accordance with Ind AS 17, 'Leases'. During the audit scrutiny of the lease deed, the audit did not find any clause which could establish that the lessee would obtain the ownership by the end of the lease term. Therefore, the company is required to amortise the capitalised value of the leasehold land in accordance with paragraph 97 of Ind AS 38. Thus, non-amortisation of the leasehold land

resulted in overstatement of profit by Rs. 87.22 lakh and overstatement of Property, Plant and Equipment by the same amount."

(Copy of C&AG comments has been supplied separately by the querist for the perusal of the Committee.)

6. The company has given reply to the Comptroller and Auditor General of India for their objection that, as per Ind AS 17, if there is reasonable certainty that at the end of the lease term, the company will obtain the ownership of the land then there is no requirement of any depreciation. Further, in Indian conditions generally, the leasehold property gets converted into a freehold as per the different schemes launched by the authority from time to time. Also as per the past practices of industry in most of the cases, the leasehold property gets converted to the freehold on payment of freehold charges. The land taken on lease of 90 years has reasonable certainty of getting freehold during the life time of the lease period. Accordingly, depreciation has not been charged on land.

7. Lease deed in opening para states "And lessor has agreed to demise"; meaning of demise is to convey or grant (an estate) by will or lease. Paragraph 13 of the Lease Agreement allows that after 5 years, the company can transfer plot with consideration after payment of transfer charges as fixed from time to time. Land in India in general, appreciates in value; therefore, this plot has reasonable certainty of appreciation and not depreciation.

8. According to the querist, when interpreting lease under section 105 of the Transfer of Property Act, 1882, Supreme Court in case of Chapsibhai V. Purshottam AIR 1971 SC 1878 has held "that where a land is held on lease for building residential houses the lease may be presumed to be permanent one." In case of the company, building of offices/ training centre makes the lease permanent in nature.

9. The querist has separately clarified the following with regard to various indicators/situations mentioned in paragraphs 10 and 11 of Indian Accounting Standard (Ind AS) 17, 'Leases':

(a) With regard to whether there is any possibility of transfer of ownership of leasehold land to the lessee, i.e., the company by the end of the lease term or has there been any past instances of such transfer in the area where the leasehold land is situated or with respect to the same lessor, the querist has mentioned that transfer of ownership is not clearly mentioned in the lease deed, however following clauses of the lease deed give a reference of transfer of ownership:

i. As per clause 2 of the lease deed, the lessee was given the demised premises for period of 90 years commencing from the

due date or actual date of execution of lease deed whichever is earlier.

ii. As per clause 7 of the lease deed, the lessee will at their own cost construct a building on the demised plot as per the floor area ratio (FAR) provided under this Scheme and in accordance with the prescribed bye laws, plan and building regulations.

iii. As per clause 13 of the lease deed, the company can transfer plot after 5 years with consideration after payment of transfer charges as fixed from time to time.

iv. As per clause 14, the lessee may with the permission of the NOIDA, mortgage the demised plot to any government organisation or any institution recognized by the government and /or RBI for raising loans for purposes of construction of the building/functioning of the project subject to such charges & terms and conditions as decided by the lessor at the time of granting the permission.

With regard to any past case/ instances where leasehold property has been converted into freehold, the querist has provided an inter-departmental communication dated May 10, 1995 for the State in which the land is situated, containing the procedure for such conversion. The querist has also informed that Noida authority is in the process of implementing of scheme of conversion of leasehold property into freehold and therefore, scheme document is not available.

(b) With regard to whether any option is available with the company to purchase the land, if yes, at what price (viz., at fair value or at a price lower than fair value) and what is the possibility that the said option would be exercised, the querist has stated that the option to purchase the land is not specifically given under the lease deed, however following the clauses of the lease deed as given above and further since leasehold property generally gets converted into freehold, the question of purchase of land does not arise.

(c) With regard to whether at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the land, the querist has mentioned that the total consideration of the land is Rs. 169,54,68,030/- which is calculated at the circle rate of Rs. 73,600.80 per sq. mtr in Noida, if the present value of the same to be considered it will be substantially of the fair value of land. On further request to provide the basis for such calculation, the querist has

informed that total consideration of the land has been calculated at the circle rate in the Noida i.e. Rs. 73,600.80 per sq. mtr.

(d) With regard to whether lease is cancellable and in case of cancellation of lease, who will bear the lessor's losses, the querist has informed that as per clause 23(b) of the lease deed, if the lessee does not abide by the terms and conditions of the lease and building bye laws or any other rules framed or directions issued by the lessor, the lease may be cancelled by the lessor and the possession of the demised premises may be taken over by the lessor followed by forfeiture of the deposits as per the prevailing policy. Further as per clause 24(iii) of the lease deed, any loss suffered by the lessor on account of the fresh lease may be recoverable by the lessor. Therefore, lease may be cancelled by the lessor and in case of cancellation, the cancellation charges shall be borne by the lessee.

(e) With regard to whether the lease is renewable or can be continued for a secondary period and in case of renewability, the terms including the details of lease term, rentals, etc., the querist has informed that original period of the lease is 90 years and as explained above that the 90 years lease property is generally converted from leasehold to freehold, therefore, the question of renewal to secondary period does not arise.

B. Query

10. The opinion of the Expert Advisory Committee of the ICAI has been sought in respect of the accounting treatment of the leasehold land as per the requirements of Ind AS 17, 'Leases' and other Indian Accounting Standards, if applicable in this particular case on the following issues:

(i) Whether the leasehold land taken on the lease for a period of 90 years has been correctly disclosed in the financial statements or land on lease needs to be amortised.

(ii) If the land is to be amortised, how much would be the period for amortisation?

C. Points considered by the Committee

11. At the outset, based on the comments of the C&AG auditor and the contentions of the querist/management of the company, the Committee notes that the basic issue raised relates to amortisation of land obtained on leasehold basis for a period of 90 years and disclosure of the same as leasehold land under 'Property, Plant & Equipment'; and the issue relating to classification of lease into operating or finance lease has not been raised. The Committee further notes that, since the land has been presented in the extant case as an item of

''Property, plant and equipment', the company has apparently determined the lease of the nature of 'finance lease'. Therefore, the Committee has not examined the appropriateness of classification of lease as 'finance lease' in the extant case. Further, the Committee has not considered any other issue that may arise from the Facts of the Case, such as, accounting for the building constructed on leasehold land, commencement of the lease, etc. Also, the Committee has examined the query only from accounting perspective and not from any other perspective, such as, legal interpretation of Transfer of Property Act, 1882 or interpretation of judgements of Supreme Court, as referred to by the querist. The Committee further wishes to mention that Indian Accounting Standards cited hereinafter refer to Standards notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee also wishes to point out that since the querist has referred to financial year 2017-18 and Ind AS 17 in the Facts of the Case, the opinion, expressed hereinafter does not examine the application of Ind AS 116, 'Leases', which is applicable from the accounting periods beginning on or after April 1, 2019.

12. With regard to amortisation, the Committee further notes the requirements of Ind AS 17, 'Leases' and Ind AS 16, 'Property Plant and Equipment', as follows:

Ind AS 17

"27 A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with Ind AS 16, *Property, Plant and Equipment* and Ind AS 38, *Intangible Assets*. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life.

28 The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term and its useful life."

"30 To determine whether a leased asset has become impaired, an entity applies Ind AS 36, *Impairment of Assets*."

Ind AS 16

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

"58 Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building."

From the above, the Committee notes that in case of leased assets, if there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life. In this context, the Committee notes that in the extant case, there is no specific clause in the lease agreement for transfer of ownership of the land by the lessor to the company; however, the querist has claimed that leasehold land will be converted into freehold property as per the laws and regulations prevailing in the State in which the land is situated and in this context, has provided an inter-departmental communication dated May 10, 1995 for the State in which the land is situated, containing the procedure for such conversion. The Committee also notes that the querist has also informed that Noida authority is in the process of implementing a scheme of conversion of leasehold property into freehold, however, scheme document is not available. Thus, the Committee notes that at present, the land given to the company is a leasehold land and there are no documents or evidence (e.g. approved schemes) etc. to substantiate that the land will be converted into freehold. Therefore, considering the requirements of Ind AS 17, the Committee is of the view that although normally useful life of land is unlimited and is not depreciated; however, in case of leasehold land in the extant case (classified as finance lease), it needs to be depreciated over shorter of lease term or its useful life. Further, the leased land shall be tested for impairment as per the requirements of Ind AS 36, 'Impairment of Assets'.

13. With regard to disclosure of leasehold land under 'property plant and equipment' as raised by the querist in the extant case, the Committee notes paragraphs 31 and 32 of Ind AS 17 and paragraph 74 of Ind AS 16 as follows:

Ind AS 17

"31 Lessees shall, in addition to meeting the requirements of Ind AS 107, *Financial Instruments: Disclosures*, make the following disclosures for finance leases:

(a) for each class of asset, the net carrying amount at the end of the reporting period.

(b) a reconciliation between the total of future minimum lease payments at the end of the reporting period, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the end of the reporting period, and their present value, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(c) contingent rents recognised as an expense in the period.

(d) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the end of the reporting period.

(e) a general description of the lessee's material leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payable is determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

32 In addition, the requirements for disclosure in accordance with Ind AS 16, Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41 apply to lessees for assets leased under finance leases."

Ind AS 16

"74 The financial statements shall also disclose:

(a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

…"

The Committee also notes the requirements of General Instructions for Preparation of Balance Sheet in Part I of Division II - Ind AS Schedule III to the Companies Act, 2013 as follows:

Part I of Division II - Ind AS Schedule III to the Companies Act, 2013:

"6. A company shall disclose the following in the Notes:

A. Non-Current Assets

I. Property, Plant and Equipment:

(i) Classification shall be given as:

(a) Land

(b) Buildings

(c) Plant and Equipment

(d) Furniture and Fixtures

(e) Vehicles

(f) Office equipment

(g) Bearer Plants

(h) Others (specify nature)

(ii) Assets under lease shall be separately specified under each class of assets."

From the above, the Committee is of the view that the company can classify the leased land in the extant case under 'Property Plant and Equipment', however, it should be specified as 'under lease' as per the requirements of the Schedule III to the Companies Act, 2013 and should also disclose the existence of restrictions on title, as per the requirements of Ind AS 16 apart from complying with other disclosure requirements as per the relevant applicable Standards, for example, Ind AS 17, Ind AS 16, Ind AS 36, etc.

D. Opinion

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

(i) and (ii) At present, the land given to the company is a leasehold land and there are no documents or evidence (e.g. approved schemes) etc. to

substantiate that the land will be converted into freehold. Therefore, considering the requirements of Ind AS 17, although normally useful life of land is unlimited and is not depreciated; however, in case of leasehold land in the extant case (classified as finance lease), it needs to be depreciated over shorter of lease term or its useful life, as discussed in paragraph 12 above. Further, with regard to disclosure of the leased land, the Committee is of the view that the company can classify the leased land in the extant case under 'Property Plant and Equipment', however, it should be specified as 'under lease' as per the requirements of the Schedule III to the Companies Act, 2013 and should also disclose the existence of restrictions on title, as per the requirements of Ind AS 16 apart from complying with other disclosure requirements as per the relevant applicable Standards, for example, Ind AS 17, Ind AS 16, Ind AS 36, etc., as discussed in paragraph 13 above.

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Query No. 9

Subject: Accounting for Embedded Derivatives in Non-Financial Host Contracts as per Ind AS 109.[1]

A. Facts of the Case

1. A Government of India (GoI) company is engaged in the construction and operation of thermal power plants in the country. The company has also diversified into hydro power generation, coal mining and oil & gas exploration etc. The company is registered under the Companies Act, 1956/Companies Act, 2013 and being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. The company prepares its annual financial statements as per the provisions of the Companies Act, 2013. The company is also listed with the Bombay Stock Exchange and the National Stock Exchange. As the company is a listed entity with a net worth of more than Rs. 500 crore, the Indian Accounting Standards (Ind ASs) notified by the Ministry of Corporate Affairs (MCA) are applicable to the company w.e.f. financial year 2016-17.

[1] Opinion finalised by the Committee on 7.8.2019.

Background

2. Provisions of Indian Accounting Standard (Ind AS) 109, 'Financial Instruments':

(i) Derivatives and Embedded Derivatives:

Ind AS 109, 'Financial Instruments' provides accounting guidelines in respect of derivatives and embedded derivatives.

The Standard defines a derivative as a financial instrument or other contract whose value changes in response to an 'underlying' like a commodity price or exchange rate. A derivative requires little or no initial investment and is settled at a future date. Examples of derivatives - commodity futures or forex forward contracts.

Derivatives which are not financial guarantee contracts or not part of an effective hedging arrangement are required to be accounted for at fair value through profit and loss account. This condition requires that changes in the fair value of derivatives are booked to the statement of profit and loss.

Paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as follows:

"An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument."

According to the querist, an embedded derivative is defined as a combined instrument which includes a non-derivative host contract and a derivative portion whose cash flows have the characteristics of a derivative. The following are few examples of embedded derivatives:

- A convertible bond – The host contract here is a debt instrument and the embedded derivative is the call option on equity securities.

- A loan paying interest based on an equity index – The host contract is a debt instrument with the interest portion being the embedded derivative which is based on an equity index.
- A loan with an interest rate formula which is leveraged: for example if the interest rate formula is 14.5 – 2.5 X LIBOR (3 months) – In this case there is a formula determining the interest rate which is the embedded derivative in a debt host contract.

Embedded derivatives can also be found in non-financial host contracts such as contracts for purchase of goods and services.

(ii) Accounting for embedded derivatives under Ind AS 109:

Provisions related to accounting for embedded derivatives under Ind AS are as follows:

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

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

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

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

4.3.4 If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard,

an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

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

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

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

4.3.7 If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, paragraph 4.3.6 applies and the hybrid contract is designated as at fair value through profit or loss."

Embedded foreign currency derivative in a host contract that is not a financial instrument

"B4.3.8

…

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

As per the querist, it is clear from the above, that the Standard requires an embedded derivative to be separated from the host contract and accounted for as a derivative when all the following three conditions are met:

a) The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract. For example, a variable interest rate loan wherein the interest rate is indexed to the value of an equity instrument is not closely related to the host loan contract since the characteristics and risks involved are different.

b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

c) The entire contract is not measured at fair value through profit and loss account – For example, non-financial contracts like contracts for supply of equipment.

Exemption from accounting for embedded derivatives under Ind AS 109

In case of non-financial host contracts, under the following conditions an entity is exempted from separation of embedded derivatives:

a) If the contract is denominated in the functional currency of either of the parties to the contract – say a contract between an Indian purchaser (whose functional currency is INR) and a seller based in the USA (whose functional currency is USD) denominated in USD.

b) If the contract is denominated in a currency which is used around the world for international trade.

c) If the contract is denominated in a currency which is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place.

3. The company is the largest power producer in the country with an installed capacity of over 45,000 MW. In attainment of its vision to be the world's largest and best power producer, the company is constructing about 24,000 MW capacity. The company enters into various types of contracts for purchase and installation of power plant equipment, purchases for operation and maintenance and purchases of fuel including through imports. Procurement of power plant equipment is usually done through international competitive bidding (ICB) in order to obtain equipment with the latest technology at competitive prices following transparent procurement procedures. Purchases to meet the operation and maintenance requirements of power stations are made from domestic and foreign vendors. This results in the following types of contracts:

a) Contracts with Indian vendors denominated in INR.

b) Contracts with Indian vendors in foreign currencies and/or INR in case of ICB (usually in multiple currencies).

c) Contracts with foreign vendors in the currency of the vendor.

d) Contracts with foreign vendors in a third currency.

e) Procurement of imported coal in USD or USD equivalent INR.

The procurements of power plant equipments are generally done through ICB. In such cases, neither the vendor nor the currency in which bids are likely to be received are known when bids are invited. There can therefore be no intention to enter into contracts with specific vendors in specific currencies with a view to achieve desired accounting results or for speculation. Further, the following characteristics of such contracts clearly indicate that there is no intention to enter into any derivative transaction:

- The contracts do not contain a leveraging provision.
- They are for purchase of items for 'own use'.
- The contracts provide for 'delivery' of ordered items and there is no option to 'net settle' at any point of time during the tenure of the contract.

- It would make no difference to the company who the vendor is or what currency is being quoted. What is important in an ICB framework is the competitiveness of the bid.

4. Two contracts which the company has entered into for equipment supplies for its project construction are discussed below:

a) Contract with domestic vendor awarded through ICB, parts of which are denominated in foreign currencies - Agency: M/s ABC, an Indian PSU.

Sl. No.	Subject	Particulars	Remarks
1.	Nature of the contracts	**First Contract:** The contract is for design, engineering, manufacturing, shop fabrication, assembly, inspection and testing at suppliers' work, type testing, packing, forwarding equipment/material /special tools & tackles and mandatory spares supply on CIF (Indian port of entry) basis.	First contract involves supply of imported equipment.
		Second Contract: The contract is for design, engineering, manufacturing, shop fabrication, assembly, inspection and testing at suppliers work, type testing, packing, forwarding equipment/material /special tools & tackles and mandatory spares to site of all ex-manufacturing works/place of despatch (both in India).	Second Contract involves supply of equipment manufactured / assembled in India.
		Third Contract: The contract is for port handling, transportation, transit insurance, installation, supervision, commissioning of all the equipment covered	Third contract involves erection, commissioning, freight, insurance etc. of the equipment covered under first

		under first & second contract.	and second contract.
2.	Amount of contract	**First Contract.** USD 25,000,000 + EURO 47,356,082. **Second Contract.** USD 90,933,349 + EURO 94,266,958 + INR 37,287,567,022 **Third Contract.** INR 22,031,905,043	Payments shall be made to M/s ABC in the respective currencies.
3.	Terms of contract	The contracts have detailed time schedules having reference to the date of notification of award (NOA). The contract has multiple milestones over the period of 5 years from the date of award.	
4.	Payment terms	The payment terms are in percentage related to the stage of completion of the work.	

Relevant pages of contract agreements have been supplied separately by the querist for the perusal of the Committee.

b) Contract with an international vendor denominated in a currency (USD) which is neither the functional currency of the vendor nor INR which is the functional currency of the company - Agency: M/s XYZ, a corporation incorporated under the laws of Russia.

Sl. No	**Subject**	**Particulars**	**Remarks**
1.	Nature of the contracts	**First Contract:** The contract is for design, engineering, manufacturing, inspection and testing at suppliers work, packing, forwarding and despatch of plant & equipment along with all accessories,	The second and third contracts have been awarded to their Indian subsidiaries/JVCs – M/s XYZ

		auxiliaries and mandatory spares on CIF (Indian port of entry) basis.	Energy (India) Limited, New Delhi). The award value of second contract [ex-works (India) supply] is INR 215,13,98,061 and of the third contract (installation services) is USD 9,530,000 and INR 66,12,47,882.
2.	Amount of contract	USD 177,746,227.	
3.	Term of contract	The contract has detailed time schedules having reference to the date of notification of award (NOA). The contract has multiple milestones over the period of 5 years from the date of award.	
4.	Payment terms	The payment terms are in percentage related to the stage of completion of the work.	

Relevant pages of contract agreements have been supplied separately by the querist for the perusal of the Committee.

The above contracts have been entered into based on the ICB. As can be seen from the details of the above contracts, the intention of the parties is not to enter into any derivative contract and the purpose is to get the equipment supplies for construction of the power plants.

5. The company is of the view that these are not embedded derivative contracts considering the following facts:

(a) Procurement is made through ICB wherein global tenders are invited in which domestic bidders can bid in foreign currency to avail various incentives of the Government of India (GoI) and the Reserve Bank of India (RBI) permits payments in foreign currency by Indian entities to domestic vendors who have been awarded contracts through ICB.

(b) Ind AS 109 is based on the IFRS 9 which was framed from a western perspective where contracts are normally entered into in the functional currency of at least one of the parties to the contract if not both as is the case for European Union countries where Euro is the common currency. Contracts in a currency which is not the

functional currency of either contracting party when entered into, are for the purpose of hedging or speculation.

The Indian economic scenario is much different from that of these countries such as of Europe following IFRS. In this regard, a critical factor to be considered is that INR is not fully convertible and therefore is not as liquid a currency as say USD, Euro or JPY. Therefore, an international vendor would always like to quote in a more liquid currency even if such a currency is not the functional currency of that vendor. Indian vendors who may be required to procure components from abroad would also like to quote in such liquid currencies.

Therefore in the Indian context, contracts for import of power equipment are entered into in liquid currencies like, USD, Euro or JPY.

(c) Keeping in view the large capacity addition requirement in the power sector, the GoI has encouraged manufacturers to set up base for power generator equipments in the country. Accordingly, several international reputed power equipment manufacturers have set up or have initiated action to set up manufacturing facilities in India through their joint ventures (JVs)/subsidiary companies established in India. It is expected that in future, orders for equipment will be placed by Indian power generators on these JVs/subsidiary companies. Any import of equipment from the joint venture partner/foreign parent will be routed through these JVs/subsidiary companies. The Indian JVs/subsidiary companies would prefer to quote in foreign currency for the imported equipment and components supplied by them. Though such components are imported, by virtue of the fact that the contract for supply of equipment is between two Indian parties (viz. the Indian generating company and the Indian JV/subsidiary company of the foreign manufacturer), the requirement for accounting of embedded derivatives should not arise.

(d) In cases where the projects are funded by multilateral/bilateral financial institutions such as the World Bank, ADB/JICA etc., Indian importers have to follow the procurement guidelines of the respective organisations and do not have much flexibility regarding the tender conditions including the 'currencies of bid'. The currencies of bid are left to the choice of the bidder as per the standard bidding documents of these organisations. Derivative accounting for equipment procurement under such funding is not in

keeping with the spirit behind the requirements of Ind AS 109 which is to prevent circumvention of derivative accounting through embedded derivatives. If embedded derivative principles are made applicable to such contracts then Indian power sector entities may avoid seeking funds from these multilateral/bilateral institutions. As there is a huge fund requirement for the growth of Indian power sector, it is not preferable that access to an important avenue of international funding is hampered by onerous accounting requirements.

(e) The tenure of contracts for supply of power plant equipment could be three to five years. An issue which will surely arise is the availability of such long period forward rates for foreign currencies on the date of contract. In India, market for forward contracts in USD is liquid for period upto 1 year and competitive quotes are not easily available for forward cover beyond 1 year. In the absence of market based forward rates, models will need to be developed involving various assumptions and approximations for estimating forward rates. Such rates would then be used for capitalisation of property, plant and equipment which is required to be recognised and measured at cost. In addition, power projects involve large number of equipments which are supplied in a phased manner over the project schedule. The exact delivery schedules of the individual items are not known at the time of entering into the contract. The contract provides broad milestones for key activities and the schedules for supply of different equipment are worked out as the contract progresses and also undergo change from time to time. The estimation of forward rates applicable for the date of supply in such situation is extremely difficult and requires a substantial level of estimation. Additionally, such contracts are large and complicated and the time and cost involved in initial and subsequent estimates of delivery schedules for determination and revision of forward rates may not be commensurate with the results obtained.

(f) The accounting for property, plant and equipment based on forward rates is also not aligned to the requirements of regulators such as Central Electricity Regulatory Commission (CERC) for the power sector. For example, the company is a rate regulated entity whose rates are determined by CERC using a cost plus methodology. The regulator considers the actual costs incurred on account of property, plant and equipment for determining the capital base for fixation of tariff. If the company is required to

> account for embedded derivatives in case of contracts as discussed above, capitalisation of property, plant and equipment shall be at the forward rates determined at the time of entering into the contract. When actual payments are made to the vendors, the exchange rates will almost certainly be different from these forward rates. In such a situation, the capital cost considered for tariff determination will be different from the capital base in the books of account. There is no provision for separate recovery/payment of derivative losses/gains arising from embedded derivatives in the tariff regulations. Thus the financial statements of a rate regulated entity will neither present a true and fair view nor reflect the economic reality of the entity.

6. As discussed above, accounting for embedded derivatives in case of non-financial host contracts under Ind AS 109 is fraught with serious consequences for the Indian corporates, particularly for the rate regulated entities such as those in the power sector. Further, application of the embedded derivative accounting for non-financial contracts on delivery basis is difficult to appreciate and does not provide any particular advantage, particularly keeping in view the Indian context where much of the import and export trade is in USD/EURO. Further, as can be seen from the details of the above contracts, the intention of the parties is not to enter into any derivative contract and the purpose is to get the equipment supplies for construction of the power plant.

7. It can be appreciated that accounting requirements of Ind AS 109 for embedded derivatives in non-financial contracts do not intend to cover the Indian context or the Indian economic scenario where most of the foreign trade is denominated in USD/Euro. It appears to the querist that the requirements of the standard are not applicable to the cases of equipment supply contracts denominated in foreign currencies as per the spirit in which these provisions were envisaged. Further, for rate regulated entities, such accounting does not have much relevance as the fixed assets for tariff purposes are valued at costs incurred as per the CERC Tariff Regulations.

8. With regard to the issue as to why USD, Euro and JPY have been considered as liquid currencies by the company, the querist has separately informed that the USD, Euro and JPY currencies have been considered as liquid currencies based on the contracts entered into by the company. It has been seen that majority of the bidders are quoting in these currencies. Further, guidance has also been taken from paragraph BCZ4.94 of the Basis for Conclusions on International Financial Reporting Standard (IFRS) 9 'Financial Instruments', issued by the International Accounting Standards Board (IASB), which is reproduced below:

> "The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an **internationally liquid currency (such as the US dollar, euro or yen)** instead of the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent." (Emphasis supplied by the querist.)

9. The querist has also informed that International competitive bidding (ICB) is the most appropriate method of procurement in public procurement. This provides the company with a wide choice in selecting the best bid from competing suppliers and contractors. It gives prospective bidders equal opportunity to bid on goods and works that are being procured. The company generally employs ICB procedures for procurement in case of initial setting up of power plants or in case of renovation and modernisation (R&M) of power plants, which have large estimated values and domestic suppliers are limited. Further, in cases of procurement where certain incentives are made available by the Government of India for inviting bids under ICB such as procurement of goods for mega power projects, the company follows ICB procedures.

10. The step by step process relating to the International Competitive Bidding has been explained by the querist as follows:

1) A feasibility report for a project or a scheme of R&M is prepared.

2) Based on the project requirement, a package list is prepared, which indicates the details of goods and services to be procured for the project. The list is prepared by a committee comprising of members from various functions/departments and approved by the Chairmen and the Managing Director. During finalisation of the list, it is decided whether ICB or Domestic Competitive Bidding (DCB) is to be followed for a particular package. Where domestic suppliers are limited and/or goods are being procured where certain incentives are made available under ICB, ICB bidding procedure is resorted to.

3) After the package list is approved, cost estimate and qualification requirements for bidders are prepared based on the scope of package.

4) Invitation for bids (IFB) are advertised. In order to have wide publicity, copies of the IFB are issued to the prospective bidders (both foreign and domestic) and those bidders who have participated in similar tenders of the company in the past. Moreover, copies of IFB are sent to embassy of various countries.

5) Bidding documents are issued to those interested parties (both domestic and foreign), who pay the requisite tender fee.

6) The following is stipulated in the bidding documents regarding currencies to be quoted:

   Prices quoted by the bidders (both foreign and domestic) shall be in the following currencies:

   a) Plant and equipment to be quoted in any currency. Domestic bidders while quoting in foreign currency must comply with the requirement as laid down by the Government of India from time to time.

   b) Local transportation, inland transit insurance and other local costs incidental to delivery of the plant and equipment and installation services shall be quoted in local currency. However, foreign component, if any, of installation services (excluding civil, structural & allied works) may be quoted in foreign currency.

   c) If the bidder wishes to be paid in a combination of amounts in different currencies, it may quote its price accordingly, but use no more than three foreign currencies.

   d) The foreign currencies in which the bid prices are quoted shall be freely convertible.

7) Based on the bidding documents and scope of work stipulated in Technical Specifications, the bids are submitted by the bidders in two part (i.e. Part 1: Techno-Commercial Bid and Part 2: Price Bid.)

8) Initially, techno-commercial bids are opened at the date and time stipulated in front of the bidder's representatives who choose to attend the bid opening. Minutes of bid opening are prepared and signed.

9) The techno-commercial bids are evaluated and the price bids of those bidders are opened whose techno-commercial bids are found to be technically and commercially qualified and meeting the technical requirements.

10) The price bids are evaluated in line with the evaluation criteria specified in the bidding documents and the lowest evaluated bid (L1) is awarded the contract, if the award price is not substantially higher than the estimated cost of work. In exceptional cases, where the price of lowest bidder is substantially higher than the estimated cost of work and the work is urgent, negotiations are resorted to bring down the price. Negotiations are only done with L1 bidder.

11) The contract is awarded in the bid currency quoted by the bidder and comprises of the following break-up:

    a) **First Contract**: For CIF (Indian port of entry) supply of plant and equipment including type test charges and mandatory spares to be supplied from abroad. (in foreign currency)

    b) **Second Contract**: For Ex-works (India) supply of plant and equipment including type test charges and mandatory spares to be supplied from within India. (Generally awarded partly in INR and partly in foreign currency)

    c) **Third Contract**: For providing all services i.e. port handling, port clearance and port charges for the imported goods, further loading, inland transportation for delivery at site, inland transit insurance, unloading, storage, handling at site, installation services including erection, civil, structural & allied works, insurance covers other than inland transit insurance, testing, commissioning and conducting guarantee tests in respect of all the equipments supplied under the 'First Contract' & the 'Second Contract' and all other services as specified in the contract documents. (Awarded in INR)

11. With regard to the basis for pricing a single contract in multiple currencies especially in contracts with local vendors/bidder, and whether the vendor/bidder can bid in foreign currency even for that component of the contract which does not involve any payment by the vendor in foreign currency, for example, supply of equipment manufactured in India, the querist has stated that, ICB procedure is followed in cases where domestic suppliers are limited and technology of the goods are mostly available with the foreign suppliers. In certain cases, domestic suppliers have to source components or raw materials from abroad in order to manufacture the domestic manufactured goods**.** Therefore, in order to have level playing field between the domestic bidder and foreign bidder and as the bids are being invited on competitive basis, domestic bidders are allowed to quote in foreign currency, subject to compliance with the requirement as laid down by the Government of India from time to time.

12. The querist has also clarified separately that this is the general practice in the industry in which the entity operates to procure equipment through ICB**.** However, in cases where ample competition is available in domestic market and no benefit is available from the GOI to resort to ICB, domestic competitive bidding is followed where bidders are allowed to quote in Indian Rupees Only. Other entities also follow this practice to procure equipment.

B. Query

13. Considering the above, the Expert Advisory Committee is requested to give its opinion on the following issues:

(a) Whether the accounting for foreign currency embedded derivatives is required for above noted contracts awarded through ICB, as mentioned in paragraphs 4 (a) and 4 (b).

(b) Whether accounting for embedded derivatives shall be applicable for other foreign currency contracts with foreign vendors, as mentioned in paragraph 4 (b) in any of the major liquid currencies used in international trade considering the Indian scenario.

C. Points considered by the Committee

14. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to whether the foreign currency embedded derivatives in the contract entered into by the company with Indian vendor in USD and Euro and the contract with foreign vendor in a third currency (i.e. neither the functional currency of the company nor of the foreign vendor), can be considered as closely related to the host contract as per the guidance in paragraph B4.3.8 (d) of Ind AS 109. The Committee further notes that the querist has specifically referred to the guidance in paragraph B4.3.8 (d) (iii) of Ind AS 109 and has raised issue as to whether USD or Euro which have been used in the contracts mentioned above can be considered as a currency that is commonly used in contracts to purchase non-financial items in the economic environment in which the transactions or contracts referred to in the extant case takes place. 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 assessment of substantial party to the contracts, accounting for the embedded derivative, accounting for the non-financial items purchased, etc. Further, the Committee has not evaluated the conditions referred in para B4.3.8 (d) (i) and (ii), since the same have not been specifically raised by the querist.

15. The Committee notes that the functional currency of the company is INR. The Committee also presumes that,

(i) the functional currency of the Indian vendor referred above is also INR and;

(ii) the functional currency of the foreign vendor is not USD .

16. The Committee further notes the following paragraph of Ind AS 109:

"B4.3.8

…

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

The Committee believes that the rationale for the above exemption is that when the embedded derivative bears a close economic relationship to the host contract, it is less likely that the derivative was embedded to achieve a desired accounting result.

17. The Committee further notes that as per the requirements of paragraph B4.3.8 (d) (iii) of Ind AS 109, an embedded foreign currency derivative in a host contract is considered as closely related to the host contract if it is denominated in a currency that is *commonly used* in contracts in the *economic environment* in which the transaction takes place. In this context, the Committee also notes the following paragraphs from the 'Basis for Conclusions' on International Financial Reporting Standard (IFRS) 9, 'Financial Instruments' (which is the corresponding International Standard of Ind AS 109), issued by the International Accounting Standards Board (IASB), as follows:

"BCZ4.94 The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) instead of the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.

BCZ4.95 In revising IAS 39, the IASB concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place (that guidance is now in IFRS 9). A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperflationary Economies*)."

The Committee notes from the above that the objective behind this exception is to eliminate burden of separating embedded foreign currency derivatives for transactions between entities in smaller countries in international stable/liquid currencies instead of local currency of these entities or pricing in foreign currency by entities operating in hyperinflationary economy. Further, foreign currency derivatives are considered as closely related to host contract if monetary amounts are viewed in terms of foreign currency and not in local currency. From this, the Committee is of the view that 'commonly used' in the extant case should be assessed in the context of the country and not just commonly used by the company or for ICB purposes. The Committee also notes that the example in paragraph B4.3.8 (d) (iii) of Ind AS 109 refers to the currency commonly used in

local business transactions or external trade. The Committee is further of the view that to apply this requirement, the company should first determine the economic environment in which the transaction takes place, viz., whether the transaction is a local business transaction or is an external trade and then the currencies that are commonly used in contracts to purchase or sell non-financial items in such economic environment. Accordingly, the Committee analyses the currency commonly used in in local business transactions (internal trade) or external trade as below:

Internal trade

From an Indian economic environment perspective, the Committee is of the view that Indian National Rupee (INR) is the currency which is commonly used for local transactions within India. This fact though, should not preclude the identification of a currency commonly used in external trade.

External trade

For any currency other than INR to be considered as 'commonly used' for external trade, the Committee believes that such assessment should be made on the basis of economic data which would support such assessment. For example, if economic data supports the contention that the US dollar is used in a wide variety of import or export contracts (external trade) by Indian entities, it can be argued that the US dollar is 'commonly used' in India for such trade. Similar assessment is required for other currencies as well. Accordingly, the Committee is of the view that the assessment regarding whether USD or Euro is a commonly used currency for external trade in the Indian economic environment should be supported by appropriate economic data (e.g. external trade statistics of India, etc.) for these currencies. It should not be concluded without such supporting evidence that these currencies are 'commonly used' in the Indian economic environment. However, in light of the Indian economic environment, the Committee notes that USD and Euro are generally considered to be the commonly used currency in foreign trade of India though this has to be substantiated by appropriate supporting evidence as discussed above.

18. Based on the above, the Committee is of the view that for local transactions (i.e. within India) with Indian vendors, INR should be considered as the 'commonly used' currency and therefore, for contracts entered into by the company with Indian vendors in USD or Euro, the foreign currency embedded derivative is not closely related to the host contract. Accordingly, foreign currency embedded derivatives in such contracts are required to be accounted for in terms of paragraph 4.3.3 of Ind AS 109. For any currency to be considered as 'commonly used' for external trade, the company should support this assessment by appropriate external trade data and accordingly, for contracts with foreign vendors in a third currency, the foreign currency embedded derivative would be

closely related to the host contract provided the company can appropriately conclude based on external trade data that USD or Euro are the 'commonly used' currency in India for external trade, as discussed in paragraph 17 above and in that case, foreign currency embedded derivatives are not required to be separated and accounted for in terms of paragraph 4.3.3 of Ind AS 109.

D. Opinion

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

(a) For contracts entered into by the company with Indian vendors in USD or Euro, the foreign currency embedded derivative is not closely related to the host contract. Accordingly, foreign currency embedded derivatives in such contracts are required to be accounted for in terms of paragraph 4.3.3 of Ind AS 109, as discussed in paragraphs 16 to 18 above.

(b) For contracts with foreign vendors in a third currency, the foreign currency embedded derivative would be closely related to the host contract provided the company can appropriately conclude based on external trade data that USD or Euro are the 'commonly used' currency in India for external trade, as discussed in paragraph 17 above and in that case, foreign currency embedded derivatives are not required to be separated and accounted for in terms of paragraph 4.3.3 of Ind AS 109.

Query No. 10

Subject: Accounting for Embedded Derivatives in Non-Financial Host Contracts as per Ind AS 109.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') was incorporated on 16th August 1984 for procuring, transmission, processing and marketing of natural gas. The company has an authorized share capital of Rs 5,000 crore out of which Rs 2,254.98 crore is paid-up share capital as on 31st March 2018. The Government of India holds 53.59% equity of the company. The securities of the company are listed with National Stock Exchange (NSE), Bombay Stock Exchange (BSE) and London Stock Exchange.

[1] Opinion finalised by the Committee on 7.8.2019.

2. One of the main activities of the company is to lay gas pipelines for transportation of natural gas. At present, the company owns over 11000 kms of pipeline and is currently having transmission capacity of about 206 MMSCM per day of natural gas. The company operates six LPG manufacturing plants in different parts of the country. The company is having an installed capacity of 1.52 Million MT of liquid hydrocarbons per annum. It is also having an integrated petrochemical plant of the capacity of 0.81 million tonnes per annum. The company has world's longest pipeline for transmission of LPG. The company has integrated its business activities and operates into city gas distribution, wind power & solar power plant and telecom business. In addition to above, the company is currently participating in 10 Exploration & Production (E&P) blocks.

3. The querist has stated that the company has prepared its accounts as per Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016. In compliance to Companies (Indian Accounting Standards) Rules, 2015, the company prepared its financial statements for the financial year (F.Y.) 2016-17 with comparative figures for F.Y. 2015-16.

4. *Analysis of the Provisions of Ind AS 109, 'Financial Instruments' by the querist:*

(i) Derivatives and Embedded Derivatives

The querist has stated that Ind AS 109, 'Financial Instruments' provides accounting principles in respect of derivatives and embedded derivatives. The Standard defines a derivative as a financial instrument or other contract whose value changes in response to an 'underlying' like a commodity price or exchange rate. A derivative requires little or no initial investment and is settled at a future date. Examples of derivatives are commodity futures, foreign exchange forward contracts, etc. Derivatives which are not financial guarantee contracts or not part of an effective hedging arrangement are required to be accounted for at fair value through profit and loss account. This condition requires that changes in the fair value of derivatives are booked to the statement of profit and loss.

Further, paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as follows:

> *"*An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable

that the variable is not specific to a party to the contract. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument."

According to the querist, an embedded derivative is defined as a combined instrument which includes a non- derivative host contract and a derivative portion whose cash flows have the characteristics of a derivative. The following are few examples of embedded derivatives:

- A convertible bond – The host contract here is a debt instrument and the embedded derivative is the call option on equity securities.
- A loan paying interest based on an equity index – The host contract is a debt instrument with the interest portion being the embedded derivative which is based on an equity index.
- A loan with an interest rate formula which is leveraged: for example if the interest rate formula is 14.5 – 2.5 X LIBOR (3 month) – In this case there is a formula determining the interest rate which is the embedded derivative in a debt host contract.

Embedded derivatives can also be found in non-financial host contracts such as contracts for purchase of goods and services.

(ii) Accounting for embedded derivatives under Ind AS 109

(A) Provisions related to accounting for embedded derivatives under Ind AS 109 are as follows:

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

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

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

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

4.3.4 If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

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

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

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

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

4.3.7 If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, paragraph 4.3.6 applies and the hybrid contract is designated as at fair value through profit or loss."

(B) Embedded foreign currency derivative in a host contract that is not a financial instrument:

"B4.3.8

…

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;
(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

Thus, as per the querist, it is clear from the above, that the Standard requires an embedded derivative to be separated from the host contract and accounted for as a derivative when all the following three conditions are met:

a) The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract. For example, a variable interest rate loan, wherein the interest rate is indexed to the value of an equity instrument, is not closely related to the host loan contract since the characteristics and risks involved are different.

b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

c) The entire contract is not measured at fair value through profit and loss account – For example, non-financial contracts like contracts for supply of equipment.

(C) Exemption from accounting for embedded derivatives under Ind AS 109:

As per paragraph B4.3.8(d), in case of non-financial host contracts, under the following conditions, an entity is exempted from separation of embedded derivatives:

(a) If the contract is denominated in the functional currency of either of the parties to the contract – say a contract between an Indian purchaser (whose functional currency is INR) and a seller based in the USA (whose functional currency is USD) denominated in USD.

(b) *If the contract is denominated in a currency which is used around the world for international trade*.(Emphasis supplied by the querist.)

(c) If the contract is denominated in a currency which is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place.

5. The company is currently executing a major Gas Pipeline Project, which is scheduled to be completed by December 2020. The company is also implementing other pipeline projects. The company procures coated / bare carbon steel line pipes to lay pipelines for any natural gas pipeline projects. Major part of project cost of any pipeline project of the company is consisting of coated / bare carbon steel line pipes of various sizes and grades. Carbon steel plates are the main raw materials for these pipes. *The domestic suppliers of these carbon steel pipes are majorly importing carbon steel plates for manufacture of coated / bare carbon steel line pipes for which they usually pay out in foreign currency. Carbon Steel plates and line pipes are mainly traded in USD in international market.* (Emphasis supplied by the querist.)

6. Existing Pipe Procurement Methodology:

6.1 As per Office Memorandum no. O-19023/1/91/ONG/D (V) dated 02.02.1993 (a copy of which has been supplied by the querist for the perusal of the Committee) of Ministry of Petroleum & Natural Gas (MoPNG) regarding "Procurement procedure and price preference scheme to be followed under Liberalized Exchange Rate Management System", oil and gas companies including the company would procure their requirement of goods and services under International Competitive Bidding (ICB) basis where besides the Indian companies, the foreign companies / entities are permitted to bid for supply of good and services.

Further, as per the above said guidelines dated 02.02.1993, the following provisions are being made in case of procurement of goods and services under Liberalized Exchange Rate Management System:

(i) In pursuance of the decision of the Empowered Committee on indigenization of Oil field equipment and services, oil and gas companies would continue to procure their requirement of goods and services under international competitive bidding, (ICB) where foreign companies / entities are permitted to bid for supply of goods and services.

(ii) In the global tenders to be floated by oil and gas companies for procurement of goods and services, Indian bidders will henceforth be permitted to bid in any currency (including Indian Rupees) and receive amounts in such currencies on par with foreign bidders. However, currency once quoted will not be allowed to be changed.

(iii) Since Indian bidders are now permitted to quote in any currency and also receive payment in the same currency, oil and gas companies will henceforth not be compensating for any exchange rate fluctuation in respect of equipment, services and turnkey contracts to be finalized under these instructions.

6.2 MoP&NG, vide letter no. L-11011/4/05-GP dated 15.06.2005 (a copy of which has been supplied by the querist for the perusal of the Committee), forwarded the minutes of meeting of group (consisting of representative from MoP&NG, Oil PSUs and consultants) on tendering process for procurement of pipe held on 27th May 2005. As per the minutes, the group inter alia arrived at the consensus that the tenders for procurement of pipes *should be floated on ICB basis* with a view to fostering greater competition and bringing transparency in the procurement process.

6.3 Accordingly, the tender for line pipe is being invited through Open International Competitive Bidding basis through e-tendering by the company.

6.4 As per the trends of the past bids, it is noted that certain Indian/domestic bidders have submitted bids against the tenders floated by the company on ICB basis and received orders in USD in line with tender provision regarding bid currency. Further, the foreign bidders are submitting their bids generally in USD.

6.5 The company has placed orders on Indian suppliers amounting to USD 62 million during F.Y. 2016-17. During F.Y. 2017-18, the company awarded 11 major contracts for procurement of coated / bare line pipes to Indian vendors in USD. The approximate amount of total commitment of these 11 contracts is USD 395 million where the goods are to be supplied in a phased manner over a period of 6 to 12 months. The supplies may overlap more than one financial year. Besides there are some O&M

contracts for purchase of chemicals, store and spares for own consumption amounting to USD 16 million.

(Emphasis supplied by the querist.)

7. Present accounting practice followed by the company for all these procurements of pipes from Indian vendors where payment is made in USD:

i) The liability is accounted for and the payment is made to the vendor as per the terms and conditions of the purchase order (PO).

ii) The company is making accounting entries only on despatch of pipes or when pipes are physically received as per the payment and other terms of the Purchase Order.

iii) Whenever delivery of pipe is made or received from Indian vendor, the liability is booked in INR after converting in US Dollars *at prevailing exchange rate* and is capitalized or shown under 'Capital Work in Progress'.

iv) On any reporting date of financial statement if the liability remains unpaid, it is reinstated with closing exchange rate by giving impact in profit and loss account.

v) The amount lying in 'Capital Work in Progress' is capitalised upon commissioning of Pipelines.

vi) During annual closing of accounts, the amount of unexecuted purchase orders is disclosed as 'Capital Commitment' in the 'Notes to Accounts' of financial statements.

The company feels that the above stated accounting methodology followed is correct; represents true and fair view of books of account and complies with the Accounting Standards.

8. The company is of the view that these POs / contracts are not embedded derivative contracts in view of the following facts:

(a) The company is a Government company and has to abide by the Government circulars. If there were no such directives, the company might not have sought bids in foreign currency from domestic suppliers.

(b) As per the MOPNG directives (as explained under paragraphs 6.1 and 6.2 above) procurements of coated / bare line pipes are made through ICB wherein global tenders are invited in compliance to Government circulars. Domestic bidders are allowed to bid in foreign currency and are permitted to receive payments in foreign currency.

This is a special dispensation given by MOPNG to the domestic bidders for supply of goods and services under ICB basis to oil and gas companies.

(c) As the domestic bidders are allowed to quote in foreign currency, they are placed on par with the foreign bidders for offering best rates. The domestic suppliers mainly import steel plates which is the major raw material of coated / bare carbon steel line pipes and make payment in USD to their suppliers.

(d) The steel plates and pipes are traded mainly in US Dollars in international market. Accordingly, the contracts are covered under exemption from accounting for embedded derivatives as per paragraph B 4.3.8(d) under Ind AS 109.

(e) *In view of the fact stated above, it can be said that all these procurement contracts placed by the company to domestic bidders under ICB basis where the purchase order currency is a foreign currency do not qualify for embedded derivative accounting under Ind AS 109. The company has therefore not recognised these purchase orders as having any embedded derivative*.

(f) Since the company purchases pipes on International Competitive Bids (ICB) basis, as per Government Directives allowing domestic bidders to quote in foreign currency, all such domestic bidders are to be considered on the same footings as International bidders and the foreign currency (USD) quoted by domestic bidders is to be considered as functional currency of bidder for these contracts and hence it comes in exempted category.

(g) It is also pertinent to mention that as per the company's information, other oil and gas companies and also other peer Government Companies do not account for embedded derivatives for the procurements made under ICB tender process where orders were placed on domestic vendors in foreign currency and accordingly payment made to vendors in foreign currency.

(h) The delivery schedule of coated / bare line pipes under these contracts spreads over 6 to 12 months from the date of placement of orders. Further, often the actual date of delivery is different from the contractual date. Therefore, the forward exchange rates considered earlier for a particular date will not be relevant and thereby will result in numerous complications in embedded derivative accounting.

Example of Purchase Order of coated carbon steel line pipe is given below.

Purchase Order Number: 1

(i) Date of placing of PO: 28.12.2017

(ii) PO Value: USD 19 million Delivery / Completion Schedule: August' 2018 (with staggered delivery schedule)

(iii) Spot Rate: Rs. 64.08/USD

(iv) Forward rate on PO date for future last delivery date (August 2018): Rs. 65.95 / USD

(v) Forward rate on reporting date (31st March'2018) for future last delivery date (August 2018): Rs. 66.29 / USD

(vi) Value of embedded derivative as on 31st March'2018 would be Rs 0.65 Cr. {1,90,00,000 USD X (66.29-65.95)}

(vii) Accounting entry on reporting date i.e. 31.03.2018 is as below:

Profit & Loss Account	Debit	Rs. 0.65 cr
Embedded Derivative Liability	Credit	Rs. 0.65 cr

(viii) Under such circumstances, if the company has to give effect in the books of account (i.e. in profit and loss account) on the reporting date i.e. 31st March 2018 under Ind AS 109, of embedded derivatives, on the basis of forward rates, a huge notional amount will be recognised in the profit and loss account. *This notional amount will be charged to profit and loss account although there is no corresponding accounting / liability towards the supply as on 31.03.2018, as the physical delivery of carbon steel line pipes as per the contractual delivery dates are in future years.*

Such accounting treatment will be incongruous and distorting the financial position as on 31.03.2018, since although there is no payment or liability recognised in the books of account as on 31.03.2018, the company will make notional entries in the profit and loss account.

(i) Further the said accounting treatment will have to be followed for every reporting period on quarterly basis without any actual delivery of material.

(j) This notional entry will have positive / negative fluctuations in the profit and loss figure for each reporting period and will not give true picture of the company's financial position to different stakeholders.

Moreover, all these coated / bare line pipes are meant for natural gas pipeline project which will be ultimately capitalised in the books of account of the company on receipt of material.

(k) It is also submitted that these purchases of coated / bare line pipes are for own use of the company for execution of cross country natural gas pipeline project and there is no speculation involved in the transactions.

(l) Notional entries of embedded derivatives on each reporting date will unnecessarily attract tax implications for the company.

(m) As discussed above, accounting for embedded derivatives in case of non-financial host contracts under Ind AS 109 will have a serious consequence for the Indian corporates with huge notional entries affecting their profit and loss account at each reporting date. These notional entries may have impact on tax liability as well.

(n) The company will be disclosing the above fact and details of ICB transactions by giving a suitable note in its annual accounts.

(Emphasis supplied by the querist.)

9. *Relevance of Ind AS 109 for Indian Companies:*

(i) The querist has stated that it should be appreciated that accounting requirements of Ind AS 109 for embedded derivatives in non-financial contracts do not appear to take into consideration the Indian context or the Indian economic scenario where most of the foreign trade is denominated in USD. This is a western concept relevant in developed countries and prevailing in the US and Europe where the transaction is in their domestic currency (e.g. USD, Euro, Pound Sterling etc.) which are also internationally traded currency. However, in the context of a developing country like India, this type of accounting treatment will lead to avoidable accounting complications, increase avoidable volatility in operating reports and is a huge burden for companies and is undesirable.

(ii) The need for the said Standard is required to be reviewed and interpreted in relation to Indian context and especially for the Public Sector Undertakings (PSU), who are strictly governed by rules and regulations of the Government of India.

10. Considering above facts, it is concluded by the company that its transactions are covered under exempted categories and it is not required to account for embedded derivatives. Further, in view of the facts and explanations given in paragraphs 8 and 9, the company is recognising the contracts with

Indian bidders who have quoted in foreign currency against the ICBs floated by the company in pursuance of Government Policy, as being exempted under paragraph B 4.3.8(d) of Ind AS 109, from being classified as embedded derivative.

11. The querist has also supplied the following information in the context of the issue raised:

(i) Step by step process relating to the International Competitive Bidding (ICB):

*How the bidding is initiated***:**

Open International Competitive bidding process is used for request for quotation (e-bids) from prospective bidders. Bids are to be submitted in the company's E-Tender website. Bidders shall submit their bids in two parts, i.e., part-I, Un-price bid containing all technical details along with applicable forms and format, and part-II, Price bid.

After receiving the Earnest Money Deposits (EMD) from the bidders, techno-commercial evaluation of the bids is made as per the documents submitted in Part-I Un-price bid and further documents as per TQ/CQ (technical query/commercial query) are evaluated. After acceptance of the same, Part-II price-bids are opened for the qualified and accepted bidders.

After that, comparative analysis is done for price bids prices/reverse auction (as the case may be) of the respective bidders and L1 bidder(s) are finalized. After finalization of the same, placement of order is made through issuance of Fax of Acceptance (FOA) to the bidder.

Who are the bidders:

Invitation for Bid (IFB) notices are made on the company's E-tender portal and also in Govt. Central Public Procurement Portal (CPP portal). Any steel pipe manufacturers who meet the technical and financial bid evaluation criteria can quote for the same.

How the vendor is selected:

Vendors/ bidders are selected who meet the technical and financial bid evaluation criteria.

Any negotiations with prospective suppliers:

Usually after price bid opening and reverse auction, no price negotiation is made with the prospective bidder(s), but in exceptional cases were L1 prices are more than the specified limit as compared with estimated

prices and procurement case is urgent in nature, procurement policy permits for price negotiation with L1 bidder(s).

How the price/currency is finalised:

The pricing of a single contract is determined on the basis of prices quoted by the bidders and becomes L1 Price. Further, as per Instructions to Bidders (ITB), paragraph 12 "Indian bidders may submit bid in Indian Rupees or in US $ / euro and receive payment in such currency".

Is the contract necessarily awarded to the lowest bidder:

As per ITB, paragraph 37 "The employer will award the contract to the successful bidder(s) whose bid has been determined to be substantially responsive, meets the technical & financial criteria and /or have been determined as a lowest bid on least cost basis to Employer".

(ii) With regard to the basis for pricing a contract especially in contracts with local vendors, the querist has mentioned that the pricing of a contract is determined on the basis of prices quoted by the bidders and becomes L1 Price as per ITB paragraph 33, 'Evaluation and comparison of bid'. "Further to facilitate evaluation and comparison, the employer will convert all the bid prices expressed in the amount in various currencies in which the bid price is payable to single currency and that will be Indian Rupees only" as per ITB para 32 Conversion to single currency. In case of ICB tender only, bids in foreign currency is allowed to quote. The vendor can bid in foreign currency even for that component of the contract which does not involve any payment by the vendor in foreign currency, as one to one matching not required for foreign currency amount vis-a vis payment by the vendor in foreign currency/ or items manufactured in India.

(iii) The querist has confirmed that the query has been raised in the context of procurement of coated/bare line pipes only, but this situation may also arise for other O&M contracts for purchase of chemicals, store and spares, etc. for which bids may be called on ICB tender.

(iv) With regard to the bids received for tenders floated as per ICB in past, for procurement of coated/bare line pipes, the querist has clarified that in past, the company has received bids in currencies other than USD also. A*s* per ITB paragraph 12 "Indian bidders may submit bid in Indian Rupees or in US $ / euro and receive payment in such currency. Foreign bidders may submit bid in the home currency of bidder's country or US $ / Euro / INR." Accordingly, in previous ICB tenders also, bids are received in currencies other than USD also.

(v) With regard to any discretion of the company to fix the price in terms of currency other than the bid currency after the biding process is over and at the time of entering into agreement/contract with the selected bidder, the querist has clarified that once the bidding process is over and at the time of entering into agreement with the selected bidder, the company cannot have discretion to fix the price in terms of currency other than the bid currency. As per Special conditions of Contract (SCC), Section III C paragraph 3, "the payment to Indian bidders shall be done as per following:

The unit ex-work/ex storage yard price quoted by the bidder in INR or US Dollar /Euro shall be paid in currency quoted."

B. Query

12. Considering the above facts and explanations, the Expert Advisory Committee is requested to give its opinion on the following:

(a) Whether the opinion of the company as concluded above in paragraph 10 is correct.

(b) The company is of the view that not withstanding the logical explanation given in paragraphs 8 and 9 above, even if at all, an extreme view is taken, then the notional entry of MTM gain or loss required to be accounted for in the books of account of the company under embedded derivative, should be shown in Other Comprehensive Income (OCI) and not in the profit and loss account.

C. Points considered by the Committee

13. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to whether the foreign currency embedded derivatives in contracts for purchase of coated / bare carbon steel line pipes, entered into by the company with Indian vendors in USD, can be considered as closely related to the host contract as per paragraph B4.3.8(d) of Ind AS 109. 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, assessment of substantial party to the contracts, accounting for the non-financial items purchased, etc.

14. The Committee notes the following paragraph of Ind AS 109:

"B4.3.8

…

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument

(such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

From the above, with regard to the first condition as to the functional currency, the Committee presumes from the Facts of the Case that USD is not the functional currency of the company. Further, the Committee notes from the Facts of the Case that the querist has contended that domestic (Indian) bidders should be considered on the same footing as International bidders and the foreign currency, viz., USD should be considered as 'functional currency' of the bidders *for these contracts.* In this regard, the Committee wishes to state that functional currency is to be determined in the context of primary economic environment in which the company as a whole operates and not in the context of particular type of contracts entered into by the company. Since apparently, USD is not the functional currency of the Indian/ domestic bidders/suppliers in the extant case, this condition is not met.

15. The Committee further notes that as per the requirements of paragraph B4.3.8(d)(ii) of Ind AS 109, an embedded foreign currency derivative in a host contract is considered as closely related to the host contract if it is denominated in a currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions). In this regard from the example quoted in the standard in terms of crude oil transactions for this condition, the Committee believes that such currency should be used for similar transactions all over the world and not merely in one region/area. In this regard, the Committee notes from the Facts of the Case that in the past for procurement of coated/bare line pipes, the company has received bids in currencies other than USD also.

From this, it is clear that the price of coated /bare line pipes is not routinely denominated in USD in commercial transactions around the world. Further, terms of ICB provide option to bidders to select currency of bids. Therefore, the Committee is of the view that this condition is also not met.

16. The Committee also notes that as per the requirements of paragraph B4.3.8(d)(iii) of Ind AS 109, an embedded foreign currency derivative in a host contract is considered as closely related to the host contract if it is denominated in a currency that is *commonly used* in contracts in the *economic environment* in which the transaction takes place. In this context, the Committee also notes the following paragraphs from the 'Basis for Conclusions' on International Financial Reporting Standard (IFRS) 9, 'Financial Instruments' (which is the corresponding International Standard of Ind AS 109), issued by the International Accounting Standards Board, as follows:

> "BCZ4.94 The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) instead of the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.
>
> BCZ4.95 In revising IAS 39, the IASB concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place (that guidance is now in IFRS 9). A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be

quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperflationary Economies*)."

The Committee notes from the above that the objective behind this exception is to eliminate burden of separating embedded foreign currency derivatives for transactions between entities in smaller countries in international stable/liquid currencies instead of local currency of these entities or pricing in foreign currency by entities operating in hyperinflationary economy. Further, foreign currency derivatives are considered as closely related to host contract if monetary amounts are viewed in terms of foreign currency and not in local currency. From this, the Committee is of the view that 'commonly used' in the extant case should be assessed in the context of the country and not just commonly used by the company or for ICB purposes, etc. The Committee also notes that the example in paragraph B4.3.8 (d) (iii) of Ind AS 109 refers to the currency commonly used in local business transactions or external trade.

The Committee is further of the view that to apply this requirement, the company should first determine the economic environment in which the transaction takes place, viz., whether the transaction is a local business transaction or is an external trade and then the currencies that are commonly used in contracts to purchase or sell non-financial items in such economic environment. In this regard, the Committee is of the view that as the transaction to buy coated/bare line pipes takes place with local/Indian suppliers in India in the extant case, although the bid is selected and the contract is awarded through ICB, economic environment should be construed in the context of economic environment in India in which local business transactions take place. The Committee is further of the view that Indian National Rupee (INR) is the currency which is commonly used for local transactions within India. Therefore, the transactions entered into by the company in USD with local/Indian suppliers for purchase of coated /bare line pipes do not fulfil the requirements of paragraph B4.3.8 (d) (iii) of Ind AS 109.

Accordingly, the Committee is of the view that in the extant case, the embedded foreign currency derivative in the host contract should not be considered as closely related to the host contract and the same should be separately accounted for by the company. In this regard, the Committee notes the following requirements of Ind AS 109:

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

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic

characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);

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

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

4.3.4 If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

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

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

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

"B4.3.9 As noted in paragraph B4.3.1, when an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard and with one or more embedded derivatives, paragraph 4.3.3 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that

reason this Standard permits the entire hybrid contract to be designated as at fair value through profit or loss.

B4.3.10 Such designation may be used whether paragraph 4.3.3 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 4.3.5 would not justify designating the hybrid contract as at fair value through profit or loss in the cases set out in paragraph 4.3.5(a) and (b) because doing so would not reduce complexity or increase reliability."

In accordance with the above requirements, the Committee is of the view that the embedded foreign currency derivative should be measured at fair value at initial recognition and subsequently with changes in fair value recognised in the statement of profit and loss and not in the statement of other comprehensive income, as being contended by the querist.

D. Opinion

17. On the basis of the above, the Committee is of the opinion that for contracts entered into by the company with domestic/Indian suppliers/vendors in USD, the foreign currency embedded derivative is not closely related to the host contract and should be accounted for separately, as discussed in paragraphs 14, 15 and 16 above. Further, the embedded foreign currency derivative should be measured at fair value at initial recognition and subsequently with changes in fair value recognised in the statement of profit and loss and not in the statement of other comprehensive income, as being contended by the querist, as discussed in paragraph 16 above.

Query No. 11

Subject: Presentation of gain or loss on account of mark to market valuation of the derivative contracts resulting from movements in exchange rates and interest rates of the underlying currencies.[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.

[1] Opinion finalised by the Committee on 7.8.2019.

2. The company operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. Globally, E&P business is carried out by way of joint arrangements or investments in form of subsidiaries/ associates. In accordance with the requirement of Ministry of Corporate Affairs (MCA) Notification dated 16th February 2015, the company has been following Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016 (Transition Date 1st April 2015). The functional currency of the company is assessed as US Dollars (USD) in accordance with the provisions of Ind ASs. The company presents its financial statements in its presentation currency which is Indian National Rupee (INR).

3. In order to finance its overseas operations, the company arranges external commercial borrowings including but not limited to debentures and bonds denominated in external currencies. The company currently has (i) Euro (EUR) denominated bonds, (ii) Indian Rupee (INR) denominated debentures and (iii) Japanese Yen (JPY) denominated long term bank loan besides bonds and debentures in the company's functional currency i.e. USD.

4. The said borrowings denominated in external currencies involve, inter alia, exchange risk and interest rate risk. In order to hedge such risks, the company enters into various derivative contracts, e.g. interest rate swaps and forward & option contracts. The company measures these financial instruments at fair value through profit or loss (FVTPL) in accordance with Indian Accounting Standard (Ind AS) 109 'Financial Instruments'. Any gain/loss arising on such valuation is recognised in the statement of profit and loss as per paragraph 20(a) of Ind AS 107 'Financial Instrument: Disclosures'.

5. During financial year (F.Y.) 2017-18, the company has entered into forward contracts covering Euro 199.50 Million and option contracts covering Euro 35 Million in respect of its Euro bonds. Further, the company has also entered into interest rate swap arrangement, swapping the coupon and principal amount of its INR denominated debentures into USD.

6. As mandated by Ind AS 109 and Ind AS 107, the company measured its derivative contracts at FVTPL by recognising net gain/loss in the statement of profit and loss. The said mark to market gain/loss was disclosed under 'Finance Cost' in the notes to the statement of profit and loss as a separate line item with heading '*Net loss (gain) on fair value of derivative contracts mandatorily measured at fair value through profit or loss'*.

7. During the course of government audit, it was highlighted by the Comptroller and Auditor General of India (C&AG) team that the net gain/loss arising on account of mark to market valuation of the derivatives is required to be classified under 'Other Income' as suggested in paragraph 9.2 of the Guidance Note on Division II - Ind AS Schedule III to the Companies Act, 2013 (hereinafter

referred to as the 'Schedule III Guidance Note'[2]), issued by the Institute of Chartered Accountants of India (ICAI).

8. The derivative contracts, mentioned in paragraph 5 above, are entered for the sole purpose of hedging the company's cash flows against volatility in underlying exchange rates of foreign currencies in which borrowings are denominated and the company's functional currency. Further, the periodic gains/losses on such derivative contracts are a result of mark to market valuation which essentially reflect the movement in exchange rates of underlying currencies.

9. The querist has stated that the foreign exchange fluctuation on restatement of foreign currency borrowings in functional currency at each period end is considered to be part of finance cost in accordance with paragraph 6 of Ind AS 23, 'Borrowings Costs'. Further, the movement in mark to market valuation of derivative contracts will always be inversely related to the movement in foreign exchange fluctuations on restatement of foreign currency borrowings as these derivative contracts are entered specifically to hedge the company against such currency fluctuations. Accordingly, to understand the actual impact of foreign exchange fluctuations on long term foreign currency borrowings, both of these amounts need to be seen in conjunction. The net impact of the gain/loss due to foreign exchange fluctuation on restatement of foreign currency borrowings and loss/gain on mark to market valuation of derivative contracts taken against these borrowings is, in substance, the true impact of foreign exchange fluctuation on long term borrowings in the company's financial statements.

10. According to the querist, it will be pertinent to mention that paragraph 9.5.5 (D) of the Schedule III Guidance Note (pre-revised) states that "Foreign exchange differences arising on foreign currency borrowings shall be disclosed under finance cost." Thus, the intent of the paragraph mentioned above is to classify the costs of the borrowings associated with the exchange risk as finance costs. As explained in paragraph 9 above, the gain/loss on mark to market valuation of derivative contracts is intricately linked with the foreign exchange fluctuations on foreign currency borrowings and the sole purpose of entering into such derivative contracts is to cover the exchange and interest rate risks and manage the finance costs. Therefore, in financial statements, it is also classified under finance costs. This will enable the readers of the financial statements to correlate the interplay of finance costs incurred due to the external borrowings and the gain/loss on valuation of financial instruments executed to hedge the

[2] The Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013 was initially issued by the ICAI in July 2017; however, the same has been subsequently revised in July 2019.

risks associated with the said external borrowings. It presents a comprehensive picture with respect to costs associated with the foreign currency borrowings (i.e. interest cost and foreign exchange fluctuations) and activities relating to covering the risks associated (i.e. gain/loss on derivative contracts) which may not be the case when the foreign currency fluctuations and gain/loss on derivatives are shown separately.

11. Therefore, according to the considered opinion of the querist, though the form of the net gain/loss on fair value measurement of derivative contracts may be of other income/other expense, but in substance, the said gain/loss is incurred to control the foreign exchange fluctuations included in finance costs and has a direct bearing thereon. In view of the same, it may be considered appropriate that the net gain/loss arising from fair valuation of derivative contracts is classified as a separate line item under the 'finance costs' so as to enable the readers of financial statements to correlate the offsetting effect of the said gain/loss on the gain/loss due to foreign exchange fluctuations on long term foreign currency borrowings.

B. Query

12. In view of the above facts, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the appropriate presentation of the net gain/loss arising on account of the measurement of derivative instruments through FVTPL, i.e., whether:

(i) the presentation of the gain/loss on mark to market valuation of derivative contracts taken to hedge the currency fluctuations on long term foreign currency borrowings by the company as a separate line item under 'finance cost' is appropriate; or

(ii) the presentation as suggested in paragraph 7 above is to be followed.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised by the querist relates to presentation of gain or loss on account of mark to market valuation of the derivative contracts, which, according to the querist, are solely taken to hedge the exchange and interest rate risks on the foreign currency borrowings. 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 such derivative contracts, the assessment of the functional currency of the company, the adjustment in interest costs arising on account of foreign exchange gains and losses on foreign currency borrowings as per paragraph 6(e) of Ind AS 23, 'Borrowing Costs', presentation of the derivative instruments and the foreign currency borrowings in the balance sheet, etc. Further, the Committee presumes

that the company has not opted for applying hedge accounting under Ind AS 109 and has measured the derivative contracts at fair value through profit and loss. Incidentally the Committee notes from the Facts of the Case that foreign exchange fluctuation on restatement of foreign currency borrowings in functional currency at each period end is considered to be part of finance cost by the company. In this regard, the Committee wishes to point out that not all exchange differences arising from foreign currency borrowings can be considered as finance cost or borrowing cost. The company should consider the requirements of paragraphs 6(e) and 6A of Ind AS 23 with regard to the extent of exchange differences required to be treated as borrowing costs. The Committee further notes that the foreign currency external commercial borrowings are measured by the querist at amortised cost using effective interest method under Ind AS 109, 'Financial Instruments'.

14. The Committee notes that paragraph 20 of Ind AS 107, Financial Instruments: Disclosures, states, inter alia, as follows:

> "An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:
>
> (a) net gains or net losses on:
>
> (i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (eg financial liabilities that meet the definition of held for trading in Ind AS 109). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.
>
> …
>
> (b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss."

From the above, the Committee notes that while Ind AS 107 requires disclosure of net gains or net losses on financial assets or financial liabilities measured at fair value through profit or loss either in the statement of profit and loss or in the Notes, it does not prescribe the line item within which the net gains or net losses should be presented. Paragraph 20(b) of Ind AS 107, requires separate disclosure of total interest expense (calculated using the effective interest method) for financial liabilities that are not measured at fair value through profit or loss (i.e. measured at amortised cost) either in the statement of profit and loss or in the notes. Further, paragraph 82 of Ind AS 1, 'Presentation of Financial Statements' while requires presentation of finance costs as a separate line item, it does not elaborate further as to what constitutes finance costs.

15. The Committee also notes that paragraphs 32, 33 and 35 of Ind AS 1, 'Presentation of Financial Statements' state as follows:

> **"32 An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.**
>
> 33 An entity reports separately both assets and liabilities, and income and expenses. Offsetting in the statement of profit and loss or balance sheet, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows. Measuring assets net of valuation allowances—for example, obsolescence allowances on inventories and doubtful debts allowances on receivables—is not offsetting."
>
> "35 In addition, an entity presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material."

From the above, the Committee notes that Ind AS 1 states that income and expenses should not be offset unless required or permitted by another standard. This is because offsetting detracts from the ability of users to understand fully the transactions, other events and conditions that have occurred and to assess the entity's future cash flows. The only exception to this is where the offsetting reflects the substance of the transaction or other event. Paragraph 35 of Ind AS 1 explains that gains and losses arising from groups of similar transactions should be reported on a net basis. The individual transactions should, however, be reported separately if they are material. Whilst Ind AS 32 prescribes when financial assets and liabilities should be offset in the balance sheet, it contains no

guidance on when related income and expenses should be offset. In the context of offsetting of income and expenses, Ind AS 109 states the following:

> "B6.6.13 If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of profit and loss. The presentation of hedging gains or losses in that statement depends on the group of items.
>
> B6.6.14 If the group of items does not have any offsetting risk positions (for example, a group of foreign currency expenses that affect different line items in the statement of profit and loss that are hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment shall be done on a systematic and rational basis and shall not result in the grossing up of the net gains or losses arising from a single hedging instrument."

These requirements imply that gains and losses from hedging instruments in hedging relationships would be presented in the same line item that is affected by the hedged item (at least to the extent the hedge is effective) rather than being shown separately, although this is not explicitly stated in Ind AS 109. Although the querist has not applied hedge accounting, the Committee is of the view that this presentation principle would be relevant.

16. The Committee also notes that paragraph B3 of Ind AS 107 states as follows:

> "B3 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Ind AS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks."

From the above, the Committee notes that as per the requirements of B3, an entity should decide, in the light of its own circumstances, how to aggregate the information to display the overall picture without combining information with

different characteristics. Accordingly, while aggregating information for disclosure purposes, it is necessary to consider the characteristics of the item(s) being aggregated with the characteristics of the head under which that item is being aggregated. In this context, the Committee notes paragraph B5 of Ind AS 107 as follows:

> "B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:
>
> …
>
> (e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income."

From the above, the Committee notes that Ind AS 107 allows interest income to be presented under net gains/losses on financial instrument for disclosure purposes. The Committee further notes that interest (time value of money) is considered as one of the component in determination of fair value of financial instruments. Further as per Ind AS 23, 'Borrowing Costs', a portion of exchange differences (which is also one of the components of fair value of a foreign currency derivative or financial instrument) is considered as borrowing cost/finance cost to the extent that they are regarded as an adjustment to interest costs. Thus, drawing an analogy, the Committee is of the view that the gain/loss on fair valuation of a foreign currency derivative or financial instrument may include elements having the characteristics of 'finance costs'.

17. The Committee further notes that Note 3 of General Instructions for Preparation of Statement of Profit and loss in Part II of Division II of Schedule III to the Companies Act, 2013 requires disclosure of 'finance costs' to be bifurcated into 'Exchange differences regarded as an adjustment to borrowing costs' and 'Other borrowing costs' and paragraph 9.5.5 of the Schedule III- Guidance Note (Revised July, 2019 Edition) that deals with 'Finance Costs', provides as follows:

> **"D) Other borrowing costs**
>
> Other borrowing costs would include commitment charges, loan processing charges, guarantee charges, loan facilitation charges, discounts/premium on borrowings, *other ancillary costs incurred in connection with borrowings*, or amortization of such costs, etc. …"
>
> (Emphasis supplied by the Committee.)

From the above, the Committee notes that as per the above-reproduced requirements of paragraph 9.5.5 of the Guidance Note, foreign exchange differences relating to foreign currency borrowings or other ancillary costs incurred in connection with borrowings can be presented under 'finance costs'. Accordingly, the Committee is of the view that in the extant case, considering the overall objective of hedging interest rate risk as well as exchange rate risk (and not solely the exchange rate risk) and the nature of derivatives/financial instruments, the gain/loss on fair valuation of the financial instruments is of the nature of ancillary cost incurred in connection with borrowings and therefore, it may not be inappropriate to present and disclose the same under 'other borrowing cost' under the head 'Finance Costs'. However, as per the requirements of paragraph 20(a) and 20(b) of Ind AS 107, separate disclosure of the net gain or loss on the said derivative contracts and the interest expense on the foreign currency external commercial borrowings (being financial liabilities not measured at fair value through profit or loss) should be made within the 'Finance costs' schedule in the financial statements. Further, as per the requirements of paragraph 21 of Ind AS 107, a disclosure in respect of the same should be given by the company in its significant accounting policies.

D. Opinion

18. On the basis of above, the Committee is of the opinion that, as discussed in paragraphs 14 to 17 above, it may not be inappropriate to present and disclose the net gain or net losses arising on fair valuation of the derivative contracts/financial instruments in the extant case, entered into to hedge the foreign currency external commercial borrowings, as 'other borrowing cost' under the head 'Finance costs'. However, as per the requirements of paragraph 20(a) and 20(b) of Ind AS 107, separate disclosure of the net gain or loss on the said derivative contracts and the interest expense on the foreign currency external commercial borrowings (being financial liabilities not measured at fair value through profit or loss) should be made within the 'Finance costs' schedule in the financial statements. Further, as per the requirements of paragraph 21 of Ind AS 107, a disclosure in respect of the same should be given by the company in its significant accounting policies.

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Query No. 12

Subject: Provision for pay revision.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the comapny') is a 100% subsidiary of a public sector undertaking (PSU), ABC Ltd. (a Mini Ratna PSU) under the Ministry of Health and Family Welfare, Government of India (GoI) and incorporated and registered under the Companies Act on 03.04.2014. Being a service providing company, the real asset of the company is its talented and experienced manpower. The remuneration and allowances to the employees are supposed to be at par with that of the industry norms. The financial statements of the company have been prepared in accordance with the Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015.

2. Department of Public Enterprises (DPE) vide its Office Memorandum (O.M.) dated 3rd August 2017, has communicated the acceptance of pay revision by the GOI, as recommended by the 3rd Pay Revision Committee (PRC) (a copy of the same has been supplied by the querist for the perusal of the Committee). Accordingly, pay revision of the Board level and below Board level executives and non-unionised supervisors of Central Public Sector Enterprises (CPSEs) shall be implemented w.e.f. 01.01.2017. Highlights of the DPE O.M. are summarised below:

(i) The revised pay scales would be implemented subject to the condition that the additional financial impact in the year of implementing the revised pay package for Board level and below Board level executives and non-unionised supervisors should not be more than 20% of the average profit before tax (PBT) of the last three financial years preceding the year of implementation.

(ii) There should be no change in the number and structure of pay scales and every executive has to be fitted into the corresponding new pay scale. In case of CPSEs which are yet to be categorised, the revised pay scales as applicable to the Schedule 'D' CPSEs should be applicable.

(iii) In case the additional financial impact in the year of implementing the revised pay-package of a CPSE is within 20% of average PBT of last 3 years, a uniform full fitment benefit of 15% would be provided.

(iv) If the additional financial impact in the year of implementing the revised pay-package is more than 20% of the average PBT of last 3

[1] Opinion finalised by the Committee on 5.11.2019.

financial years (FYs), then the revised pay-package with recommended fitment benefit of 15% of basic pay (BP) + dearness allowance (DA) should not be implemented in full but only partly, as below:

a. More than 20% but upto 30% of average PBT of last 3 FYs, the fitment benefit shall be 10% of BP+DA.

b. More than 30% but upto 40% of average PBT of last 3 FYs, the fitment benefit shall be 5% of BP+DA.

c. No fitment of any other benefit of pay revision will be implemented in the CPSE where the additional financial impact of revised pay package is more than 40% of the average PBT of last 3 FYs.

(v) At the time of implementation of pay revision, if the additional financial impact after allowing full/part fitment exceeds 20% of average PBT of last 3 FYs then Performance Related Pay (PRP) pay out / allowances should be reduced so as to restrict the impact of pay revision within 20%.

(vi) Board of Directors of the CPSE would consider the proposal of pay revision based on the affordability of the CPSE to pay and submit the same to Administrative Ministry for approval.

(vii) The Administrative Ministry concerned will issue the Presidential Directive with the concurrence of its Financial Adviser in respect of each CPSE separately.

(viii) After implementation of pay revision, the profitability of the CPSE shall be reviewed after every three years and

a. If there is improvement in the average PBT of the last 3 years, then full pay package /higher stage of pay package would be implemented while ensuring that total additional impact (sum total of previously implemented part pay package and proposed additional package) stays within 20% of the average of PBT of last 3 years.

b. If the profitability of a CPSE falls in such a way that the earlier pay revision now entails impact more than 20% of average PBT of last 3 years, then PRP/allowances will have to be reduced to bring down impact.

3. The company is following the pay-scales and other benefits as that of the parent company, ABC Ltd. for both executives and non-executives. Since the

company is not a categorized CPSE and is 100% subsidiary of ABC Ltd. (Schedule B), the company is operating the pay scales from E0-E7, applicable to Schedule B CPSE, same as in the case of ABC Ltd. and the last revision of scale of pay was made effective from 01.01.2007.

4. For implementation of 3rd Pay revision, Board of Directors (BOD) of the company at its 16th Board meeting took decision to constitute committee to review the proposal for implementation of revision of scale of pay for Board level and Board level executives and non-unionised supervisors w.e.f. 01.01.2017 and submit the recommendation to the Board of Directors for further approval. In the same Board Meeting, provision for pay revision of Rs. 4.00 crore for the F.Y. 2017-18 was also approved. The Committee could not meet due to superannuation of two members.

5. In order to review the proposal of implementation of revision of scale of pay, at the 20th Board meeting, it is proposed that pay revision committee may be reconstituted with the following new members:

(i) Director (Finance) - ABC Ltd.
(ii) Chief Operating Officer/Chief Executive Officer (the company)
(iii) Senior Vice-President (SVP) (HR)-ABC Ltd.

Further, Board of Directors at the 20th Board meeting approved the provision of pay revision of Rs. 3.87 crore for the F.Y. 2018-19 and cumulative provision as on 31.03.2019 is Rs. 7.87 crore.

6. For releasing the payment to the employees, the company has to go through the following steps:

a. Committee constituted by BOD is yet to give its recommendation as per eligibility of the company for pay revision.

b. Board approval for pay revision proposal on the recommendation of committee

c. Holding company's approval on pay revision proposal, and

d. Administrative Ministry's approval for pay revision as per the DPE's OM

However, although the actions as mentioned above are still pending and the company is not in a position to implement the pay revision immediately, the provision is made on the basis of fair estimation of the possible outflow due to pay revision in the future on year to year basis. Further, after completing all the procedures, there should not be big impact on a particular year. Also, the said provision has been booked on the basis of generally accepted accounting principles, i.e., 'Matching' concept which states that related expenditure for the

particular period must be booked in the same period in which they are incurred, regardless of when the transfer of cash occurs in order to show the true profit for the period.

7. Since inception, the company has been in the growth path and is rapidly growing year after year. The provisions are made on the basis of following eligibility in F.Y. 2017-18 and F.Y. 2018-19.

Table-A shows eligibility criteria for the F.Y. 2017-18

Financial Year	**PBT (Rs. in Crore)**
2015-16	1.75
2016-17(without provision for PRP of Rs. 0.22 Crore)	4.31
2017-18 (without provision of pay revision)	15.26
TOTAL PBT	**21.32**
Average PBT	**7.11**
20% of average PBT	**1.42**
30% of average PBT	**2.13**
40% of average PBT	**2.84**
Total implication including 5% fitment benefit & 35% cafeteria perks	**2.52**
Total implication including 15% fitment benefit & 35% cafeteria perks	**4.00**
Provision for Pay Revision Created	**4.00**
Total Provision for Pay Revision as on 31.03.2018	**4.00**

Table-B shows eligibility criteria for the F.Y. 2018-19

Financial Year	**PBT (Rs. in Crore)**
2016-17(without provision for PRP of Rs. 0.22 Crore)	4.31
2017-18 (without provision of pay revision of Rs. 4 Crore & PRP-Rs. 0.58 Crore)	15.84
2018-19 (without provision of pay revision of Rs.3.87 Cr & PRP-Rs. 1.54 Crore)	35.72
TOTAL PBT	**55.86**
Average PBT	**18.62**
20% of average PBT	**3.72**
30% of average PBT	**5.59**
40% of average PBT	**7.46**

Total implication including 5% fitment benefit & 35% cafeteria perks	**5.36**
Total implication including 15% fitment benefit & 35% cafeteria perks	**7.87**
Provision for Pay Revision Created	**3.87**
Total Provision for Pay Revision as on 31.03.2019	**7.87**

(Emphasis supplied by the querist.)

8. The eligibility of the company with 5% fitment benefit and 35% cafeteria perks was always available with the company. However, the company has provided full provision considering 15% fitment benefit and 35% cafeteria perks considering the facts mentioned below in paragraphs 9, 10 and 11.

9. At present, the company is having an excellent order booking in hand in all the business segments. Based on this, the average turnover of the company would be in excess of Rs. 200 crore in the next few financial years with a definite growth and the PBT may remain beyond Rs. 30 crore with an increasing trend. Based on the past history of performance and future prospective performance and as per present trends in the business of the company, in future, the liability to pay the pay revision will be the maximum to the extent of DPE guidelines allows.

10. Accordingly, the provision has been made based on the reliable estimate of the likely expenditure for the services rendered by the employees of the company in the relevant period. In the process it may be possible that the provision may surpass the limit of 20% of average profit of last 3 years' profit in a particular year and in some of the years, there might be additional amount available in the limit of 20% but overall impact on the profit will not surpass the limit at the time of implementation and pay out to the employees.

11. Provisions of Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets' were also considered, while making the provision for pay revision which are as follows:

a. An entity has a present obligation (legal or constructive) as result of a past event, i.e., the company has the present obligation to revise pay scale of the employees who have already rendered / are rendering the service to the company.
b. It is essential that an outflow of resources will be required to settle the obligation.
c. The provision made is a reliable estimate of the company which is calculated on the basis of services rendered by the employees of the company.

d. Moreover, during the period of financial statement, it can be fairly estimated that the outflow of recourses will occur in future.

e. The said provision has been booked on the basis of generally accepted accounting principles, i.e., 'Matching' concept which states that related expenditure for a particular period must be booked in the same period in which they are incurred, regardless of when the transfer of cash occurs in order to show the true profit for the period.

f. Further as per paragraph 48 of Ind AS 37, future events that may affect the amount required to settle an obligation, shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur. As the company is a growing organisation and it is evident from the turnover and profitability trends and increase in business operations of the company, the liability of pay revision shall accrue to the extent of maximum in the near future.

12. The maximum possible outflow for the pay revision, as per DPE guidelines i.e. calculated based on the fitment benefit of 15% to the existing employees. Accordingly, the company has created total provision w.e.f. 01.01.2017 to 31.03.2019 (27 months) of Rs. 7.87 crore. The provision of Rs. 4.00 crore has already been made in the previous year and the balance provision of pay revision of Rs. 3.87 crore for the F.Y. 2018-19 has been provided in books of account in the F.Y. 2018-19.

13. Disclosure in this regard is also made in the explanatory notes. The above provision is approved by the Board of Directors and in this regard, committee is constituted for giving recommendation as per the eligibility of the company in accordance with the DPE guidelines. After obtaining approval of the Board and the concurrence of the parent company, the same shall be submitted to the concerned Ministry for approval.

14. *Treatment in Accounts and Disclosure:*

The company has created the provision of pay revision in the books of account in the F.Y. 2017-18 for Rs. 4.00 crore and in F.Y. 2018-19 for Rs. 3.87 crore. Hence, the total provision for pay revision was Rs. 7.87 crore. In this regard, an explanatory note was also made in the financial statements which is given as below:

> "Department of Public Enterprises (DPE) vide O.M. No. W-02/0028/2017-DPE (WC)-GL-XIII/17 dated 3rd Aug, 2017 has communicated the acceptance of pay revision by GOI, as recommended by the 3rd Pay Revision Committee (PRC) for the pay revision of board level and below board level executives and non-unionised supervisors to be implemented w.e.f. 01.01.2017. As per the above guidelines maximum ceiling of fitment

benefit is 15% of Basic + DA and the ceiling of the perks is 35% of the revised basic pay. Accordingly a provision of Rs. 400 lakh was made in F.Y. 2017-18 and the same was approved by the Board of Directors at its 16th Board meeting held on 30/05/2018. Further, an additional provision for pay revision of Rs. 387.84 lakh has also been made in F.Y. 2018-19 (Total provision from 01/01/2017 to 31/03/2019 Rs. 787.84 lakh) in order to follow the matching principle of accounting. As per the matching principle, the expenses should be recorded during the period in which they are incurred, regardless of when the transfer of cash occurs.

For the implementation of the same, Board of Directors has constituted a committee consisting of VP (HR)-ABC Ltd., CEO (of the company) and Director (F)-ABC Ltd. which is in the process of giving recommendation as per the eligibility of the company in accordance with the DPE guidelines. After obtaining approval of the Board and the concurrence of the Parent company, the same shall be submitted to the concerned Ministry for approval".

B. Query

15. On the basis of the above, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) is sought on following issues:

(i) Whether the accounting treatment given by the company by making provision is appropriate in the given condition and will not lead to understatement/overstatement of profit.

(ii) Whether the matter of provision disclosed in explanatory statement by the management is also appropriate for disclosure.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised in the query relates to creation of provision for pay revision made in accordance with the DPE guidelines pending the recommendations of the committee constituted in this regard, approval of the BODs, approval of the parent company and the Presidential Directive from the concerned Ministry. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case such as, legal interpretation of Office Memorandum (OM) issued by the DPE (hereinafter referred to as DPE Guidelines) including the categorisation of CPSE into which the company falls, computation of profit before tax (PBT) of the last three financial years preceding the year of implementation as per the OM/DPE Guidelines, fitment benefit, measurement of the provision created etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter, is in the context of Indian

Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee presumes from the Facts of the Case that the DPE guidelines are mandatory for the company to be followed.

17. The Committee notes the following paragraphs of Indian Accounting Standard (Ind AS) 19, 'Employee Benefits', notified under the Companies (Indian Accounting Standards) Rules, 2015 and the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards (Framework), issued by the ICAI:

Ind AS 19:

"4 The employee benefits to which this Standard applies include those provided:

(a) under formal plans or other formal agreements between an entity and individual employees, groups of employees or their representatives;

…

(c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. An example of a constructive obligation is where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

5 Employee benefits include:

(a) short-term employee benefits, such as the following, if expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services:

(i) wages, salaries and social security contributions;

…"

"11 **When an employee has rendered service to an entity during an accounting period, the entity shall recognise the undiscounted amount of short-term employee benefits *expected to be paid* in exchange for that service:**

(a) as a liability (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an asset (prepaid expense) to

the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

(b) as an expense, unless another Ind AS requires or permits the inclusion of the benefits in the cost of an asset (see, for example, Ind AS 2, Inventories, and Ind AS 16, Property, Plant and Equipment)."

(Emphasis supplied by the Committee.)

Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards:

"49 (b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."

"60 An essential characteristic of a liability is that the entity has a present obligation. 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. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities."

"64 Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe these liabilities as provisions. The definition of a liability in paragraph 49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations."

From the above, the Committee notes that when an employee has rendered service during a period, the employee benefits which are *expected to be paid* in exchange for that service are required to be provided for as liability. Further, as per the requirements of the Framework, liability is a present obligation (which may be legally enforceable as a consequence of a binding contract or statutory requirement) arising from past events, the settlement of which is *expected to*

result in an outflow of resources embodying economic benefits. Further, a provision should be recognised where liability can be measured only by using a substantial degree of estimation provided it meets the definition of liability.

18. The Committee further notes that Ind AS 19 does not provide detailed guidance as to when and in what circumstances, employee benefits should be considered to be expected to be paid and accordingly whether there is any need to provide for the same in the financial statements. Similarly, the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards also does not give detailed guidance on present obligation and when can it be considered to exist. In this regard, the Committee notes that Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' provides detailed guidance on present obligation and the circumstances in which liability/provision should be recognised. Accordingly, although provisions relating to employee benefits have not been addressed in Ind AS 37, the Committee notes the following paragraphs of Ind AS 37 dealing with the recognition of a provision:

> **"14 A *provision* shall be recognised when:**
>
> **(a) an entity has a present obligation (legal or constructive) as a result of a past event;**
>
> **(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and**
>
> **(c) a reliable estimate can be made of the amount of the obligation.**
>
> **If these conditions are not met, no provision shall be recognised."**
>
> "16 In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence:
>
> (a) where it is more likely than not that a present obligation exists at the end of the reporting period, the entity

recognises a provision (if the recognition criteria are met); and

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

17 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 entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation."

"20 An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities."

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

"**A *contingent liability* is:**

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

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability."

The Committee notes from the above that a provision is recognised when an entity has a present obligation (legal or constructive), for which it is probable that an outflow of resources will be required and a reliable estimate can be made for the same. An element of judgement is required to determine whether there exists an obligation and therefore whether a provision needs to be recognised or not. It is for the management of the entity to exercise that judgement and the auditor to assess in the specific facts and circumstances of the entity, considering all the evidences/factors available as on the reporting date.

19. In this regard, the Committee notes that Clause 3 of the DPE Guidelines states as follows:

"3. **Affordability:** The revised pay scales would be implemented subject to the condition that the additional financial impact in the year of implementing the revised pay-package for Board level and below Board level executives and non-unionised supervisors should not be more than 20% of the average Profit Before Tax (PBT) of the last three financial years preceding the year of implementation."

Thus, it is the year of implementation in which the financial impact has to be considered before implementing the revised pay package. Further, Clause 18 of the DPE guidelines states as follows:

"18. Issue of Presidential directive, effective Date of implementation and payment of allowances. The revised pay scales will be effective from 01.01.2017 ... The Board of Directors of each CPSE would be required to consider the proposal of pay revision (based on their affordability) to pay, and submit the same to the Administrative Ministry for approval. The administrative Ministry concerned will issue Presidential

> Directive with the concurrence of its Financial Adviser in respect of each CPSE separately."

Thus, considering that the DPE guidelines are to be mandatorily followed by the company, the new/revised pay scales are to be implemented w.e.f. 1.1.2017 for which average profits of last three financial years of the entity are to be considered. Further, apparently the board of directors also are required to consider the proposal of pay revision based on the financial affordability of the entity. The Ministry's approval also appear to be based on the financial soundness and affordability of the specific entity. Thus, the main thrust of the DPE guidelines for revised pay structure is on the affordability of the company based on the average profits of the last three years.

Considering these requirements, the Committee is of the view that since as per the querist, the financial affordability criteria for F.Y. 2016-17 and 2017-18 on the basis of average profits is met, had the revised pay scales been implemented in the financial year 2016-17 or 2017-18 itself it might have given rise to present obligation arising from past events as per the requirements of Ind AS 37 provided other conditions/factors as discussed below are met. However, since the financial affordability criteria is to be seen in the year of implementation and the new pay structures are yet to be implemented in the extant case, while determining whether there exists a present obligation as per the requirements of Ind AS 37, the company should consider in its own facts and circumstances whether such criteria will be met in the expected year of implementation considering all the evidences available as on the reporting date and various factors such as, future profitability based on past trends and future prospects of the business carried on by the company, events occurring after the reporting date, expert's opinion in this regard, etc. Apart from legal obligation based on the fulfilment of criteria as per DPE guidelines, the company should also consider whether there exists any constructive obligation in this respect (for example, due to any past informal practice of the company, etc.). Further, while determining whether present obligation exists or not, the company should assess as to whether the steps yet to be followed by the company for releasing payment to the employees, viz., recommendation by the Committee constituted by BOD, Board approval, Holding company's approval and Administrative Ministry's approval are only procedural in nature if the financial affordability criteria is met and not substantive in nature so as to change/modify the nature/amount/extent of the obligation for pay revision at any of the abovementioned levels even though financial criteria will be met in the expected year of implementation of the revised pay structure.

Accordingly, on the basis of above exercise, if it is determined that a present obligation (legal or constructive) exists and other conditions as per paragraph 14 of Ind AS 37 are met, provision should be recognised. However, where it is

determined that 'present obligation' does not exist or due to any other reason, provision cannot be recognised (for example, due to non-fulfilment of conditions as per requirements of Ind AS 37), then, the company should also consider whether there is any need for disclosure as a 'contingent liability' (unless the possibility of an outflow of resources embodying economic benefits is remote), as per the requirements of Ind AS 37.

20. As far as appropriateness of disclosure of explanatory notes with regard to provision made by the company in paragraph 14 above is concerned, the Committee notes that these provide the details of the current situation, the extent of the provision made, extent of the approvals received and the remaining steps to be followed. The Committee is of the view that the nature of disclosures would depend upon whether the situation requires creation of provision or not, as discussed above. In this regard, the Committee also notes the following paragraphs of Ind AS 37:

"84 For each class of provision, an entity shall disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (ie incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period; and

(e) the increase during the period in the discounted amount Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required.

85 An entity shall disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

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

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

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

(c) the possibility of any reimbursement.

From the above, the Committee is of the view that the company should provide the above-mentioned details for the provision/contingent liability recognised/disclosed respectively in the financial statements.

D. Opinion

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

(a) As per the requirements of Ind AS 19, employee benefits which are expected to be paid in exchange for the employee services during a period are required to be provided for as liability. Further as per the requirements of Framework, liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits and a provision should be recognised where liability can be measured by using a substantial degree of estimation. However, in the absence of detailed guidance for application of these requirements in Ind AS 19 and the Framework, as discussed in paragraph 18 above, the requirements of Ind AS 37 in this regard should be applied. Accordingly, the company should determine whether there exists a present obligation and therefore whether a provision needs to be recognised or not in the specific facts and circumstances, considering all the evidences and factors available as on the reporting date, as discussed in paragraph 19 above. If on the basis of this exercise, it is determined that a present obligation (legal or constructive) exists and other conditions as per paragraph 14 of Ind AS 37 are met, provision should be recognised. However, where it is determined that

'present obligation' does not exist or due to any other reason, provision cannot be recognised, then, the company should also consider whether there is any need for disclosure as a 'contingent liability' (unless the possibility of an outflow of resources embodying economic benefits is remote), as per the requirements of Ind AS 37.

(b) Refer to paragraph 20 above.

Query No. 13

Subject: Classification of spares.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') was incorporated on 2nd April 1976 as the country's prestigious 100% Export Oriented Unit (EOU) with head quarter at Bengaluru, Karnataka and was originally engaged in the mining and beneficiation of low-grade magnetite ore into high grade iron ore concentrate and export of the same. Subsequently, as per the Supreme Court Order, mining operation and beneficiation at XYZ mine site was stopped with effect from 01.01.2006.

2. At present, pelletisation and blast furnace units of the company are in operation at its Mangaluru establishment. The company is having facilities to operate 3.5 metric tonnes per annum (MTPA) iron-oxide pellet plant, blast furnace unit to manufacture 2.16 lakh tons per annum pig iron at Mangaluru. In view of the iron ore being sold in Karnataka only through e-auction mode as per the Supreme Court's order, the input, hematite iron ore fines, as raw material for the manufacture of pellets and iron ore lumps for pig iron, is being procured mainly from Bailadila sector of one of the public sector undertakings, through road (railway rakes) cum sea route. Efforts are also on to procure iron ore from other sources including imported sources. The pellets are exported and also sold in the Domestic Tariff Area (DTA) market.

3. As a part of its operations, the company procures stores and spares from time to time and is maintaining the stock of spares in anticipation of requirement at any time during operation of the plant. Upto the financial year 2016-17 till the adoption of Ind AS, these spares were classified as 'Inventory'.

[1] Opinion finalised by the Committee on 21.11.2019.

4. During the financial year 2017-18, the company reviewed stock of all the stores and spares based on their usage, quality and present physical condition. A technical committee was constituted to examine all the stores and spares and to recommend about their usability, retention as 'Inventory' etc. The Committee after reviewing all the items of stores and spares, recommended that the spares worth Rs. 1,331.43 lakhs as on 31.03.2018 which are directly attributable to any particular plant & machinery should be classified as 'capital spares', thereby segregating these from normal inventories, towards better disclosure. Based on the said technical assessment, Spares usable only for any particular plant & machinery were categorised as 'capital spares' and were disclosed in the financial statements separately under the head 'Inventory'. The total value of spares consumed during the financial year were charged off as expenses.

5. From the financial year 2015-16, the Companies Act, 2013 mandated application of 'Component Accounting' whenever relevant and material. As per Note 4 of Notes to Schedule II to the Companies Act, 2013:

> "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."

Thus, as per the querist, under 'Component Accounting', companies will need to identify and depreciate significant components with different useful lives separately. The querist has mentioned in this context that the spares mentioned above cannot be classified as 'Component' as per the above criteria of 'Component Accounting'.

6. Further, the querist has stated that there is no specified useful life of these spares and these are not frequent in usage. The use of these spares towards replacement of damaged/broken down parts of the relevant plant and machinery is not likely to increase the future benefits from the said plant and machinery. Whenever spares are used to replace any parts, the useful life of the original plant and machinery does not change. The removed parts are sold as scrap in the normal course of business.

7. The company followed the said practice during the subsequent financial year 2018-19 also as per the principle of consistency. Accordingly, as on 31.03.2019, capital spares worth Rs. 1,093 lakh (634 items, list supplied by the querist for the perusal of the Committee) was disclosed as a separate line item as 'Capital Spares' under the head 'Inventory' in the financial statements for the financial year 2018-19.

8. During the audit of annual accounts for the said year, Director General of Commercial Audit (CAG) has made the observation that there was incorrect

classification of capital spares under the head 'Inventories'. The same should be classified under 'Property, Plant and Equipment' as per the provisions under paragraphs 7 and 8 of Ind AS 16, 'Property, Plant and Equipment'.

9. Provisional Comments of CAG

"Inventories (Note 7.a) Rs. 30886.63 Lakh

The above is overstated by Rs.1093.00 Lakh due to incorrect classification of Capital Spares under inventories instead of classifying the same under Property, Plant and Equipment (Note 3.1) as per the provisions under para 7 and 8 of Ind AS 16 Property, Plant and Equipment. Further, as per the Accounting Policy no 1.12 on Inventories, "Capital Spares are valued at Cost". The same is also not in line with provisions of Ind AS 16 Property, Plant and Equipment. This has also resulted in understatement of Property, Plant and Equipment (Note 3.1) by Rs.1093.00 Lakh and non-compliance to the provisions of Ind AS 16 Property, Plant and Equipment. The impact on account of depreciation could not be quantified due to non-availability of data."

10. Reply given by the company to CAG:

"During the year Capital Spares amounting to Rs. 1,093.00 Lakh (Previous Year Rs. 1,331.43 Lakhs) are classified as Capital Spares and shown in the Balance Sheet as "Inventories". As per Ind AS 16, property, plant and equipment are tangible items that:

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

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

These Spares to be used for maintenance of assets, stand-by equipment and life of spares cannot be ascertained. Accordingly, Capital Spares/Stand by Equipment is not Property, Plant and Equipment.

As per paragraph 8 of Ind AS 16 "Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as Inventory."

As Capital Spares are not Property, Plant and Equipment, meant for use as servicing equipment and charged to revenue in the year of use, classified under 'Inventory'."

11. The querist has stated that CAG after perusal of reply given by the company, decided to retain their observation under section 143(6)(b) of the Companies Act, 2013 on the accounts of the company for the year ending 31st

March, 2019. Since the company differed with the comment given by CAG, it was decided that the issue would be examined during the financial year 2019-20 by external consultants/professional bodies like Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI). Based on the opinion obtained from such external experts, the appropriate accounting adjustment if required would be made in the books of account.

B. Query

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

(a) Whether the practice followed by the company to classify such spares as 'capital spares' and disclosed as separate line item under 'Inventories' under the head 'Current Assets' is correct.

or

(b) Such capital spares should be classified under 'Property, Plant and Equipment' as commented by CAG.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to classification of spares worth Rs. 1093 lakhs as 'Inventory' or 'Property, Plant and Equipment' in the books of account of the company. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for transition to Indian Accounting Standards, depreciation on spares if these qualify as 'property, plant and equipment', accounting treatment of any other item of property, plant and equipment or inventory, component accounting, etc. The Committee wishes to point out that the opinion expressed hereinafter, is in the context of Indian Accounting Standards (Ind ASs), notified under Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time. At the outset, the Committee wishes to point out that the querist has classified some spares as 'capital spares' under the head 'Inventory', which term is no longer used under Ind AS Framework; therefore the Committee has not examined the appropriateness of using such term and also the said classification made by the company. Accordingly, the opinion expressed hereinafter, covers all types of spare parts, as covered under the Ind AS framework.

14. With regard to accounting for spares, the Committee notes the following requirements of Ind AS 16, 'Property, Plant and Equipment':

"*Property, plant and equipment* are tangible items that:

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

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

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

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

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

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

9 This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

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

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

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

From the above, the Committee notes that spare parts are recognised as an item of property plant and equipment only if they meet the definition of property, plant and equipment otherwise, these are classified as Inventory. The Committee further notes that as per the requirements under Ind AS 16, for the purpose of classification of spares as 'inventory' or 'property, plant and equipment', one has to determine the nature of the spares and the purpose for which these are held; and the useful life of the spares. As far as nature and purpose is concerned, the company should first identify whether the spares are small parts which are required for day-to day servicing or repairs and maintenance of an item of property, plant and equipment (PPE) or whether these are held for replacement of significant components of PPE. If these are acquired for day-to-day servicing or repairs and maintenance, these should not be recognised in the carrying amount of the PPE. Further, a judgement is required in applying the recognition criteria to an entity's specific circumstances and sometimes it may be appropriate to aggregate individually insignificant items and to apply the recognition criteria to the aggregate value. Accordingly, in the extant case, the company should evaluate the nature of the spare parts and the purpose for which these are acquired or held. On the basis of such evaluation, if these spares are not for day-to day servicing or repair and maintenance, and if they meet the definition of PPE, these should be classified as property, plant and equipment', assuming that their cost can be measured reliably. Further, the company should also evaluate whether in the facts and circumstances of the company, it is appropriate to aggregate these spares which are not individually significant (considering the aggregate value in relation to the overall related assets for which these are to be used) and apply the recognition criteria to the aggregate value.

15. As far as useful life is concerned, the Committee notes that the querist has stated that there is no specified useful life of the spares and that the life of

spares cannot be determined. In this context, the Committee wishes to mention that the useful life of a spare part is normally linked to the useful life of the asset/part for which it is kept and may be determined on the basis of its frequency of replacement. Thus, howsoever long or short it may be, the company should determine the useful life of the spares. If the spares are expected to be used for more than one period, then, assuming that their cost can be measured reliably, the same should be classified as 'Property, Plant and Equipment'; otherwise, such items should be classified as 'inventory'.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the company should evaluate in its own facts and circumstances the nature of the spares and the purpose for which these are held; and determine the useful life of the spares, as discussed in paragraphs 14 and 15 above. On the basis of such evaluation, if these spares are not for day-to day servicing or repairs and maintenance and if they meet the definition of 'Property, plant and equipment', these should be classified as 'Property, plant and equipment', assuming that their cost can be measured reliably. Further, the company should also evaluate whether in the facts and circumstances of the company, it is appropriate to aggregate these spares which are not individually significant (considering the aggregate value in relation to the overall related assets for which these are to be used) and apply the recognition criteria to the aggregate value.

Query No. 14

Subject: Presentation of the grant receivable from the Government of India (under SEIS) in the statement of profit and loss.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') was incorporated on 10th March, 1988 under the Companies Act, 1956. It is governed by the Ministry of Railways (MoR) being its administrative ministry. Main objective of the company is to serve as a catalyst in promoting containerisation and give a boost to India's international and internal trade and commerce by organising multimodal logistics support. With its excellent performance consistently over the years, the company has been conferred with Navratna Status by the Government of India.

[1] Opinion finalised by the Committee on 21.11.2019.

2. The company's main function is to provide cost effective and reliable logistics support services to its customers. The bouquet of logistics services that are offered to trade comprises of operations of Inland Container Depots (ICDs), Container Freight Stations (CFSs) and Domestic Container Terminals (DCTs), transportation by rail & road, warehousing, storage, end-to-end logistics solutions, movement of refrigerated cargo in containers and other value added solutions. It has established itself as the leading logistics company in the country. The company has also grown its business by setting up subsidiaries and partnering others through strategic joint ventures, including at the leading sea ports.

3. In its journey of last 30 years, it has established a vast network of container terminals all over the country at prime locations, which are the centers for generation (origin) and consumption (destination) of cargos. It has built large capacities to meet the growing demand of Export-Import (EXIM) and domestic trade. The major portion of its revenue i.e., around 80% comes from EXIM business. Over the years, the company has played a pivotal role in development of the containerization in the country, particularly in the EXIM segment. It has done huge investments in creating logistics infrastructure in the country, which has promoted the international trade of India and going forward it has innovative plans and strategies in place to expand the said infrastructure further.

4. At present, the company is operating through 83 terminals spread across the country and it is likely to reach to 100 terminals in next few years. These terminals are connected by rail/road across the length and breadth of the country. With the help of these terminals and the other complementary resources i.e., large fleet of wagons and containers owned by the company, the company operates as a carrier, inland port operator and terminal services provider.

5. At present, the equity shares of the company are listed with Mumbai and National Stock Exchanges and its market capitalisation was approx. Rs. 32,006 crores as on 31.03.2019. The Twenty-Foot Equivalent Units (TEUs) handled and gross turnover of the company during the year 2018-19 were 3.8 million and Rs. 7,216.14 crores respectively. A copy of annual report of the company for the year 2018-19 has been supplied separately by the querist for the perusal of the Committee.

6. Under the Foreign Trade Policy (FTP) 2015-20 of the Government of India, various incentives are being provided to the trade and one of such benefit to service sector in which the company operates is Service Export from India Scheme (SEIS). The objective of SEIS as stated in the FTP is to give reward to offset infrastructural in-efficiencies and associated costs involved and to provide level playing field.

7. The SEIS benefit to the company under FTP 2015-20 are for the services being provided by the company from its Inland Container Depots (ICDs) and Container Freight stations (CFSs). At these facilities, services for handling, transportation by rail/road of export/import laden and empty containers carried under customs control and the services related to clearance of goods for home use, warehousing, temporary admissions, re-export, temporary storage for onward transit and outright export, trans-shipment are provided. As these services are related to EXIM (i.e. Export & Import) trade of the country and are provided to Foreign Shipping Lines or their Indian agents, the company is entitled to claim SEIS benefit on the same under FTP 2015-20.

8. The revenue from all the elements of services provided at ICDs/CFSs are forming part of the company's 'Revenue from Operations'. The SEIS benefit being claimed by the company from the Authorities i.e. Directorate General of Foreign Trade (DGFT) is granted in the form of scrips (which are tradable) issued for a value arrived at a specified percentage of the above elements of revenue from operations from ICDs/CFSs. As the SEIS income is derived out of the operations of the company, the same has been considered as part of revenue from operations. This income clearly arises as a result of the company's ordinary business comprising services for export or import related to containers/cargo. Had the company not performed EXIM operations, such income would not have accrued. As such, there is a direct nexus between EXIM operations of the company and SEIS benefit accruing from it.

9. The company has recognised the SEIS benefit in its books of account in the period in which the right to receive the same is established, i.e., the year during which the services for grant of SEIS benefit are performed. Hence, SEIS income has been classified as 'export incentives' under 'revenue from operations', sub-head 'other operating income' in the statement of profit and loss.

10. The querist has stated that, SEIS benefit is a kind of Government grant, the accounting treatment and presentation of which has been laid down under Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance'. As per the paragraph 29 of Ind AS 20, in respect of presentation of grants related to income, "Grants related to income are presented as a part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense."

11. From above, it is clear that Ind AS 20 gives three options for presentation of Government grants related to income in statement of profit and loss, which are (i) either separately; or (ii) under a general heading such as 'Other income'; or (iii) they are deducted in reporting the related expense. So, an entity has the option to choose any one of the method from these three.

12. Further, paragraph 31 of Ind AS 20, inter alia, states that disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income and expense which is required to be separately disclosed is usually appropriate.

13. In accordance with the above provision, it is clear that Ind AS 20 permits the grant related to income to be presented as part of statement of profit and loss either separately or under a general heading such as 'Other Income' or they are deducted in reporting the related expense.

14. As SEIS income in the company is based upon the operating revenue earned and it is a grant related to income, it has been shown separately as export incentives in the note to the statement of profit and loss under 'Income from Operations', sub-head 'other operating income', which is in compliance of the above provisions of Ind AS 20 that it has to be shown separately. In addition to above, the nature of this income has also been elaborated in the foot note below the above note to the statement of profit and loss.

15. The above treatment and presentation have been given consistently by the company in its financial statements for four years i.e. 2015-16 to 2018-19. The above presentation and disclosure are in accordance with Ind AS 20 and the users of the financial statements can easily understand the impact of SEIS income from the above treatment.

16. The querist has further stated that some other reputed companies are also following similar practices as is being followed by the company for presentation of Government grants related to income. It has also been seen that these companies are classifying these grants under the head 'Other Operating Income'. This further goes on to establish that the presentation of SEIS income, which is a Government grant, by the company is in compliance with Ind AS 20 and the practices being followed by other reputed entities.

17. Accounting policy being followed by the company in respect of accounting for SEIS income at present, provides as under:

> "Grants are recognised when there is a reasonable assurance that the company has complied with the conditions attached to them and it is reasonably certain that the ultimate realisation and utilisation will be made. Grants which are receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the company, with no future related costs are recognized in the statement of profit & loss of the period in which they have accrued.
>
> Grants related to depreciable assets including non-monetary grants (at fair value), are presented in the balance sheet as 'Deferred Income' of the period, in which they become receivable. Such grants are usually

> recognized in the statement of profit and loss over the periods in the proportions, in which depreciation expense on those assets is recognised.
>
> The grants under 'Served from India Scheme (SFIS)' are recognized at the time of utilization of SFIS scrip towards procurement of assets and inventories. Such assets/inventories have been capitalized with a gross value from transaction date based on deemed cost exemption availed by the company.
>
> The grants under 'Service Export from India Scheme (SEIS)' are recognised when the conditions attached with the grant have been satisfied and there is reasonable assurance that the grants will be received. These are recognized in the period in which the right to receive the same is established i.e. the year during which the services eligible for grant of SEIS have been performed."

In line with the provisions of Ind AS 20, the practices being followed by other reputed companies and the above accounting policy of the company, the SEIS claim has been presented separately as export incentives under 'revenue from operations', sub-head 'other operating income' in the statement of profit and loss. As per the accounting policy, it is being recognised as an income during the year in which the services for SEIS benefits are provided. From the above presentation of SEIS income, readers of the financial statements can clearly understand its impact on the financial statements, which as per the querist, is both in letter and spirit, a compliance of the provisions under Ind AS 20 for presentation of Government grants.

CAG's View:

18. Comptroller and Auditor General of India (CAG) did not agree with the above treatment given by the company in its financial statements for the year 2018-19 and it has in its report under section 143(6)(b) read with section 129(4) of the Companies Act, 2013 has issued comment on the said financial statements (standalone and consolidated) of the company and has stated that:

> "The company has shown Rs.339.22 crores, being grants receivable from the Government of India (under Service Export from India Scheme (SEIS)), during the current year, under 'Other Operating Income'. The same should be shown as 'Other Income' as per Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance'."

Management's reply on the CAG's view:

19. It appears that CAG is of the view that SEIS grants should be shown under 'Other Income' in which earnings like income from investments (interest/dividend), rent, etc. are shown. Whereas, the company has been

correctly showing the same separately as export incentives under 'revenue from operations', sub-head 'other operating income' which is in accordance with Ind AS 20. Accordingly, the management of the company in reply to the above comment of CAG on its financial statements for the year 2018-19 has replied as under:

> "As per interpretation of the management, presentation of SEIS benefits amounting to Rs. 339.22 crores under 'Other Operating Income' has been done as per the provisions of Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance'. However, the matter will be referred to the Institute of Chartered Accountants of India (ICAI) for its expert advice."

B. Query

20. On the basis of the above, the opinion of the Expert Advisory Committee is sought on whether the income recognised on accounting for grant receivable from the Government of India (under SEIS) has been correctly presented by the company separately as 'export incentives' under 'revenue from operations', sub-head 'other operating income' in the statement of profit and loss or as stated by CAG in its comments, it has to be shown under 'Other Income'.

C. Points considered by the Committee

21. The Committee notes that the basic issue raised by the querist relates to the presentation of the duty credit scrips/entitlement received from the Government of India under SEIS in the statement of profit and loss. 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, nature of the grant under Ind AS 20 and other aspects of accounting, such as, recognition, timing thereof, measurement, etc.; accounting for other types of grants; etc. The opinion expressed is purely from the accounting perspective and not any other perspective such as legal interpretation of Service Export from India Scheme and the Committee has not examined the eligibility of the company under SEIS or compliance by the company with the conditions attached, etc.

22. With regard to presentation of the duty credit scrips/entitlement received from the Government of India under SEIS in the statement of profit and loss, the Committee notes the following paragraphs of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance':

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

30 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method it is argued that the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

31 Both methods are regarded as acceptable for the presentation of grants related to income. Disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate."

23. Further, the Committee notes the following paragraphs of the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013 (revised July, 2019), issued by the Institute of Chartered Accountants of India (hereinafter referred to as the 'Guidance Note'):

"**9.1.7.** Revenue from operations needs to be disclosed separately as revenue from

(a) sale of products,

(b) sale of services and

(c) other operating revenues.

It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".

9.1.8. The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities."

"9.2. Other income

The aggregate of 'Other income' is to be disclosed on face of the Statement of Profit and Loss. As per Note 5 of General Instructions for the Preparation of Statement of Profit and Loss 'Other Income' shall be classified as:

(a) Interest Income;
(b) Dividend Income;
(c) Other non-operating income (net of expenses directly attributable to such income)."

24. On a reading of above paragraphs, the Committee notes that as per the requirements of Ind AS 20, the grant related to income should be presented *either separately* or under a general heading such as 'Other income'. Alternatively, it can also be deducted in reporting the related expense. Further, from the above-reproduced requirements of the Guidance Note, the Committee notes that the 'other operating revenue' includes *revenue* arising from a company's *operating activities*, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from sale of products or rendering of services. In this context, whether a particular income constitutes 'other operating revenue' or 'other income' is to be decided based on the facts of each case and detailed understanding of the company's activities.

The Committee notes that the objective of the Service Exports from India Scheme (SEIS), is to encourage and maximise export of notified Services from India and the eligibility criteria of the scheme is based on the net free foreign exchange earnings by the service provider. In this context, the Committee notes from the Facts of the Case that the querist has specifically stated that major portion of the revenue of the company arises from export of services and thus, exports is a key revenue generating activity of the company. Therefore, keeping in view the activities of the company in the extant case, the duty credit scrips/entitlement can be considered to arise in the course of revenue generating activities of the company. Accordingly, considering the requirements of the Guidance Note, the Committee is of the view that it may be appropriate to disclose the duty credit scrips/entitlement under SEIS as 'other operating revenue' under 'revenue from operations' in the statement of profit and loss. Further, in this connection, the Committee notes paragraph 113 of Ind AS 115, 'Revenue from Contracts with Customers', which states as follows:

"113 An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of profit and loss in accordance with other Standards:

(a) revenue recognised from contracts with customers, which the entity shall disclose separately from its other sources of revenue; and

(b) any impairment losses recognised (in accordance with Ind AS 109) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall

disclose separately from impairment losses from other contracts."

The Committee notes from the above that Ind AS 115 recognises that 'revenue' could arise from sources other than contracts with customers also, which should be presented separately from 'revenue recognised from contracts with customers'. Since in the extant case, duty credit scrips/entitlement under SEIS is not in the nature of revenue received from contracts with customers, the former should be presented separately from the latter as 'other operating revenue'. The company should also give adequate disclosures (including the accounting policy for recognition of such income) so as to appropriately explain the nature of the item.

D. Opinion

25. On the basis of the above, the Committee is of the opinion that keeping in view the activities of the company, it may be appropriate to present the duty credit scrips/entitlement under Service Export from India Scheme (SEIS) as 'other operating revenue' under 'Revenue from Operations' in the statement of profit and loss, as discussed in paragraph 24 above. The company should also give adequate disclosures (including the accounting policy for recognition of such income) so as to appropriately explain the nature of the item.

Query No. 15

Subject: Accounting treatment of certain indirect administrative overheads (i.e., salary of the KMPs, directors' sitting fees, audit fees, statutory and other levies) incurred during construction phase of the Power Plant.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company'), a joint venture of ABC Limited (Government of India enterprise) and XYZ Ltd. (State Government enterprise) is setting up a coal based supercritical thermal power plant with a capacity of 1980 MW (3 X 660 MW) with 51:49 equity participation.

2. The company was incorporated in the year 2012 to construct and operate 3 x 660 MW Thermal Power Project in Uttar Pradesh. The electricity tariff of the Power Plant will be decided by CERC as per the applicable CERC regulation.

[1] Opinion finalised by the Committee on 21.11.2019.

The Government of India (GoI) has accorded sanction for the project on 27.07.2016 with the sanctioned cost of Rs.17,237.80 crores and the schedule for completion of the project is 52 months, 58 months and 64 months from the date of GoI sanction for the 1st, 2nd and 3rd unit of 660 MW each respectively.

3. 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 of India (C&AG). The C&AG auditors had also undertaken supplementary audit under section 143(6) of the Companies Act, 2013. The company being a power generating company, tariff of the company will be as per regulations of Central Electricity Regulation Commission (CERC).

4. As informed by the querist, presently the construction activities of the power plant are going in full swing and a capital expenditure of Rs. 6590.70 crores is spent till 30.06.2019. All expenditure incurred till March 2018 was booked under capital work in progress in balance sheet except the pre-incorporation expenditure of Rs. 200.21 lakh. During the year 2018-19, as per the provisions of Indian Accounting Standard (Ind AS), Rs. 28.40 lakh of indirect administrative overheads was charged to the statement of profit and loss.

5. The querist has further informed that C&AG auditors have expressed the following views during their supplementary audit:

> "*Balance Sheet as on 31.03.2019*
>
> *Assets*
>
> *Capital Work in Progress – Rs. 4,988.34 Crore.*
>
> Sub-para (a) of paragraph 17 of Ind AS 16 provides that the costs of employee benefits (as defined in Ind AS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment would form the directly attributable cost of an item of property, plant and equipment.
>
> During the review of the expenditure charged in the profit and loss account for the year ended 2018-19, it was noted that it includes mainly the salary of the Company Secretary, certification fees, and other employees related benefits. It was noticed that the company is in the construction phase of its only plant. All the concerned staff is deputed at construction site including the company secretary and other related sections. As still the major construction work is in progress, the main agenda of different meetings (BoD etc.) is construction work only. In the light of the facts, it can be determined that the mentioned expenditure are

directly related to project. Hence, same should have been capitalised instead of charging it off in the profit and loss account.

Non-capitalisation of the mentioned expenditure has resulted into understatement of Capital Work-in-Progress and over statement of expenditure by Rs. 0.28 crore."

6. The company has submitted the following reply to above Half Margin of C&AG:

"As per Ind AS 16, in paragraph 16 (b), Elements of cost under Measurement at recognition, the cost of an item of property, plant and equipment comprises: "any costs *directly attributable* to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management".

As defined in paragraph 19 (d) of Ind AS 16, administration and other general overhead costs are not costs of an item of property, plant and equipment.

In view of the above paras, indirect administrative overheads like, Company Secretary Salary, Board Meeting Expenditure, Audit Fees totaling Rs. 28.40 lakh are charged to Profit and Loss Account instead of transferring the same to Capital Work in Progress.

It is proposed to seek opinion from experts including our Statutory Auditors, Expert Advisory Committee of the Institute of Chartered Accountants of India, Peer companies during the year 2019-20 and accordingly treat such expenditure in Financial Statements."

(Emphasis supplied by the querist.)

B. Query

7. On the basis of above, the opinion of the Expert Advisory Committee is requested on whether indirect administrative overheads (i.e., salary of the key management personnel (KMPs), directors' sitting fees, audit fees, statutory and other levies related to the company etc.) incurred during the construction phase of the power plant shall be capitalized along with the cost of the project or to be charged to the profit and loss account of the respective year even though there is no income generated by the company during its construction phase.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to the accounting treatment of certain indirect administrative overheads (i.e., salary of the KMPs, directors' sitting fees, audit fees, statutory and other levies related to the company etc.) incurred during the construction phase of the project. The

Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for any other expense incurred by the company in relation to the power plant project, accounting for pre-incorporation expenditure, consideration of materiality, etc. The Committee has also not examined whether the use of the expression 'Key management personnel (KMP)' by the company is the same as defined in Indian Accounting Standard (Ind AS) 24, 'Related Party Disclosures' or the Companies Act, 2013. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

9. At the outset, the Committee wishes to point out that various expenses are incurred during construction phase. However, it is not necessary that all expenses incurred during construction phase are eligible to be capitalised to the plant/project being constructed. The capitalisation of an item of cost to a plant/project depends upon the nature of such expenses in relation to the construction activity in the context of requirements in this regard laid down in the applicable Indian Accounting Standards. Further, the Committee also wishes to state that just because the company is engaged in construction of a single plant at present does not mean that all the costs incurred by the company are directly attributable costs to the construction of the plant/project in accordance with the requirements of Ind AS 16.

10. The Committee notes the following paragraphs of Ind AS 16, 'Property, Plant and Equipment', notified under the Companies (Indian Accounting Standards) Rules, 2015:

> "16 The cost of an item of property, plant and equipment comprises:
>
> …
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> …
>
> 17 Examples of directly attributable costs are:
>
> (a) costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
>
> …
>
> (f) professional fees."

"19 Examples of costs that are not costs of an item of property, plant and equipment are:

…

(d) administration and other general overhead costs."

From the above, the Committee notes that the basic principle to be applied while capitalising an item of cost to a property, plant and equipment (PPE) is that it is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The Committee is of the view that 'directly attributable' costs are generally such costs which are necessary to enable the construction activity, i.e. these costs are directly related to the construction activity and without the incurrence of which the asset cannot be brought to the location and condition necessary for it to be capable of operating in the manner intended by management.

11. The Committee notes that paragraph 17 of Ind AS 16 gives examples of directly attributable costs and it includes costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment. Therefore, the Committee is of the view that the employee benefit expenses arising directly from the construction of the plant/project should only be capitalised and rest should be charged to the statement of profit and loss as and when incurred. With regard to employee benefit expenses relating to KMPs and directors fee, the Committee is of the view that there is normally, no direct relation between the meetings of BoD or activities undertaken by KMPs and the construction activity as the BoD or KMPs are involved in overall supervision, strategic planning and other related activities which are not directly related to construction as such. Further, in this context, the Committee also notes that the company, itself is considering this as administrative overheads. Accordingly, the Committee is of the view that the employee benefit expenses relating to key management personnel and directors' sitting fess in the extant case are not directly attributable to the construction of project; rather are of the nature of administration and general overheads and therefore, should not be capitalised with the item of PPE.

12. With regard to audit fees, the Committee is of the view that it is purely in the nature of administration expenses, as given in paragraph 19(d) of Ind AS 16, which cannot be considered as 'directly attributable cost' of construction of the project and therefore, it cannot be capitalised as cost of an item of property, plant and equipment. Further, with regard to statutory and other levies, the Committee is of the view that to the extent these levies are directly attributable to construction e.g. fees/charges paid for obtaining license or seeking mandatory approvals/clearances for construction etc., the same should be capitalised and the rest should be recognised as expense in the statement of profit and loss.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the employee benefit expenses relating to key management personnel and directors' sitting fee, are not directly attributable to the construction of project; rather are of the nature of administration and general overheads and therefore, should not be capitalised with the item of PPE, as discussed in paragraph 11 above. Further, audit fee is purely in the nature of administration expenses, and therefore, it cannot be capitalised as cost of an item of property, plant and equipment, as discussed in paragraph 12 above. Statutory and other levies, to the extent, these are directly attributable to construction e.g. fees/charges paid for obtaining license or seeking mandatory approvals/clearances for construction etc., should be capitalised and the rest should be recognised as expense in the statement of profit and loss, as discussed in paragraph 12 above.

———————

Query No. 16

Subject: Accounting for Concession Agreement.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a public limited company registered under the Companies Act, 1956. The entire equity of the company is held by the Ministry of Railways (MOR). The company was set up as a special purpose vehicle (SPV) to implement the Project of design, construction and commissioning of New Railway and the operation, maintenance and repair of the New Railway and the signaling and communication centre (including the control centre) during the operation period.

2. For the said purpose, the Ministry of Railways has entered into a Concession Agreement dated 28th February 2014 and an Addendum to the Concession Agreement dated 31st March 2014 (hereinafter referred to as 'Concession Agreement' or 'Agreement') with the company which provides various rights and obligations of the MOR and the company; and the company in terms of the said agreement is to construct and operate dedicated freight corridors in the country.

3. In order to fund the required cost of construction of dedicated freight corridors being a Western Corridor from Jawaharlal Nehru Port Trust, Mumbai to Dadri near New Delhi and an Eastern Corridor from Ludhiana to Dankuni near

[1] Opinion finalised by the Committee on 21.11.2019.

Kolkata (hereinafter referred to as 'Corridors'), the company through the Ministry of Railways/ Government of India has tied up with Japan International Cooperation Agency **(**JICA), a Japanese Funding Agency and the World Bank for funding the project. JICA is providing loan for the Western Corridor and the World Bank is providing loans for the Eastern Corridor. Financing structure of the construction of dedicated freight corridors as per paragraph 5.5 of Concession Agreement is as follows:

(Amount in Rs. crores)

Particulars	**Eastern Freight Corridor**	**Western Freight Corridor**	**Total**
Loan	13,625	38,722	52,347
Equity	13,049	2,680	15,729
Total	**26,674**	**41,402**	**68,076**
IDC	-	5,316	5,316
Total (excluding land)	**26,674**	**46,718**	**73,392**

Ministry of Railways has granted to the company during the concession period, the right to implement the Project subject to terms of Agreement.

4. The querist has stated that the company has incurred Rs. 14,757.08 crores upto 31st March 2018 and shown the same as capital work in progress in the financial statements. The capital work in progress mainly comprises track, earthwork, bridges and other electrical equipment. Further, capital work in progress also includes borrowing costs. These will be accounted for as per accounting treatment prescribed under Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' and Ind AS 23, 'Borrowing Costs'.

5. The Concession Agreement between the MOR and the company dated 28th February 2014 provides various rights and obligations of the MOR and the company. The relevant extracts of the said Concession Agreement have been reproduced by the querist as below:

Terms as per Concession Agreement:

Concession Period means the period commencing on the Commencement Date and ending on the earlier of:

(a) the 30th anniversary of the earlier of:

(i) The latest date for completion; and

(ii) The Completion Date for the final New Railway Stage,

(as extended in accordance with clause 22.5); or

(b) The date on which this Agreement is terminated.

Terminal Date means the date after the end of the aggregate of the following periods:

(a) 30 years after Commencement Date; and

(b) All delay periods accepted by MOR pursuant to clause 14.2(c) or otherwise determined pursuant to clause 33.

5.8 Risks accepted by Ministry of Railways (MOR)

Subject to this agreement and without prejudice to the obligations of the company under the Project documents, the MOR accepts certain risks and obligations, as set out in this agreement, including in relation to:

(a) a delay in its funding of the MOR loans and other fundings to be made available by it to the company and any corresponding rise in costs;
(b) a delay in giving, or a failure to give, within a reasonable period any approval required from MOR (subject to the company having complied with all applicable conditions for the grant of such Approvals);
(c) failure to grant MOR License for all the land required for project at the time such land is required to comply with the Construction programme;
(d) the Undisclosed interests;
(e) Pre-existing contamination and MOR subsequent contamination;
(f) damage to the New railway caused by defective trains run by Authorized Rail Users; (the protocol for establishing the cause/cost of damage, etc. shall be unambiguously stated in the disaster management manual or appropriate manual issued by the company with the approval of MOR);
(g) loss of traffic or inability to carry traffic as a result of corresponding MOR improvements not being completed as planned.

5.9 Payment of Track Access Charges

MOR shall utilize the company's network and in return shall pay Track Access Charges (TAC) as per Track Access Agreement. TAC so paid shall be deposited in an escrow account to be opened by the company. TAC liability shall be worked out by MOR and provisions shall be made under demand under separate Head.

Track Access Charges means the aggregate of the Fixed Capacity Charges and Variable Charges due and payable or paid to the company under the Track Access Agreement.

5.10 Transfer of Traffic

Subject to fulfillment of the company's obligation by the company, MOR will transfer at least 70% of Traffic Due on to the New Railway in each of the years of the Concession Period. (Emphasis supplied by the querist.)

6.1 The company's fundamental obligations

The company shall, in accordance with the Project Documents and at its own cost and expense:

(a) assist MOR in the acquisition of land and interests in land in the New Corridor;

(b) develop the design, construct and commission the New Railway (other than the MOR improvements) during the Construction Period which meets the Minimum Performance Criteria;

(c) operate, maintain and repair the New Railway during the Operation Period so that the New Railway meets the Minimum Performance Criteria on a continuous basis;

(d) …

(e) …

(f) comply with the guidelines, determinations of tariffs and charges and directions of Tariff Regulatory Authority; and

(g) hand over the New Railway to the MOR on the Handover date.

Handover date means the date on which the concession period ends.

7.7 MOR's right of access

The MOR and any other persons authorized by the MOR may enter the new corridor in accordance with and subject to the conditions contained in the MOR license. MOR shall have the right to provide any new connectivity to New corridor which may be required for any additional line or siding, in consultation with the company.

16.4 Tariff and Track Access Charge

Tariff and Track Access Charge shall be determined by Tariff Regulatory Authority. The parties agree that they shall comply with the guidelines, determination of tariffs and charges and directions of Tariff Regulatory Authority. Till the time Tariff Regulatory Authority is set up, the determination of tariffs and charges shall be undertaken by the company in accordance with the Track Access Agreement and with the approval of MOR.

19.1 The company may undertake Changes

Subject to the clause 19.2, the company may at its own cost and risk undertake Changes to the New Railway from time to time during the Operation Period.

The MOR shall have no obligation whatsoever to pay for or to contribute to the cost of any change including any change required as a result of any increased or different level of rail traffic on the New Railway.

19.2 MOR to approve all Changes

(a) Subject to the clause 19.2 (b), the company shall not undertake any change pursuant to clause 19.1 unless and until:
   (i) it has given the MOR all the information relevant to the MOR's decision to give or withhold its approval to the Change, including:
      A. The reasons for, and the purpose of, the proposed Change; and
      B. The design documentation for the proposed Change; and
   (ii) the MOR has approved the Change.

(b) The company shall not be required to obtain the prior approval of the MOR to a Change which is required in the event of an emergency either for safety reasons or in order to protect property. The company shall, however, promptly notify the MOR of the Change after it has been effected.

30.4 No other termination rights

The MOR acknowledges and agrees that it has no right to and shall not terminate this Agreement other than as expressly provided for in clauses 3.5, 30 and 31.

Schedule 4: Early Termination Amount

Relevant extracts

In case the contract is early terminated, the company shall have the right to receive the following amount in accordance with the following formula:

ETA=MORD + CBC

Where,

ETA= Early termination amount

MORD = MOR loans or loans from World Bank, JICA, etc. that have been directly given to the company on Government guarantee (for the New Corridor and New Railway) outstanding as at the date of termination together with the direct costs of repaying such loans (including break costs);

CBC = the aggregate of following amounts:

(a) The amount payable in respect of work done under each Construction Contract but not yet paid;
(b) An amount equal to the reasonable demobilization costs of the company and the Construction companies in respect of the project;
(c) The aggregate of all payments of items ordered by the Construction Companies to fulfil their obligations under the Construction Contracts to the extent that the orders cannot be cancelled;
(d) The aggregate of all costs reasonably incurred by the Construction Companies in the expectation of completing the whole of the work under the Construction Contracts;
(e) The amount payable in respect of indemnifying the Construction Companies for the third-party claims against them which arise as a direct result of the termination of the Construction Contract due to the termination of this Agreement, except to the extent that any such claims are made by sub-contractors on account of indirect or consequential losses such as unearned profit forgone; and
(f) …

Relevant Extracts from Track Access Agreement

Clause 2 of Track Access Agreement

TRACK ACCESS RIGHTS

Clause 2.1 of Track Access Agreement

Grant to MOR of Train Paths

(a) the company grants to the MOR during the Term the exclusive use and availability of the Train Paths and the use of Network for this purpose by Authorized Rail Users upon the terms and conditions set out in this agreement.

(b) …

Clause 5.6 of Track Access Agreement

Fixed Capacity Charges

(a) The MOR shall pay to the company all Fixed Capacity Charges specified in the Charges Schedule and applicable taxes and Duties irrespective of whether or not the MOR uses all or any part of the Network.

(b) The MOR shall pay all Fixed Capacity Charges at the end of each calendar month (or within such other period as may be agreed between the Parties).

Clause 5.7 of Track Access Agreement

Variable Charges

The MOR will pay to the company all Variable Charges as specified in the Charges Schedule calculated with reference to the actual GTKM carried on the Network and applicable tax and Duties.

Clause 4.1 of Track Access Agreement

The Track Access Charge (TAC) payable by MOR to the company shall be mutually agreed between the parties so as (a) to provide revenue adequate for the company to be a commercially sustainable company earning a reasonable return on investment (revenue adequacy principle) and (b) to incentivize it to handle increments to traffic, maintain agreed performance standards and seek efficiency improvements (incentive principle).

Clauses 5.8 and 5.9 of Track Access Agreement

The level of the Fixed Capacity Charges and Variable Charges shall be reviewed:

(a) during the construction period on occurrence of each completion date; and

(b) during the full operation period, at the end of each period of three years after the commencement of full operation period.

6. *Extracts from the company's financial statements:*

"Accounting Policies:

Note 2.1 of the financial statements for the year ended 31st March 2018

e) Property, plant and equipment

Recognition and measurement

- The initial cost of property, plant and equipment comprises its purchase price, including import duties and non-refundable purchase taxes, and any directly attributable costs of bringing an asset to working condition and location for its intended use. In case where the final settlement of bills with contractors is pending, but the asset is complete and ready to use, capitalisation is done on estimated basis subject to necessary adjustment, including those arising out of settlement of arbitration/ court cases, in the year(s) of final settlement.
- Capital Work-in-Progress is carried at Cost. Expenditure during construction net of incidental income is capitalized as part of relevant assets.

- Capital stores are valued on weighted average cost.

If significant parts of an item of property, plant and equipment have different useful lives, then they are accounted for as a separate item (major components) of property, plant and equipment. Any gain on disposal of property, plant and equipment is recognised in profit and loss account.

Subsequent Measurement

Subsequent expenditure is capitalised only if it is probable that the future economic benefits associated with the expenditure will flow to the company.

Depreciation

Depreciation on property, plant and equipment is charged on pro-rata basis from/ upto the date on which the asset is available for use/ disposal.

Depreciation on property plant and equipment is provided as per Para 219 of Indian Railway Finance Code Volume I which specifies the normal life of the various classes of Railway Assets. In case a particular component of property plant and equipment is not available in the said Para 219 of Indian Railway Finance Code, then depreciation on these assets are provided on Straight Line Method using the useful life specified in Schedule II of the Companies Act, 2013 except in case of certain assets, the useful lives have been determined based on technical evaluation done by the management's expert which are lower than those specified by Schedule II of the Companies Act, 2013, in order to reflect the actual usage of the assets.

Property, plant and equipment created on Leasehold Land and Leasehold Premises Improvements are depreciated fully over the residual period of lease of respective Land/ Leasehold Premises or over the life of respective asset as specified in Schedule II of the Companies Act, 2013, whichever is shorter.

Where the life and / or efficiency of an asset is increased due to renovation and modernization, the expenditure thereon along with its unamortized depreciable amount is charged prospectively over the revised / remaining useful life determined by technical assessment.

Where the cost of the depreciable assets has undergone a change during the year due to price adjustment, change in duties or similar factors the unamortized balance of such assets is depreciated prospectively over the residual life of such assets.

Depreciation methods, useful lives and residual values are reviewed in each financial year end and changes, if any, are accounted for prospectively.

Assets purchased during the year costing Rs. 5,000 or less are depreciated at the rate of 100%."

7. *Comptroller and Auditor General of India (CAG) Comments:*

During supplementary audit conducted by the Comptroller and Auditor General of India (CAG) under section 143(6) of the Companies Act, 2013 of the accounts of the company for the year ended 31st March 2018, they raised the following preliminary queries and the company's management gave an assurance to CAG that the related matter would be referred to the Institute of Chartered Accountants of India (ICAI) for its perusal and valued opinion:

a) The company has entered into service concession agreement with Ministry of Railways on 28th February 2014. As per the agreement, the company will implement the project and operate and maintain the new railway. The concession period is of 30 years excluding construction period. This aspect has not been disclosed by the company in its financial statements. As per Ind AS 11, the company is required to give relevant disclosure regarding construction contracts and as per Ind AS 11 (Appendix B) the disclosure regarding concession agreement is required.

   Thus, the notes to the financial statement of the company are deficient as stated above.

b) CWIP: Rs. 14,78,712.22 lakh

   The above amount represents the expenditure incurred by the company on construction of Eastern and Western Dedicated Rail Freight Corridor. The company has entered into a Concession agreement with MOR to implement the project and operate and maintain the new railway for a concession period of 30 years. As per the track access agreement, the company will charge track access charges for use of new railway facility. As per Ind AS 11 (Appendix A), the infrastructure created cannot be recognized as property plant and equipment. This can be recognized as either intangible assets or financial assets.

   Thus, due to recognition of infrastructure created under concession agreement as Property, Plant and Equipment (Capital work in progress) instead of intangible assets/ financial assets, the property, plant and equipment (Capital work in progress) has been overstated by Rs. 14,78,712.22 lakh and intangible asset/ financial assets (under development) has been understated by the same amount.

8. *Views of the company:*

(a) Extracts from Accounting Standards:

Appendix A, 'Service Concession Arrangements' to Indian Accounting Standard (Ind AS) 11 'Construction Contracts':

"This Appendix is an integral part of Indian Accounting Standard (Ind AS)

Background

1 Infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

2 In recent times, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructure. The infrastructure may already exist, or may be constructed during the period of the service arrangement. An arrangement within the scope of this Appendix typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement.

3 A feature of these service arrangements is the public service nature of the obligation undertaken by the operator. Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:

(a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.

(b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

(c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement

(d) the operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

Scope

4 This Appendix gives guidance on the accounting by operators for public-to-private service concession arrangements

5 This Appendix applies to public-to-private service concession arrangements if:

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls—through ownership, beneficial entitlement or otherwise — any significant residual interest in the infrastructure at the end of the term of the arrangement."

Appendix D, 'Service Concession Arrangements' to Ind AS 115, 'Revenue from Contracts with Customers':

"**Background**

1 Infrastructure for public services — such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks — has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

2 … An arrangement within the scope of this Appendix typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that

sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement.

3 A feature of these service arrangements is the public service nature of the obligation undertaken by the operator. Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:

(a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.

(b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

(c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.

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Scope

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in the infrastructure at the end of the term of the arrangement."

(b) Conclusion of the views of the company:

(i) Ground No. 1

The Concession Agreement between Ministry of Railways and the company makes it evident that the company is a public sector company and is wholly owned by the Ministry of Railways and therefore, it does not satisfy the primary condition of being a private sector entity mentioned in Service Concession Arrangements as per Ind AS 11, 'Construction Contracts' and now Ind AS 115, 'Revenue from Contracts with Customers'.

According to the querist, the service concession arrangements as per Ind AS 11, 'Construction Contracts' and now Ind AS 115, 'Revenue from Contracts with Customers' are primarily based on IFRS 15, 'Revenue from Contracts with Customers', IFRIC 12, 'Service Concession Arrangements' and SIC 29, 'Service Concession Arrangements: Disclosures'. Public sector and private sector are two separate nature of entities. Inference can be drawn from International Financial Reporting Standards (IFRSs) and IAS 24 'Related Party Disclosures'.

Paragraph 25 of IAS 24, 'Related party Disclosures' also gives exemptions to a reporting entity from the disclosure requirements set out in paragraph 18 thereof in relation to related party transactions and outstanding balances (including commitments) with:

- a government that has control or joint control of, or significant influence over, the reporting entity, and
- another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity.

IAS 24 includes a definition of 'government' for the purposes of the partial exemption from the disclosure requirements of IAS 24 for 'government related entities'. Government refers to government, government agencies and similar bodies whether local, national or international. [Paragraph 9 of IAS 24] A government-related entity is an entity that is controlled, jointly controlled or significantly influenced by a government. [Paragraph 9 of IAS 24]

Similarly, when one looks into the definitions of Government and government-related entity as per Indian Accounting Standard (Ind AS) 24 'Related Party Disclosures', 'Government' refers to government, government agencies and similar bodies whether local, national or international and a 'government-related entity' is an entity that is controlled, jointly controlled or significantly influenced by a government.

As per paragraph 11 of Ind AS 24, "In the context of this Standard, the following are not related parties:

(a) …

…

(c) (i) …

(iv) departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity,

… "

As per paragraph 25 of Ind AS 24, "**A reporting entity is exempt from the disclosure requirements of paragraph 18 in relation to related party transactions and outstanding balances, including commitments, with:**

(a) a government that has control or joint control of, or significant influence over, the reporting entity; and

(b) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity."

Background to the Appendix D, 'Service Concession Arrangements' of Ind AS 115, 'Revenue from Contracts with Customers', inter alia, states that, "In recent times, *governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructure.* The infrastructure may already exist, or may be constructed during the period of the service arrangement. An arrangement within the scope of this Appendix typically involves a *private sector entity* (an operator) constructing the infrastructure used to provide the *public service* or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time".

Thus, considering this, as per the querist, generally, an arrangement within the scope of the Service Concession Arrangements as per Ind AS 115 normally involves a private sector operator, who is responsible for rendering public services. Therefore, the operator, who is a private sector entity, is expected to be completely independent of the Government. In certain cases entities which are owned by the Government may also have autonomy to conduct their own affairs so that they act independently of the grantor i.e. Government and not as its agent.

The Concession Agreement has been entered between the Ministry of Railways and the company, which is wholly owned by the Ministry of Railways. Therefore,

the first leg of the condition, i.e., Government should be the party that grants the service arrangement (the grantor) is satisfied but the second part of the above-mentioned condition, i.e., to involve a *private sector entity* (an operator) constructing the infrastructure used to provide the public service or upgrading it is not satisfied. Although the company is managed by the Board of Directors and has independent directors, the appointment of directors is done by the shareholders, which is the Ministry of Railways.

Accordingly, in the view of the querist, since the Concession Agreement itself provides that the company is a special purpose vehicle established by the Ministry of Railways (MOR) to implement the Project and operate and maintain the New Railway consistent with the Project objectives and is a railway administration under the Railways Act, 1989, it could be construed that the company's obligation and rights as per Concession Agreement are towards MOR only and it permits use of track by MOR or authorized rail user on payment of Tariff Access Charges. The MOR vide letter dated 26th November 2018 has also stated that while determining Track Access Charges, there will be no return on equity as long as Indian Railways is a sole user and land lease charges shall be at nominal charges @ Re. 1/-. Therefore, the condition of operator being a *private sector entity and to act independently of the grantor,* i.e., Ministry of Railways *is not satisfied.*

(Emphasis supplied by the querist.)

(ii) Ground No. 2

The Background to the Service Concession Arrangements as per Ind AS 115 states that "Infrastructure for public services — such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks — has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation." The examples of service concession arrangements, as per querist, involve water treatment and supply facilities, motorways, car parks, tunnels, bridges, airports and telecommunication networks. *In the above examples, services provided by Railways is not covered in the service concession arrangements* and therefore the provision of freight services to MOR or authorized rail user by the company is outside the scope of the Service Concession Arrangements as per Ind AS 115. (Emphasis supplied by the querist.)

(iii) Ground No. 3

Further the meaning of 'public service nature of the obligation' is not defined in the Appendix A/D, 'Service Concession Arrangements' to Ind AS 11 / Ind AS 115. If as per Service Concession Arrangement, the service has to be 'public service' then the definition of public service becomes critical. For a public

service obligation to exist, the services offered need not be made available to all the members of the public. Rather, the services need to benefit members of public even if it is to a section of a public. In the view of the querist, providing freight services to MOR or authorized rail user on payment of TAC as per Concession Agreement *does not constitute a public service* as defined in the Background to the Service Concession Arrangements as per Ind AS 115, *as the service is to the owner of the entity and not to the public at large* on behalf of the grantor viz., MOR even though the owner of the entity (grantor) i.e. MOR is providing public services. (Emphasis supplied by the querist.)

In view of the above grounds, the querist has stated that the company has treated project expenditure incurred of Rs. 14,757.08 crores upto 31st March 2018 as capital work in progress in its financial statements and shall capitalize the same as per the requirements of Ind AS 16, 'Property, Plant and Equipment' and Ind AS 23, 'Borrowing Costs' on completion of the project.

B. Query

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

(i) Whether the accounting treatment consistently followed by the company in treating expenditure incurred by the company on the project as 'Property, Plant and Equipment' and 'Capital Work in Progress' is in compliance of various applicable Ind ASs notified under the Companies (Indian Accounting Standards) Rules, 2015 read with section 133 of the Companies Act, 2013. If not, what is the appropriate accounting treatment?

(ii) If not, how the said expenditure is to be treated in financial statements as per various applicable Ind AS and if Appendix D, 'Service Concession Arrangements' to Ind AS 115, 'Revenue from Contracts with Customers' is applicable to the expenditure incurred by the company on the project, whether the same would be treated as an intangible asset or as a financial asset in the company's financial statements.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to the applicability of Appendix D, 'Service Concession Arrangements' to Ind AS 115, 'Revenue from Contracts with Customers' or the erstwhile Appendix A 'Service Concession Arrangements' to Ind AS 11, 'Construction Contracts' to the concession agreement between the company and the MOR and the consequential accounting treatment. 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 policy of the company in respect of recognition, measurement (initial and subsequent) and depreciation of 'property plant and equipment' as mentioned in paragraph 6 above, applicability of Appendix C to Ind AS 17 or Ind AS 116 to the arrangement, existence of related party relationship or disclosure of related party transactions and balances under Ind AS 24, etc. Further, the Committee has restricted the opinion only to the accounting under Indian Accounting Standards (Ind ASs), notified under Companies (Indian Accounting Standards) Rules, 2015, as amended, and not looked into the legal or regulatory aspects arising from the concession agreement referred to by the querist.

11. At the outset, the Committee notes that one of the major contention of the querist is that the company is a public sector company owned by the Ministry of Railways, Government of India and therefore, it does not satisfy the primary condition of being a 'private sector entity' as mentioned in Appendix D to Ind AS 115 or Appendix A to Ind AS 11. In this regard, the Committee is of the view that an entity, which is not a public sector entity should be considered as a private sector entity for the purposes of Appendices D and A. While the Appendices D and A do not define the term 'Public Sector Entity', in the view of the Committee, this term is intended to include the type of entities described by the International Public Sector Accounting Standards Board of International Federation of Accountants (IFAC). Therefore, the Committee notes the following description of public sector entities given in the Preface to International Public Accounting Standards, issued by International Public Accounting Standards Board (IPSASB) of International Federation of Accountants (IFAC) of which the ICAI is also a full-fledged member:

> *Preface To International Public Sector Accounting Standards:*
>
> "10. The IPSASs are designed to apply to public sector entities that meet all the following criteria:
>
> (a) Are responsible for the delivery of services to benefit the public and/or to redistribute income and wealth;
>
> (b) Mainly finance their activities, directly or indirectly, by means of taxes and/or transfer from other levels of government, social contributions, debt or fees; and
>
> (c) Do not have a primary objective to make profits."

From the above, the Committee notes that one of the criteria is that the entity does not have a primary objective to make profits. In the extant case, although at present the company is serving only MoR and receiving track access charges as per track access agreement without any return on equity, it cannot be said that

the company does not have any objective to make profit. The Committee is also of the view that mere infusions of funds from Government by means of equity or loan cannot be the only criteria to determine whether an entity is public sector entity or not. Further, the other objective as mentioned by the company in its Memorandum of Association (as available in public domain) also enlists many other type of commercial and profit making activities that the company may undertake in future. Therefore, the Committee is of the view that the company is not a public sector entity envisaged under Appendix and drawing an analogy, it is a private sector entity. Accordingly, the arrangement in the extant case is a public-to-private arrangement.

12. The Committee notes the following requirements of Appendix D to Ind AS 115 and the erstwhile Appendix A to Ind AS 11:

> "2 … An arrangement within the scope of this Appendix typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement.
>
> 3 A feature of these service arrangements is the public service nature of the obligation undertaken by the operator. Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:
>
> (a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.
>
> (b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

(c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.

(d) the operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

4 This Appendix gives guidance on the accounting by operators for public-to-private service concession arrangements.

5 This Appendix applies to public-to-private service concession arrangements if:

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls — through ownership, beneficial entitlement or otherwise — any significant residual interest in the infrastructure at the end of the term of the arrangement."

(Emphasis supplied by the Committee.)

13. The Committee notes that a feature of service concession arrangements under Appendix D to Ind AS 115 or Appendix A to Ind AS 11 is that the operator is responsible for at least some of the management of the infrastructure and the related services and does not merely act as an agent on behalf of the grantor (paragraph 3(b)). Accordingly, the Committee is of the view that the company should make an assessment in the extant case whether it is acting as an agent or principal in relation to the service concession arrangement. The assessment whether the company is acting as an agent or principal should be made based on the facts and circumstances, including the contractual provisions as stated above and also the guidance provided in Appendix B to Ind AS 115 (paragraphs B34-B38).

14. The Committee further notes that the company should also take into consideration, amongst others, the following facts while making the principal versus agent considerations:

- The company is a special purpose vehicle established by MOR to implement the Project and operate and maintain the New Railway consistent with the Project Objectives and is a railway administration under Railways Act, 1989.

- While determining Track Access Charges, the MOR has also stated that there will be no return on equity as long as Indian Railways is the sole user and land lease charges shall be at nominal rate of Re 1/-.
- Paragraph 1.1 of the Concession Agreement dated 28th February 2014 shared by the querist defines 'Associates' as "in relation to a party, an employee, officer, member, *agent*, contractor, consultant or adviser of that party…" and states that MOR and the company will not be associates of each other.
- Paragraph 5.7 of the Concession Agreement states that the company shall have autonomy and independence from MOR in relation to its management of the implementation of the Project and the performance of its obligations and exercise of its rights under the Project Documents.
- There are no private sector funds involved in the construction of dedicated freight corridors. The lenders of the company are international government agencies which may be covered under the definition of 'government' under the following definition provided under Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance':

  *"**Government** **refers to government, government agencies and similar bodies whether local, national or international**."*

Accordingly, the Committee is of the view that the company shall consider, amongst others, these facts and contractual provisions while making an assessment whether it is autonomous and independent of MOR or is an agent of the MOR. If it is assessed that the company is an agent, the company's performance obligation under Ind AS 115 may be to arrange services for another party to transfer those services. Further, if it is assessed that the company is acting as agent, the company should also assess whether the assets/infrastructure being constructed are being held on its own or on behalf of the principal, viz., the Government.

15. The Committee further notes that the querist has submitted in Ground No. 2 in paragraph 8(b)(ii) above that the services provided by Railways is not covered as an example in the Background to the Service Concession Arrangements as per Appendix D to Ind AS 115 or Appendix A to Ind AS 11 and therefore the provision of freight services to MOR or authorized rail user by the company is outside the scope of the Service Concession Arrangements as per Ind AS 115/Ind AS 11. In this context, the Committee notes that paragraph 1 of Appendix D to Ind AS 115 or Appendix A to Ind AS 11 states as follows:

> "1 Infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation."

The Committee notes that the term 'infrastructure' is not used in a restrictive or exhaustive manner in Appendix D to Ind AS 115 or Appendix A to Ind AS 11, but it is an inclusive term which shall encompass any infrastructure, including railway transportation facilities, that is to be constructed or acquired by the operator.

16. The Committee also notes that the querist has submitted in Ground No. 3 in paragraph 8(b)(iii) above that it is providing freight services to MOR or authorized rail user on payment of TAC as per Concession Agreement. The querist has stated that as the service is to the owner of the entity and not to the public at large on behalf of the grantor (MOR), the same does not constitute a 'public service' and therefore, Appendix D to Ind AS 115 or Appendix A to Ind AS 11 is not applicable. In this context, the Committee notes that paragraph 3(a) of Appendix D/Appendix A identifies the grantor of a service concession arrangement in terms of a public sector body, including a governmental body or a private sector entity to which the responsibility for the public service has been devolved. Further, while providing guidance as to what constitutes control over services and prices in paragraph 5(a) of Appendix D to Ind AS 115, the Application Guidance on Appendix D (AG2) explains what might be considered as 'public service' as follows:

> "AG2 The control or regulation referred to in condition (a) could be by contract or otherwise (such as through a regulator), and includes circumstances in which the grantor buys all of the output as well as those in which some or all of the output is bought by other users. In applying this condition, the grantor and any related parties shall be considered together. If the grantor is a public sector entity, the public sector as a whole, together with any regulators acting in the public interest, shall be regarded as related to the grantor for the purposes of this Appendix D."

From the above, the Committee notes that even if the grantor (who is acting in public interest and provides services to the public) purchases all of the output from the operator, it may be considered as providing public service.

17. The Committee notes that there are two applicability criteria in paragraph 5 of Appendix D to Ind AS 115 or Appendix A to Ind AS 11. The first criterion is whether the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price. In the extant case, the company is providing freight services to MOR or

authorized rail user on payment of TAC as per Concession Agreement between the company and MOR. Therefore, in the view of the Committee, the grantor (MOR), through the Concession Agreement, is controlling and regulating the services that the company shall provide, to whom the same is to be provided and the price at which the same is to be provided.

The second criterion in paragraph 5 of Appendix D to Ind AS 115 or Appendix A to Ind AS 11 is whether the grantor controls - through ownership, beneficial entitlement or otherwise - any significant residual interest in the infrastructure at the end of the term of the arrangement.

In the extant case, the Committee notes that the company is obliged to handover the infrastructure to the MOR at the handover date at the end of the concession. Therefore, in the view of the Committee, MOR controls significant residual interest in the infrastructure at the end of the term of the arrangement.

Accordingly, on the basis of above discussion, the Committee is of the view that, unless the company is acting as an agent, Appendix D to Ind AS 115 or Appendix A to Ind AS 11 shall be applicable to the company.

18. If it is assessed that Appendix D to Ind AS 115 or Appendix A to Ind AS 11 is applicable, the next issue relates to classification of the consideration for the operator's construction services for which the following guidance is provided in the Appendix D to Ind AS 115 (Appendix A to Ind AS 11 also contains similar requirements):

> "15 If the operator provides construction or upgrade services the consideration received or receivable by the operator shall be recognised in accordance with Ind AS 115. The consideration may be rights to:
>
> (a) a financial asset, or
>
> (b) an intangible asset.
>
> 16 The operator shall recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the

operator ensuring that the infrastructure meets specified quality or efficiency requirements.

17 The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.

18 If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognised initially in accordance with Ind AS 115."

In the extant case, as mentioned in paragraph 5 above, as per clause 5.6 of the Track Access Agreement, which is a part of the Concession Agreement, the MOR shall pay to the company Fixed Capacity Charges as specified in the Charges Schedule irrespective of whether or not the MOR uses all or any part of the network. This means that the company has an unconditional right to receive cash irrespective of the actual usage of the infrastructure. The Committee is of the view that this shall constitute a financial asset as per paragraph 16 of Appendix D to Ind AS 115 or Appendix A to Ind AS 11.

In addition, as mentioned in paragraph 5 above, as per clause 5.7 of the Track Access Agreement, the company is also entitled to variable charges based on the actual usage of the infrastructure. This, in the view of the Committee, shall constitute a right to charge for the use of the infrastructure contingent on the extent of use of the service of the company.

Therefore, the consideration shall be partly financial asset and partly intangible asset in the concession arrangement. The company shall therefore recognize and measure each component separately as per the requirements of Appendix D to Ind AS 115 or Appendix A to Ind AS 11.

19. In case the company assesses that Appendix D of Ind AS 115 is not applicable to it, the Committee further notes that paragraph 4 of Appendix C, 'Determining whether an Arrangement contains a Lease' to Ind AS 17, 'Leases' states the following:

"4 This appendix does not apply to arrangements that:

(a) are, or contain, leases excluded from the scope of Ind AS 17; or

(b) are public-to-private service concession arrangements within the scope of Appendix D of Ind AS 115, *Service Concession Arrangements*."

Similarly, Ind AS 116, 'Leases' (which is effective from financial year beginning on or after 1 April 2019) scopes out public-to-private service concession arrangements within the scope of Appendix D of Ind AS 115. Therefore, Appendix C to Ind AS 17 or Ind AS 116 do not apply to arrangements that are within the scope of Appendix D of Ind AS 115. Therefore, in case the company assesses that Appendix D of Ind AS 115 is not applicable to it, it shall assess whether the arrangement with MOR constitutes a lease under Appendix C to Ind AS 17 or Ind AS 116 and shall account for the arrangement accordingly. If it is assessed that the arrangement contains lease, the company (lessor) should classify the lease into finance lease or operating lease based on the criteria laid down in Ind AS 17/Ind AS 116.

Factors such as, the minimum fixed capacity payments from MOR, the company's obligations to handover the infrastructure to the MOR at the handover date at the end of the concession, the company's entitlement in case of early termination, MOR's obligation to divert 70% of the traffic to the company and MOR's risk, etc. as pointed in paragraph 5 above should also be considered for the purpose of the assessment of whether the arrangement contains lease as well as for the purpose of classification as operating or finance lease. The Committee is further of the view that in case it is assessed that the arrangement contains a lease, till the time, the company does not start lease accounting as per the requirements of Ind AS 17/Ind AS 116, as applicable, the company should consider applicability of the accounting requirements of Ind AS 16, 'Property, Plant and Equipment', based on its own facts and circumstances, for construction of railway tracks/other infrastructure assets.

D. Opinion

20. As mentioned in paragraphs 12-14 above, a feature of service concession arrangements under Appendix D to Ind AS 115 or Appendix A to Ind AS 11 is that the operator is independently responsible for the management of the infrastructure and the related services and does not merely act as an agent on behalf of the grantor. Therefore, the Committee is of the view that the company should evaluate, based on its facts and circumstances, and the indicators provided in Appendix B to Ind AS 115 (paragraphs B34-B38) as to whether it is acting as a principal or an agent on behalf of MOR. Based on the same, if it is assessed that it is not merely acting as an agent for MOR and has significant level of independence in providing the management of the infrastructure and the related services, Appendix D to Ind AS 115 or Appendix A to Ind AS 11 shall be applicable. The consideration, as mentioned in paragraph 17 above, would result

in consideration being classified partly as financial asset and partly as intangible asset in the concession arrangement. In that scenario, the current accounting policy of the company to classify and present the expenditure incurred on the project as capital work in progress under Ind AS 16 as mentioned in paragraph 4 above, shall be incorrect.

If it is assessed that it is acting as an agent on behalf of MOR, then Appendix D to Ind AS 115 or Appendix A to Ind AS 11 shall not be applicable. In that case, the company should assess whether its performance obligation under Ind AS 115 may be to arrange services for another party to transfer those services and whether the assets/infrastructure being constructed are being held on its own or on behalf of the principal. Further, in that scenario, the current accounting policy of the company as capital work in progress under Ind AS 16 as mentioned in paragraph 4 above, shall be incorrect.

If it is assessed that Appendix D to Ind AS 115 or Appendix A to Ind AS 11 is not applicable, it should also be assessed as to whether the arrangement with MOR constitutes a lease under Appendix C to Ind AS 17 or Ind AS 116 and if it is assessed that the arrangement contains a lease, the company shall classify the lease into finance lease or operating lease based on the criteria laid down in Ind AS 17 / Ind AS 116, as applicable. Also, in case it is assessed that the arrangement contains a lease, till the time, the company does not start lease accounting as per the requirements of Ind AS 17 / Ind AS 116, as applicable, the company should, based on facts and circumstances, apply accounting requirements of Ind AS 16, 'Property, Plant and Equipment', for construction of railway tracks/other infrastructure assets.

———————

Query No. 17

Subject: Classification of an entity as a subsidiary or joint venture.[1]

A. Facts of the Case

1. A Ltd. (hereinafter referred to as 'the company') is a joint venture company floated by W Ltd., X Ltd., Y Ltd. and Z Ltd. The companies have entered into joint venture agreement to regulate their relationship as shareholders and Joint Venture (JV) partners in the company on the mutually agreed terms and conditions as specified in JV agreement. As on 28.03.2019, W Ltd. has acquired 52.63% shareholding of X Ltd.; and X Ltd. has become

[1] Opinion finalised by the Committee on 21.11.2019.

subsidiary of W Ltd. under the Companies Act, 2013. As on 31.03.2019, W Ltd. was holding 36% (approx.) and X Ltd. was holding 21% (approx.) shareholding in the company. Remaining shares were held by Y Ltd. and Z Ltd.

2. The querist has stated that as per section 2(87) of the Companies Act, 2013, the company qualifies for classification as subsidiary of W Ltd. as W Ltd. along with its subsidiary X Ltd. holds more than one half (36% + 21%) of total equity share capital of the company.

3. The querist has referred to the following extracts from Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements':

(a) **An investor**, regardless of the nature of its involvement with an entity (the investee), **shall determine whether it is a parent by assessing whether it controls the investee**.

(b) **An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee**.

(c) Thus, **an investor controls an investee if and only if the investor has all the following**:

(i) power over the investee;

(ii) exposure, or rights, to variable returns from its involvement with the investee; and

(iii) **the ability to use its power over the investee to affect the amount of the investor's returns.**

(d) An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7.

(e) Two or more investors collectively control an investee when they must act together to direct the relevant activities. **In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee**. Each investor would account for its interest in the investee in accordance with the relevant Ind ASs, such as, Ind AS 111, *Joint Arrangements*, Ind AS 28, *Investments in Associates and Joint Ventures,* or Ind AS 109, *Financial Instruments.*

(Emphasis supplied by the querist.)

4. The querist has also referred to the following extracts from Ind AS 111, Joint Arrangements (extracts from text):

(a) **A joint arrangement** is an arrangement of which **two or more parties have joint control**.

(b) A joint arrangement has the following characteristics:

- The parties are bound by a contractual arrangement.
- The contractual arrangement gives two or more of those parties joint control of the arrangement.

(c) A joint arrangement is either a joint operation or a joint venture.

(d) **Joint control** is the contractually agreed sharing of control of an arrangement, which exists only **when decisions about the relevant activities require the unanimous consent of the parties sharing control.**

(Emphasis supplied by the querist.)

5. The querist has provided the following key pointers from JV agreement between promoters of the company:

1. The JV agreement provides that, subject to provisions of section 252 of Companies Act, 1956, the number of Directors of the company shall not be less than four (4) and not more than fifteen (15). Further, one Director each shall be nominated by each of the parties (subject to holding of at-least 10% shareholding by respective party).

2. Paragraph 7.8 of JV agreement specifies "Reserved Matters" on which decision can be taken only with the affirmative vote of the majority of Directors, which **majority shall include affirmative vote of at least one Director each nominated by all parties**.

   Matters covered under "Reserved Matters" which merit attention are following:

   (a) **The annual revenue budget** of the company
   (b) Five year **annual plans of development, capital budget** etc.
   (c) Winding up of the company
   (d) Any matter related to transfer, sale, lease, exchange, mortgage and/or disposal otherwise of the whole or substantially the whole of the undertaking of the company or part thereof.
   (e) Increase or otherwise alter the authorised or issued **share capital** of the company.

(f) **Induction of new investors**

(g) **Taking of any loan or other borrowing** or issue of any debt or other instrument or security carrying the right or option to convert the whole or part thereof or any such instrument or security, as the case may be, or any accrued interest thereon into the shares of the company.

(h) Any matter relating to

- promotion of new company/companies including formation of subsidiary company/companies.
- **entering into partnership and/or arrangement of sharing profits**.
- taking or otherwise acquiring and holding shares in any other company.
- pledging or encumbering of any assets of the company and the issuance of corporate guarantee or incurring of usual liability, except as set forth in the annual operating and capital budget or as required for the procurement of working capital needs, or as may be required by any government authorities or for any tax purposes.
- **Recommendations / approval of dividend by the company**
- Arrangement involving **foreign collaboration** proposed to be entered by the company.

(i) Change in the name of the company.

(j) Entering into any profit sharing or any share option or other similar schemes for the benefit of the officers and other employees of the company.

(Emphasis supplied by the querist.)

(A copy of the JV agreement has been supplied separately by the querist for the perusal of the Committee.)

6. Contention of W Ltd.:

(i) Keeping in view restrictions imposed through "Reserved Matters" paragraph (discussed above) in joint venture agreement wherein unanimous of all the JV partners is required, W Ltd. is of the view that the company should be treated as a jointly controlled entity for the purpose of accounting and should be consolidated using equity method of consolidation.

(ii) Following may also be considered in support of W Ltd.'s view:

a) Recommendation and approval of dividend has been categorised under reserved matter. Thus, it restricts the ability of W Ltd. to use its power over the investee (the company) to affect the amount of the investor's returns which is an important condition to establish control.

b) One of the public sector undertaking, in its critical judgment section, in consolidated financials for Financial Year (F.Y.) 2017-18 has given the following note:

'In case of H Ltd. and C Ltd wherein subsidiary company ABC Ltd. held majority voting rights of these companies (74% stake), other JV partner has substantive participative rights through its right to affirmative vote items. Accordingly, being a company with joint control, H Ltd. and C ltd. have been considered as Joint Venture company for the purpose of consolidation of financial statement under Ind AS. However, for the purpose of Companies Act 2013, these companies have been classified as subsidiary companies as defined under section 2 therein'

c) Paragraph 9 of Ind AS 112, Disclosure of Interests in Other Entities, inter-alia, requires that an entity shall disclose significant judgements and assumptions made in determining that it does not control another entity even though it holds more than half of the voting rights of the other entity.

From the above, it is clearly evident that Ind ASs requires classification not merely on the basis of shareholding more than 50%.

7. Contention of the auditor of W Ltd.:

One of the statutory auditors of W Ltd. is of the view that since, W Ltd. holds directly and indirectly more than 50 % of voting rights in the company, it should be classified as subsidiary and should be consolidated on line by line basis.

8. The querist has separately provided the details of shareholding pattern of the company as on 31.03.2019 as under:

Party Name	As on 31/3/19 % age holding	As on 31/3/18 % age holding
Y Ltd.	36.36%	31.71%
W Ltd.	36.36%	31.71%
X Ltd.	21.70%	31.71%
Z Ltd.	5.58%	4.87%

Further, the details of shareholding pattern as on 30.06.2019 are as under:

Party Name	As on 30/6/19	% of Shares
Y Ltd.	3,654,880,000	41.29
W Ltd.	2,455,000,000	27.73
X Ltd.	2,181,000,000	24.64
Z Ltd.	561,183,500	6.34
TOTAL	**8,852,063,500**	**100**

The composition of directors of the company has also been provided by the company separately for the perusal of the Committee.

B. Query

9. What should be the classification of the company in the standalone books of W Ltd. and how it should be consolidated in consolidated accounts of W Ltd. (equity method or line by line consolidation)? W Ltd. while finalising financial statements for financial year 2018-19, has classified it as a joint venture company and followed equity method of accounting.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to classification of the company as joint venture company or subsidiary company in the consolidated financial statements of W Ltd. for the financial year 2018-19. 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 for transactions between the joint venture partner companies, accounting in the books of the company, X Ltd., Y Ltd. and Z Ltd., manner of consolidation in the books of W Ltd., impact on classification due to changes in shareholding pattern and other changes after 31.03.2019, classification of joint arrangement as joint venture or joint operation, etc. Further, the Committee has opined purely from accounting perspective and not from any legal perspective, such as, legal interpretation of Joint Venture Agreement, legal compliance with any Act or Law in force, etc.

11. At the outset, the Committee notes that W Ltd. holds directly and indirectly more than 50% of the voting rights in the company and therefore, the auditors are contending that it should be classified as subsidiary in the consolidated financial statements of W Ltd. In this regard, the Committee notes that vide Notification G.S.R 680(E) dated 4th September 2015, issued by the Ministry of Corporate Affairs (MCA), the following Rule has been inserted in the Companies (Accounts) Rules, 2014:

> "4A **Forms and items contained in financial statements**.- The financial statements shall be in the form specified in Schedule III to the Act and comply with Accounting Standards or Indian Accounting Standards as applicable:
>
> Provided that the items contained in the financial statements shall be prepared in accordance with the definitions and other requirements specified in the Accounting Standards or the Indian Accounting Standards, as the case may be."

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

> **"8.1.8.4. …**
>
> The terms 'subsidiary', 'associate' and 'joint venture' shall be as defined in the respective Ind AS. ..."
>
> **"8.2.1.16. …**
>
> …The terms 'subsidiary' and 'associate' should be understood as defined under Ind AS 110 and Ind AS 28. ..."
>
> **"12. Part III – General Instructions for Preparation of Consolidated Financial Statements**
>
> The Act defines a 'subsidiary company' and an 'associate company' which is different from the definition of a 'subsidiary', an 'associate' and a 'joint venture' under Ind AS. An amendment to Companies (Accounts) Rules, 2014 on 4 September 2015, newly inserted Rule 4A which state that "*financial statements shall be in the form specified in Schedule III to the Act and comply with Accounting Standards or Indian Accounting Standards as applicable, provided that the items contained in financial statements shall be prepared in accordance with the definitions and other requirements specified in the Accounting Standards or the Indian Accounting Standards, as the case may be.*"
>
> The Act mandates that the companies which have one or more subsidiaries or associates (which as per the Act includes joint ventures) are required to prepare Consolidated Financial Statements (CFS), except under certain circumstances exempted under the Act and Rules.
>
> Accordingly, Ind AS definitions of subsidiary, associate and joint venture shall be considered for assessment of control, joint control and significant influence even though the requirement of preparation of CFS will be governed by the Act."

From the above, the Committee is of the view that for the purpose of preparation of financial statements, the requirements of Ind ASs have to be considered. Therefore, in the extant case, the term 'subsidiary' should be understood as it is defined under Ind AS 110, 'Consolidated Financial Statements'. In this context, the Committee notes that Appendix A to Ind AS 110 defines 'subsidiary' as "an entity that is controlled by another entity". Thus, the determination of a subsidiary is to be made on the basis of 'control' as given in Ind AS 110, and not merely on the basis of shareholding.

12. The Committee further notes the requirements of Ind AS 111, 'Joint Arrangements', as follows:

> **"4 A joint arrangement is an arrangement of which two or more parties have joint control.**
>
> **5 A joint arrangement has the following characteristics:**
>
> **(a) The parties are bound by a contractual arrangement (see paragraphs B2–B4).**
>
> **(b) The contractual arrangement gives two or more of those parties joint control of the arrangement (see paragraphs 7–13)."**
>
> **"7 Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.**
>
> 8 An entity that is a party to an arrangement shall assess whether the contractual arrangement gives all the parties, or a group of the parties, control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the activities that significantly affect the returns of the arrangement (ie the relevant activities).
>
> 9 Once it has been determined that all the parties, or a group of the parties, control the arrangement collectively, joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that control the arrangement collectively."
>
> "12 An entity will need to apply judgement when assessing whether all the parties, or a group of the parties, have joint control of an arrangement. An entity shall make this assessment by considering all facts and circumstances (see paragraphs B5–B11)."

"B3 When joint arrangements are structured through a separate vehicle (see paragraphs B19–B33), the contractual arrangement, or some aspects of the contractual arrangement, will in some cases be incorporated in the articles, charter or by-laws of the separate vehicle."

"B5 In assessing whether an entity has joint control of an arrangement, an entity shall assess first whether all the parties, or a group of the parties, control the arrangement. Ind AS 110 defines control and shall be used to determine whether all the parties, or a group of the parties, are exposed, or have rights, to variable returns from their involvement with the arrangement and have the ability to affect those returns through their power over the arrangement. When all the parties, or a group of the parties, considered collectively, are able to direct the activities that significantly affect the returns of the arrangement (ie the relevant activities), the parties control the arrangement collectively.

B6 After concluding that all the parties, or a group of the parties, control the arrangement collectively, an entity shall assess whether it has joint control of the arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that collectively control the arrangement. Assessing whether the arrangement is jointly controlled by all of its parties or by a group of the parties, or controlled by one of its parties alone, can require judgement.

B7 Sometimes the decision-making process that is agreed upon by the parties in their contractual arrangement implicitly leads to joint control. For example, assume two parties establish an arrangement in which each has 50 per cent of the voting rights and the contractual arrangement between them specifies that at least 51 per cent of the voting rights are required to make decisions about the relevant activities. In this case, the parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing.

B8 In other circumstances, the contractual arrangement requires a minimum proportion of the voting rights to make decisions about the relevant activities. When that minimum required proportion of the voting rights can be achieved by more than one combination of the parties agreeing together, that arrangement is not a joint arrangement unless the contractual arrangement specifies which

parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement.

Application examples

Example 1

Assume that three parties establish an arrangement: A has 50 per cent of the voting rights in the arrangement, B has 30 per cent and C has 20 per cent. The contractual arrangement between A, B and C specifies that at least 75 per cent of the voting rights are required to make decisions about the relevant activities of the arrangement. Even though A can block any decision, it does not control the arrangement because it needs the agreement of B. The terms of their contractual arrangement requiring at least 75 per cent of the voting rights to make decisions about the relevant activities imply that A and B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing."

"B9 The requirement for unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions (about the relevant activities) without its consent. If the requirement for unanimous consent relates only to decisions that give a party protective rights and not to decisions about the relevant activities of an arrangement, that party is not a party with joint control of the arrangement."

From the above, the Committee notes that in order to determine the nature of arrangement that exists between the parties, it is to be evaluated that whether the arrangement is jointly controlled by all of its parties or by a group of the parties, or controlled by one of the parties (viz., W Ltd.) alone. The Committee also notes that the concept of 'joint control' involves concept of 'control', which is dealt with in detail in Ind AS 110, 'Consolidated Financial Statements'. Accordingly, the Committee examines the requirements of Ind AS 110 on the concept of control in the paragraph 13 below.

13. The Committee notes the following paragraphs of Ind AS 110:

"6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

7 Thus, an investor controls an investee if and only if the investor has all the following:

(a) power over the investee (see paragraphs 10–14);

(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80–B85).

9 Two or more investors collectively control an investee when they must act together to direct the relevant activities. In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant Ind ASs, such as Ind AS 111, *Joint Arrangements*, Ind AS 28, *Investments in Associates and Joint Ventures,* or Ind AS 109, *Financial Instruments.*

Power

10 An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee's returns.

11 Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements."

Further, the Committee notes the following paragraphs from Appendix B of Ind AS 110, reproduced below, which provides application guidance on the requirements of Ind AS 110:

> "B5 When assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities.
>
> B6 When an investee's purpose and design are considered, it may be clear that an investee is controlled by means of equity instruments that give the holder proportionate voting rights, such as ordinary shares in the investee. In this case, in the absence of any additional arrangements that alter decision-making, the assessment of control focuses on which party, if any, is able to exercise voting rights sufficient to determine the investee's operating and financing policies (see paragraphs B34–B50). In the most straightforward case, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee."
>
> "B8 An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor's consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside."
>
> "B11 For many investees, a range of operating and financing activities significantly affect their returns. Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:
>
> (a) selling and purchasing of goods or services;
>
> (b) managing financial assets during their life (including upon default);
>
> (c) selecting, acquiring or disposing of assets;

(d) researching and developing new products or processes; and

(e) determining a funding structure or obtaining funding.

B12 Examples of decisions about relevant activities include but are not limited to:

(a) establishing operating and capital decisions of the investee, including budgets; and

(b) appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment."

"B15 Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:

(a) rights in the form of voting rights (or potential voting rights) of an investee (see paragraphs B34–B50);

(b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;

(c) rights to appoint or remove another entity that directs the relevant activities;

(d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and

(e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

B16 Generally, when an investee has a range of operating and financing activities that significantly affect the investee's returns and when substantive decision-making with respect to these activities is required continuously, it will be voting or similar rights that give an investor power, either individually or in combination with other arrangements."

"Power with a majority of the voting rights

B35 An investor that holds more than half of the voting rights of an investee has power in the following situations, unless paragraph B36 or paragraph B37 applies:

(a) the relevant activities are directed by a vote of the holder of the majority of the voting rights, or

(b) a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

Majority of the voting rights but no power

B36 For an investor that holds more than half of the voting rights of an investee, to have power over an investee, the investor's voting rights must be substantive, in accordance with paragraphs B22–B25, and must provide the investor with the current ability to direct the relevant activities, which often will be through determining operating and financing policies. If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the investor, the investor does not have power over the investee."

From the above, the Committee notes that the assessment of 'control' or 'joint control' is a matter of judgement, which should be evaluated in the particular facts and circumstances and considering the requirements of any specific contractual arrangement between the parties concerned. In this regard, the Committee notes that the companies W Ltd., X Ltd., Y Ltd. and Z Ltd. have entered into the Joint Venture Agreement which contains their rights and obligations in relation to the company.

14. The Committee notes the following clauses from the Joint Venture Agreement (as modified/amended from time to time by the Supplementary Agreement(s)) and Articles of Association, as supplied by the querist for the perusal of the Committee:

Joint Venture Agreement

"WHEREAS

…

d) In a meeting taken by Secretary (Power) held on 29th October 2008, wherein the issue of creation of a separate corporate entity exclusively dealing with energy efficiency implementation was discussed and proposed a need for strong Government led leadership to unlock the market potential in Energy Efficiency. Further, it was also decided on 6th July 2009 that all the promoting CPSUs shall subscribe equal equity participation i.e. … for creating the company. …

e) The Parties hereto as leaders in the area of Power generation, power project financing, power transmission and rural electrification projects have agreed to collaborate for setting up JV

Company for implementation of Energy Efficiency projects. The parties have also agreed to setforth more elaborately the objectives in the Memorandum of Association of the JVC for realisation of the above intent.

f) In pursuance of the above, the Parties hereto have agreed to incorporate a Joint Venture Company for achieving the above objectives. The Parties have, therefore, entered into this Agreement to regulate their relationship as shareholders and Joint Venture partners in the JVC on the mutually agreed terms and conditions as hereinafter specified."

"1.0 DEFINITIONS

...

iv) "Affiliates"/ "Associates" in relation to "Y Ltd.", "W Ltd.", "Z Ltd." and "X Ltd.", respectively shall mean person(s)/ body corporate of which "Y Ltd.", "W Ltd.", "Z Ltd." and "X Ltd.", as the case may be, is owner or beneficial owner of not less than 50% of the paid-up share capital/voting rights.

…"

"xiii) "JVC" or the company shall mean the Joint Venture Company incorporated under the Act pursuant to this Agreement."

"7.1 The JVC shall be managed by its Board of Directors. The Board shall be responsible for the overall functioning of the JVC. The Business of the JVC shall always be carried on in accordance with the policies laid down by the Board from time to time."

"7.3 The Board of the JVC shall comprise maximum 13 (Thirteen) Directors that include Nominee Directors, Part-Time Directors, Independent directors & Functional Directors.

The PROMOTERS shall be entitled to nominate one Director each on the Board of JVC provided that the shareholding of each such Party does not fall below 10% of the paid up share capital of the JVC.

Apart from the Directors nominated by PROMOTERS, two Part-Time Directors and Independent Directors will be nominated by MoP, GOI, one of whom would be from BEE.

The Managing Director and other Functional Directors shall be appointed in accordance with Clause 8.0(c) & 8.0(f) of this agreement.

… The Board shall be responsible for overall functioning of the JVC. The business of the JVC shall always be carried on in accordance with the policies laid down by the Board from time to time."

"7.5 The non-executive Chairman of the Board shall be amongst the Directors nominated by the Promoters on the Board of the JVC for a period of two years. The Chairman of the Board shall be rotated amongst the Promoters. The first Chairman of the proposed JVC shall be nominated by Y Ltd. and subsequent Chairman shall be nominated by W Ltd., X Ltd. and Z Ltd. in order of sequence. The Chairman shall not be below the level of Director of the Promoters. …"

"7.8 Reserved Matters

7.8.1 Neither the Board of Directors nor a committee thereof (whether at a Board Meeting or at a committee meeting or by circular resolution or otherwise) nor its MD or any other person purporting to act on behalf of the JVC shall take any action in respect of any of the following matters (Reserved Matters) except with the affirmative vote of the majority of Directors, which majority shall include affirmative vote of at least one Director each nominated by all Promoters.

a. The annual revenue budget of the JVC.

b. The Five Year Annual Plans of development, the capital budget of the Company and processing of any modernisation, expansion schemes including programme of capital expenditure or purchase of capital equipment which exceeds Rs. 10 Crore.

c. Winding up of the company.

d. Any matter relating to the transfer, sale, lease, exchange, mortgage and/or disposal otherwise of the whole or substantially the whole of the undertaking of the Company or part thereof.

e. Increase or otherwise alter the authorized or the issued share capital of the Company.

f. Induction of New investors

g. Taking of any loan or other borrowing or issue of any debt or other instrument or security carrying the right or option to convert the whole or part thereof or any such instrument or

security, as the case may be, or any accrued interest thereon into the Shares of the JVC.

h. Any matter relating to

- the promotion of new company/companies including formation of subsidiary company/companies.
- …
- pledging or encumbering of any assets of the JVC and the issuance of corporate guarantee… except as set forth in the annual operating and capital budgets or as required for the procurement of working capital needs, or as may be required by any government authorities or for any tax purposes.
- Recommendations/approval of dividend by the Company
- …

i. Change in the name of the Company

j. Entering into any profit sharing, or any share option or other similar schemes for the benefit of the officers and other employees of the JVC …"

"7.9 Meetings of the Board of Directors

…

(c) The quorum for a meeting shall be determined from time to time in accordance with the provisions of Section 287 of the Act, provided that there shall be no quorum in any meeting unless at least one nominee Director each from atleast three Parties is present."

"8.0 Functional Management

(a) JVC shall have its own professional management team of Managing Director (MD) and functional directors. The professional management team will be headed by Managing Director.

(b) The Board shall delegate to the MD such powers and authorities as would enable him to have operational autonomy in the day-to-day management of business and affairs of the Company and in like manner may withdraw or annul any such power and/or authority as may be considered necessary.

(c) Subject to the provision of the Act, Managing Director of the Company shall be selected by Search and Selection Committee comprising of:

1. Secretary (Power)
2. CMD of the PROMOTERS
3. DG, BEE,

and appointed by the Board on such terms and conditions as the recruitment rules approved by the Board, to manage the affairs and business of the Company.

(d) The functional management of the JVC including sourcing, purchasing, personnel, finance and other commercial and managerial decisions shall vest with the MD, who shall have authority and responsibility for the management of day-to-day affairs of the JVC for which appropriate power may be delegated to him by the Board. …

(f) Subject to the provisions of the Act and Clause 7.3 of the JV Agreement, the other Functional Directors of the Company except Managing Director, shall be selected by Selection Committee comprising of:

1. Chairman of the company
2. Managing Director of the company,
3. one representative each from Promoter Companies, Ministry of Power

   (Government of India), Bureau of Energy Efficiency,

from the Promoter Companies for period up-to 5 years or through Open Recruitment in case no suitable candidate could be selected from the Promoter Companies, on such terms and conditions as may be approved by the Board from time to time."

"14.0 Articles of Association

14.1 The Parties shall cause the JVC to fully adopt, ratify, consent to and fully agree to be bound by this agreement.

14.2 The Articles of Association of the JVC shall be suitably framed / amended to incorporate the main provisions of this Agreement to the extent permissible under the Act."

"16.2 In the event of a Party ceasing to hold at least 10% (ten percent) of the paid-up share capital of the JVC, all rights of such Party under the Agreement shall cease."

"21.0 Ratification of this agreement

The Parties' rights and obligations shall be governed primarily by this Agreement, which shall also prevail inter-se amongst the Parties in the event of any ambiguity or inconsistency between this Agreement and the Memorandum and Articles of the Association to the extent permissible under law."

Articles of Association

"180 After Incorporation, the Company shall adopt the Joint Venture Agreement executed among Y Ltd., W Ltd., Z Ltd. and X Ltd. and in case of any inconsistency between this Articles of Association and Joint Venture Agreement, the provisions of latter will prevail, subject to provisions of the Act."	**Adoption of JVA**

15. The Committee notes from the above that the purpose of entering into this JV agreement is to establish a special purpose vehicle, viz., the company, which is intended to be a joint arrangement/ joint venture company. The Committee also notes that as per clause 7.8.1 of the Joint Venture Agreement, extracts of which are also given in paragraphs 5 and 14 above, any action in respect of 'reserved matters' shall be taken only with the affirmative vote of the majority of Directors, which majority shall include affirmative vote of atleast one Director each nominated by all the promoters. The reserved matters include matters related to annual revenue budgets; 5 year annual plans of development, capital budget and capital expenditure or purchase of major capital equipment; the transfer, sale, lease, exchange, mortgage and/or disposal otherwise of the whole or substantially the whole of the undertaking of the company or part thereof, increase or otherwise alter the authorised or issued share capital, induction of new investors, recommendation of dividend, etc. Considering these matters and other rights as per other clauses of the JV agreement, such as, quorum, participating rights in the board meetings for other matters like appointment of Managing Director and Functional Directors of the company who shall be responsible for the functional and day-to-day management of the company, etc., the Committee is of the view that these activities are in the nature of relevant activities as per the requirements of Ind AS 110 reproduced above and therefore,

may entitle the parties to the JV Agreement 'control' of the company. Further, the provisions of JV Agreement have been adopted in the Articles of Association (AoA) of the company as noted from the above-reproduced clause of AoA and therefore the clauses of the JV Agreement are also binding on the company. As far as W Ltd. is concerned, the Committee notes that it holds directly or indirectly by virtue of shareholding or other rights in X Ltd., majority shareholding in the company, which may be argued to be providing W Ltd. with the ability to 'control' the company.

The Committee also notes that Z Ltd. holds less than 10% shareholding and accordingly, as per the Joint Venture agreement, Z Ltd. will not be entitled to nominate the directors on the Board of Directors of the company (A Ltd.) and therefore, while considering the reserved matters, Z Ltd. shall not be considered. However, since in respect of reserved matters, directors of all the parties to the JV agreement have to unanimously agree before any action can be taken in respect of such matters and for the purpose of quorum of board meetings also, at least one nominee Director each from atleast three Parties has to be present and also after considering the composition of the board of directors, separately provided by the company, etc. the Committee is of the view that inspite of its majority shareholding, W Ltd., unilaterally will not be able to take the decisions about the relevant activities of the company.

Thus, inspite of shareholding and other rights in the X Ltd., since for taking decisions in the reserved matters of the company, as per the JV agreement, the exercise of voting by the director nominated by Y Ltd. is also essential, the Committee is of the view that in case of the company, W Ltd. cannot take important decisions about the relevant activities of the company unilaterally. Therefore, W Ltd. cannot be considered as controlling the activities of the company, unilaterally. Accordingly, the company is not a subsidiary of W Ltd., rather is a joint arrangement and therefore, W Ltd. should not do line by line consolidation of the financial statements of the company; rather should consider it as a joint arrangement and accordingly, account for the same as per the requirements of Ind AS 111.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the company in the extant case is not a subsidiary of W Ltd. The said arrangement is to be considered as a joint arrangement and accordingly should be accounted for as per the requirements of Ind AS 111, for the reasons mentioned in and as discussed in paragraph 15 above.

———————

Query No. 18

Subject: Disclosure/classification of late payment interest charges collected from customers in the statement of cash flows.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a public limited company domiciled in India and incorporated under the provisions of the Companies Act. The company is a government company under section 2(45) of Companies Act, 2013. Its shares are listed on Bombay Stock Exchange and National Stock Exchange in India. The company is engaged in the business of distribution of natural gas in various cities/districts in India. Natural gas business involves distribution of gas from sources of supply to centres of demand and to the end-user customer, i.e., industrial, commercial, domestic customers and CNG to transporter as fuel.

2. The querist has stated that the company prepares its annual financial statements as per the provisions of the Companies Act, 2013 and follows financial year as its accounting year. Sales are billed bi-monthly for domestic customers, monthly/fortnightly for commercial and non-commercial customers and fortnightly for industrial customers and billed on the spot / daily / weekly / fortnightly cycle in case of CNG customers.

3. Further, the company charges late payment charges/delayed interest charge on overdue balances to the customers who have not paid the bill within due date as per published tariff or as per Gas sales agreement signed with respective customers. The late payment charges are fixed amount in case of domestic customers (irrespective of the days of delay) and variable percentage in case of other categories of customers on overdue amount for delayed days.

4. As informed by the querist, during the financial year 2018-19, the company has collected Rs. 19.70 crores as late payment charges broken up into Rs. 8.24 crores from domestic customers and Rs. 11.46 crores from industrial and commercial customers. This has been accounted and disclosed as 'Interest Income' under the head 'Other Income' in the annual accounts. An extract of the financial statements has been provided as below:

[1] Opinion finalised by the Committee on 21.11.2019.

"Note 31

OTHER INCOME (Rs. in Crores)

Particulars	For the year ended 31st March, 2019	For the year ended 31st March, 2018
Interest Income (including interest on tax refunds Rs. 55.29 Crores, Previous year Rs. 0.53 Crores)*	**98.61**	**27.77**
Provisions no longer required written back	2.91	0.55
Profit/(Loss) on sale as scrap and diminution in Capital Inventory	-	0.53
Other Non-Operating Income	9.76	6.83
Total	**111.28**	**35.68**

*Includes interest income on deposits, staff advances, employee loans and delayed payments from customers.

Detailed break-up of interest income of the company is as below:

(Rs. in Crores)

Sr. No.	Other Interest (including interest on income tax refunds)	for the year ended 31st March - 2019	for the year ended 31st March - 2018
1	Late payment charges – Customer	8.24	8.22
2	Interest on delayed payment - Customer	11.46	6.75
	Interest income from customers for delayed payment	**19.70**	**14.97**
3	Interest On Income Tax Refund	55.29	0.53
4	Interest on Fixed Deposits / Bank Balances	23.27	11.76
5	Interest income - others (on loan & advances & deposits)	0.34	0.50
	Total	**98.61**	**27.77**

5. The querist has stated that the treatment in the statement of cash flows is as follows:

A. Late payment charges and interest on late payment charges

In the statement of cash flows, the late payment charges and interest on late payment charges Rs. 19.70 crores have been adjusted as non-cash item from net profit before tax for determining Cash flow from Operating Activities. Further, since the income has been shown as a non-operating income, for the purposes of statement of cash flows, it has been classified under the head 'Cash flow from Investing Activities'.

B. Other interest income including interest on income tax refunds

In the statement of cash flows, other interest income including interest on income tax refunds of Rs. 55.29 crores has been adjusted as non-cash item from net profit before tax for determining 'Cash flow from Operating Activities'. Further, since the income has been shown as a non-operating income, for the purposes of statement of cash flows, it has been classified under the head 'Cash flow from Investing Activities'.

6. The querist has informed that the Office of Comptroller and Auditor General of India **(**C&AG) had conducted the supplementary audit of annual accounts of the company under section 145(6)(b) of the Companies Act, 2013 and issued the following comment on the annual accounts for the financial year 2018-19 vide letter dated 09.07.2019 (Copy of comments received from C&AG Office has been supplied by the querist for the perusal of the Committee):

Statement of Cash Flows

*Net Cash Flows from Investing Activities – (*Rs*. 604.19 crores)*

Interest Received – Rs. 95.83 crores

The above includes interest income of Rs. 19.70 crores comprising of late payment charges of Rs. 8.24 crores and interest on late payment charges Rs. 11.46 crores collected from domestic, industrial and commercial customers. The same has been adjusted as non-cash item from net profit before tax for determining 'Cash flow from Operating Activities' and has been classified under the head of Cash flow from Investing Activities.

As late payment charges and interest on late payment charges of Rs. 19.70 crores pertain to the operational activities of the company, the same should have been classified under the head of Cash flow from Operating Activities instead of Cash flow from Investing Activities.

This has resulted in understatement of Cash flow from Operating Activities and overstatement of Cash flow from Investing Activities by Rs. 19.70 crores.

7. *Company's views:* In the statement of cash flows, the late payment charges and interest on late payment charges have been adjusted /deducted as Other items for which the cash effects are investing or financing cash flows from 'Net profit before tax' for determining 'Cash flow from Operating Activities' and has been classified under the head of 'Cash flow from Investing Activities' based on the following grounds:

(i) Paragraphs 31 and 33 of Indian Accounting Standard (Ind AS) 7, 'Statement of Cash Flows', provide as follows:

"Interest and dividends

31 Cash flows from interest and dividends received and paid shall each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial institution should be classified as cash flows arising from operating activities. *In the case of other entities, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities."*

"33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. *However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments."*

In reference to the above definition and provisions of Ind AS, *it is more appropriate that interest received is classified as investing cash flows, because they are costs of obtaining financial resources or returns on investments.*

(ii) Paragraph 9.2 of the Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013 (revised July, 2019 Edition), issued by the Institute of Chartered Accountants of India (ICAI), *inter alia*, states that "…'Other Income' shall be classified as: (a) Interest Income …

Ind AS 107, paragraph 20(b) requires total interest revenue calculated using the effective interest method for financial assets that are measured at amortized cost and that are measured at FVOCI, to be shown separately.

Accordingly, 'Interest Income' for financial assets measured at amortized cost and for financial assets measured at FVOCI, calculated using effective interest method, should be presented in separate line items under 'Other Income'."

Based on the above guidance, the company has consistently followed the practice to present interest income as part of 'Other Income'.

Further, with respect to 'other income', the Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013 (paragraph 9.2.2) provides that all *kinds of interest income for a company other than a finance company should be disclosed under 'Other Income'. Examples of other income are interest on fixed deposits, interest from customers on amount overdue, etc.*

(iii) Paragraph 9.1.8 of the Guidance Note on Division II - Ind AS Schedule III to the Companies Act 2013 provides that, "The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from the sale of products or rendering of services. *Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities."*

Further, paragraph 14 of Ind AS 7, 'Statement of Cash Flows', states that "Cash flows from operating activities are *primarily derived from the principal revenue- producing activities of the entity. …".* Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Hence the interest received of ₹ 19.70 crores collected from customers towards interest on late payment charges is not the principal operating revenue-producing activities of the company.

(iv) Further, Trade receivable is treated as financial assets in financial statements prepared under Ind AS and overdue amount after due date is an indirect way of financing the customer. The late payment interest charges would presumably be based on calculations using effective Interest method (EIR) which is under Ind AS 109 and accordingly, 'Interest Income' for financial assets should be presented in separate line items under 'Other Income'.

Further, paragraph 65 of Ind AS 115, 'Revenue from Contracts with Customers' states that, "an entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of profit and loss. Interest revenue or interest expense is recognised only to the extent that a *contract asset* (or receivable) or a contract liability is recognised in accounting for a contract with a customer". It does not define operating or non-operating. Hence, based on the Guidance Note on Schedule III and Ind AS, the company opted to show this as non-operating since these were infrequent. This policy has been consistently followed, as management is of the view that this presents the true and fair picture.

(v) Further, the same treatment has been given by other entities for interest and late payment charges collected from customers towards overdue outstanding; and same are treated as 'other income' and disclosed under 'Cash Flow from Investing Activities' in the Statement of Cash Flows.

Accordingly, the company has classified the interest received of ₹ 19.70 crores collected from customers towards interest on late payment charges as 'Cash Flow from Investing Activities'. Further, the company has been following the same practice consistently.
(Emphasis supplied by the querist.)

B. Query

8. On the basis of above, the company has sought the opinion of the Expert Advisory Committee of the ICAI as to whether the disclosure already given by the company relating to interest income collected from customers towards late payment charges as interest received in the statement of cash flows (adjusted as non-cash item from net profit before tax for determining Cash Flow from Operating Activities and has been classified under the head of Cash Flow from Investing Activities) is in order or not. If not, then what is the correct disclosure/classification of the same?

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to the disclosure of interest income collected from customers towards late payment charges/delayed interest charges (hereinafter referred to as 'the late payment charges') in the statement of cash flows. 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, presentation and disclosure in the statement of profit and loss, measurement of late payment charges, timing of recognition, accounting for interest on income tax refunds, determination of transaction price, separation of financing component or other aspects for revenue recognition/ measurement under Ind AS 115, initial recognition/measurement of the receivables, detailed aspects related to calculation of interest income, timing of recognition, applicability of Ind AS 114, 'Regulatory Deferral Accounts' and Ind AS 116, 'Leases' (as the same have not been specifically referred to by the querist in the extant case), etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time. Further, the opinion issued is purely from accounting perspective and not from the perspective of legal interpretation of Tariff Regulations or gas sales agreement, etc.

10. The Committee notes that in order to determine the appropriateness of presentation of this income, it is necessary to evaluate the nature of late payment charges. In this context, the Committee notes from the Facts of the Case that the company charges late payment charges/delayed interest charge on overdue balances to the customers who have not paid the bill within due date as per published tariff or as per Gas sales agreement signed with respective customers; and that the late payment charges are fixed amount in case of domestic customers (irrespective of the days of delay) and variable percentage in case of other categories of customers. Thus, in case of customers other than domestic customers, the amount of consideration varies due to difference in timing of payments (as the consideration will increase with increase in timing of payment) and therefore, it appears that the late payment interest/charge in such a case is directly linked to the timing of payment by the customers. Therefore, the Committee is of the view that the late payment interest/charge is of the nature of finance income in the case of customers other than domestic customers and should be accounted for and presented accordingly in the financial statements.

11. Having determined that the late payment charges are in the nature of finance income, with regard to presentation in the statement of cash flows, the Committee notes the following requirements of Ind AS 7:

"33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments."

"11 An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities."

From the above, the Committee is of the view that considering the business of the company of distribution of natural gas and that the company is not a financial institution/NBFC, the late payment interest/charge in case of customers other than domestic customers in the extant case, should be presented as 'cash flows from investing activities'.

12. As far as the domestic customers are concerned, the Committee notes that the late payment charges are fixed amount, irrespective of the days of delay and therefore, the Committee is of the view that the company should consider its facts and circumstances to determine as to whether the same, in substance, represents a compensation for time value of money or whether it is compensation for some other element, such as penalty. The Committee is further of the view that to the extent, it represents time value of money, it should be presented as 'cash flows from investing activities', otherwise, it should be considered and presented as 'cash flows from operating activities'.

D. Opinion

13. On the basis of the above, the Committee is of the view that considering the business of the company of distribution of natural gas and that the company is not a financial institution/NBFC, the late payment interest/charge in case of customers other than domestic customers in the extant case should be presented as 'cash flows from investing activities', as discussed in paragraphs 10 and 11 above. As far as domestic customers are concerned, the late payment interest/charge, to the extent, it represents time value of money, should be presented as 'cash flows from investing activities', otherwise, it should be

considered and presented as 'cash flows from operating activities', as discussed in paragraph 12 above.

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Query No. 19

Subject: Accounting for surcharge on delayed payment.[1]

A. Facts of the Case

1. A public sector undertaking (hereinafter referred to as 'the company') owned by the Government of India comes under the administrative control of the Ministry of Coal. The company is engaged in the business of mining of lignite and generation of power.

2. The company has entered into Power Purchase / Sale Agreement with different Electricity Boards (EBs) and DISCOMs. Power is being sold to the said DISCOMs as and when generated. However, billing for the said power sale takes place once in a month. As per the Tariff Regulation of Central Electricity Regulatory Commission (CERC), the purchaser has a right to pay the bill value within 45 days from the date of receipt of bill. In case the purchaser fails to pay the power bill within the allowed 45 days' period, delayed payment surcharge is applicable at a specified rate i.e., 1.5% per month. Similarly, if the purchaser pays the bill within 45 days' period, graded rebate is also allowed based on the date of payment of the bill. Both delayed payment surcharge as well as rebate are as per the tariff (pricing) Guidelines issued by the regulator (CERC).

3. *Accounting for Surcharge*

As per the accounting practice, the rebate allowed to the power purchaser, is adjusted from the sales revenue. However, the surcharge billed / collected is considered as other revenue.

4. The querist has stated that considering the accounting principles and the relevant accounting standards (Ind AS 115), if the revenue activities relate to the main business of the company, the same has to be classified under 'Operating Revenue'.

5. The querist has also stated that the company has also checked the practice followed by other PSUs in this regard. It has been observed that, some of the PSUs operating in the power business are considering the same as 'operating income' whereas some other companies are considering the same as

[1] Opinion finalised by the Committee on 21.11.2019.

'other income'. There is no consistency in the accounting treatment of the said element of revenue among the PSUs of the country.

B. Query

6. In this regard, the querist has sought the opinion from the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issue:

> "When the product pricing guidelines are issued by a regulator allowing provisions both for early payment and late payment of the billed amount, whether the late payment surcharge (billed / received) from the Electricity Boards should be considered under the head 'Operating Revenue' or as 'Other Income' as per applicable Accounting Standards (Ind AS)."

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to presentation and disclosure of late payment surcharge billed to/received from the Electricity Boards in the statement of profit and loss of the company. 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, presentation in the statement of cash flows, accounting for the early payment rebate, determination of transaction price, separation of financing component or other aspects for revenue recognition/ measurement under Ind AS 115, initial recognition/measurement of the receivables, detailed aspects related to calculation of interest income, timing of recognition, applicability of Ind AS 114, 'Regulatory Deferral Accounts' and Ind AS 116, 'Leases' (as the same have not been specifically referred to by the querist in the extant case), etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time. Further, the opinion issued is purely from accounting perspective and not from the perspective of legal interpretation of Tariff Regulations issued by the CERC.

8. With regard to the presentation of late payment surcharge, the Committee notes the following clauses from Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2019:

> **"**59. Late payment surcharge**:** In case the payment of any bill for charges payable under these regulations is delayed by a beneficiary or long term customers as the case may be, beyond a period of 45 days from the date of presentation of bills, a late payment surcharge at the rate of 1.50% per month shall be levied by the generating company or the transmission licensee, as the case may be."

From the above, the Committee notes that the terms for late payment from the day of presentation of bills to customers are expressly provided in the Tariff Regulations, which are binding on both the buyer as well as the company.

9. In the extant case, the Committee notes from the Tariff Regulations, as reproduced above that the amount of consideration varies due to difference in timing of payments, for example, if customer paid within the prescribed period, which is 45 days from the day of presentation of bills, no late payment surcharge would be charged from the customers, whereas if the customer pays beyond the prescribed period, late payment surcharge would be levied. Thus, it appears that the late payment surcharge in the extant case is directly linked to the timing of payment by the customers and is to compensate the entity for the time value of money. Therefore, the Committee is of the view that the late payment surcharge is of the nature of finance income in the extant case and should be accounted for and presented accordingly in the financial statements. The Committee also notes that the company is not an NBFC (Non-banking Financial Company) and thus, the Division III of Schedule III to the Companies Act, 2013 is not relevant. Therefore, as far as presentation of the late payment surcharge is concerned, the Committee notes the following paragraphs from the Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013, issued by the ICAI:

> "9.2 **Other income**
>
> The aggregate of 'Other income' is to be disclosed on face of the Statement of Profit and Loss. As per Note 5 of General Instructions for the Preparation of Statement of Profit and Loss 'Other Income' shall be classified as:
>
> (a) Interest Income;
>
> (b) Dividend Income;
>
> (c) Other non-operating income (net of expenses directly attributable to such income).
>
> Ind AS 107, para 20(b) requires total interest revenue calculated using the effective interest method for financial assets that are measured at amortized cost and that are measured at FVOCI, to be shown separately.
>
> Accordingly, 'Interest Income' for financial assets measured at amortized cost and for financial assets measured at FVOCI, calculated using effective interest method, should be presented in separate line items under 'Other Income'."

From the above and considering the nature of late payment surcharge as that of a finance income, the Committee is of the view that the late payment surcharge in the extant case should be presented as 'other income'.

D. Opinion

10. On the basis of the above, the Committee is of the view that the late payment surcharge in the extant case should be presented as 'other income', as discussed in paragraph 9 above.

———————

Query No. 20

Subject: Accounting clarification on revenue recognition under input method in respect of Manufactured Goods-ready for despatch.[1]

A. Facts of the Case

1. A public sector company (hereinafter referred to as 'the company') has a net worth of Rs. 31,400 crore as on 31.03.2019. 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 EPC contracts (Engineering, Procurement & Construction) or BTG Packages (i.e. Boiler, Turbine and Generator packages). In case of BTG contracts, civil works and Balance of Plant (BOP) package items are not in the scope of the company. 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 company includes supply of equipment, erection, commissioning, synchronizing the plant to the grid, completing the trial operation and proving the guaranteed parameters. In respect to construction contracts, the company transfers control of goods or services to the customer and recognizes revenue over time based on input cost method.

2. The querist has provided following extracts of the accounting policies of the company:

> Accounting Policy No.1(d)(i) states that:
>
> "The Company uses input method based on cost approach in accounting for the revenue in respect of construction contracts. Use of input method

[1] Opinion finalised by the Committee on 10.2.2020.

requires the Company to estimate its costs relative to the total expected costs in the satisfaction of its performance obligation. The estimates assessed continually during the term of the contract and the company re-measures its progress towards complete satisfaction of its performance obligations satisfied over time at the end of each reporting period.

Company updates its estimated transaction price at each reporting period, to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period."

As per Accounting Policy No.8 –

"Revenue is recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

In relation to construction and long term service contracts, the company transfers control of goods or services to the customer and recognizes revenue over the time.

Revenue is recognized using input method based on the cost approach. Progress towards complete satisfaction of performance obligation satisfied over time is re-measured at reporting period end.

Revenue from sale of goods and services is recognized on the transfer of control to the customer and upon the satisfaction of performance obligations under the contract."

3. The querist has referred to the following extracts of the Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers':

"**31 An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset."**

"35 An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3—B4);

(b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or

(c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

36 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs B6—B8 provide guidance for assessing whether an asset has an alternative use to an entity."

"B6 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

B7 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

B8 A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic

loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas."

"37 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs B9—B13 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date."

"B9 In accordance with paragraph 37, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

(a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or

(b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

B10 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity shall consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

B11 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

B12 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

(a) legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer;

(b) relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; or

(c) an entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

B13 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract."

Measuring progress towards complete satisfaction of a performance obligation

"39 For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity's performance obligation).

40 An entity shall apply a single method of measuring progress for each performance obligation satisfied over time and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.

Methods for measuring progress

41 Appropriate methods of measuring progress include output methods and input methods. Paragraphs B14–B19 provide guidance for using output methods and input methods to measure an entity's progress towards complete satisfaction of a performance obligation. In determining the appropriate method for

measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer."

"Input methods

B18 Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis."

"43 As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*."

4. The querist has stated that in respect of construction contracts, the company designs and manufactures equipments which are meant for specific projects and are not interchangeable. Such designed and manufactured items, when complete, are stored at plant before these are despatched to the customer site. These are despatched based on the requirement at the site considering various issues related to proper storage at site, types of contracts being executed etc.

5. The querist has further stated that considering that such items are very specific to the project (as per design and specification of the project agreed with customer) and enforceable right to payment also exists as per the terms & conditions of the contract, the cost of 'manufactured items-ready for dispatch' (for projects), the readiness duly certified by a cross**-** functional committee at the respective Unit and endorsed by Head of the Unit, will also be considered as cost incurred for measuring the progress under input method for recognising revenue over time. These fulfill the conditions necessary for satisfaction of performance obligation as per the criteria of paragraph 35 (c) of Ind AS 115 for recognition of revenue over time.

6. The querist has also stated that such manufactured goods-ready for dispatch are based on design specifications that are unique to a particular project/customer. These will not have alternative use broadly under clause B8 of Ind AS 115. There is a practical limitation to direct such completed asset for

another use as significant economic losses will have to be incurred to direct the asset for another use.

7. According to the querist, though the raw material and work in progress lying at plant may be specific to project but at that stage, there are possibilities of alternative use of such items during the manufacturing process, i.e., until the work is substantially completed. Hence, the management does not consider the conditions under paragraph 35(c) of Ind AS 115 completely fulfilled in respect of such items and therefore, such items are shown as part of inventory and not considered for measuring progress for revenue recognition under input method.

8. The inclusion of cost of manufactured items- ready for dispatch referred in paragraph 5 above is considered appropriate by the company considering the experience of issues relating to site storage, changes in the market scenario, types of contracts being executed etc.

B. Query

9. On the basis of above, the opinion of Expert Advisory Committee has been sought as to whether the approach of the entity for measuring the progress for revenue recognition is appropriate and is in line with Ind AS.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to whether the approach of the company of determination of cost incurred to include the cost of internally manufactured and completed items and equipments which are ready for despatch to customer while measuring progress towards complete satisfaction of a performance obligation under cost-based input method so as to recognize revenue over time under Ind AS 115 is correct or not. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, revenue recognition with regard to any other item either manufactured/completed or work-in-progress/inventory, measurement of revenue, other aspects of Ind AS 115, including, whether there are single or multiple distinct performance obligations, whether it is appropriate to recognize revenue over time in the extant case and whether the company fulfills the conditions under paragraph 35(c) of Ind AS 115, whether inputs method of measure of progress is appropriate in the extant case, etc.

11. The Committee notes from the Facts of the Case that in the extant case in respect of items manufactured for certain specific construction contracts for which the issue has been raised, the company's performance does not create an asset with alternative use to the company and the enforceable right to payment also exists as per the terms and conditions of the contract. Accordingly, in respect of such contracts, the conditions necessary for satisfaction of performance obligation as per the criteria of paragraph 35(c) of Ind AS 115 for

recognition of revenue over time get fulfilled and therefore, the company recognises revenue over time for these contracts. Without getting into the examination of the above criteria being fulfilled or not and the accounting treatment being followed by the company in this regard, the Committee notes that as per the Standard, when it is determined that a performance obligation is satisfied over time, an entity is required to select a method to measure progress so as to recognise revenue over time. In this context, the Committee notes that the company has selected input method based on cost incurred to measure progress. The issue now, is with regard to the approach of determination of cost incurred to include the cost of internally manufactured and completed items and equipments which are ready for despatch to customer while measuring progress under cost-based input method so as to recognize revenue over time under Ind AS 115.

12. With regard to the approach of inclusion of cost of items/equipments manufactured and ready for dispatch in the 'cost incurred' under input method of measuring progress towards satisfaction of performance obligation under the contract, the Committee notes paragraphs 39, 41, 42, B14 and B18 as follows:

> "39 For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity's performance obligation)."
>
> "*Methods for measuring progress*
>
> 41 Appropriate methods of measuring progress include output methods and input methods. Paragraphs B14–B19 provide guidance for using output methods and input methods to measure an entity's progress towards complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.
>
> 42 When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation."

"B14 Methods that can be used to measure an entity's progress towards complete satisfaction of a performance obligation satisfied over time in accordance with paragraphs 35–37 include the following:

(a) output methods (see paragraphs B15–B17); and

(b) input methods (see paragraphs B18–B19)."

"B18 Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis."

The Committee notes from paragraph 39 of Ind AS 115 that an entity should recognise revenue over time by measuring the progress towards complete satisfaction of performance obligation and while measuring progress, the objective is to depict an entity's performance in transferring control of goods or services promised to a customer. Paragraph B18 states that under input method, revenue is recognised on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation, for example, costs incurred relative to the total expected inputs/cost to the satisfaction of that performance obligation. Further, the Committee notes that in the extant case, the conditions of paragraph B 19 of Ind AS 115 are not met as these items and equipments are manufactured and designed internally by the company for specific projects and are not simply procured from a third party Rather, cost of these items, since reflect the company's efforts or inputs to the satisfaction of performance obligation as per the contract with the customer, the cost incurred thereon should be included in the measure of progress of the performance.

D. Opinion

13. On the basis of above, the Committee is of the opinion on the issues raised in paragraph 9 above, the approach of the company with regard to the inclusion of the cost of manufactured and completed items and equipments that are ready for dispatch to customer's site as 'cost incurred' under inputs method of measuring the entity's progress towards complete satisfaction of a performance obligation is correct under Ind AS 115, as discussed in paragraph 12 above.

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PART II:
Opinions on Accounting Standards

Query No. 21

Subject: Whether the arrangement is in nature of Operating Lease or Finance Lease.[1]

A. Facts of the Case

1. M/s ABC has been constituted as a statutory authority under the Airports Authority of India Act, 1994. It has been created by merging the erstwhile International Airports Authority of India and National Airports Authority of India.

2. The querist has informed that the main functions of M/s ABC are as under:

- Control and management of the Indian airspace (excluding special user airspace) extending beyond the territorial limits of the country, as accepted by International Civil Aviation Organization (ICAO).
- Provision of communication, navigational ad surveillance aids.
- Expansion and strengthening of operational areas, viz. runways, aprons, taxiways etc. and provision of ground based landing and movement control aids for aircrafts and vehicular traffic in operational area.
- Design, development, operation and maintenance of passenger terminals.
- Development and management of cargo terminals at international and domestic airports.
- Provision of passenger facilities and information systems in the passenger terminals.

3. M/s ABC operates 129 Airports comprising of 23 International Airports, 77 Domestic Airports, 9 Customs Airports and 20 Civil Enclaves at Defence Airfields. M/s ABC prepares its annual accounts as per the format notified by the Ministry of Civil Aviation vide notification dated 27th March, 2014 framed under the Airports Authority of India (Annual Report and Annual Statement of Accounts) Rules 2014 which is aligned to the format of accounts as per schedule III to the Companies Act, 2013 and all mandatory Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) are followed. The querist has further informed that the Comptroller and Auditor General of India (C&AG) is the sole auditor of M/s ABC.

4. The querist has further informed that M/s ABC has placed supply orders for supply, installation, testing, commissioning and comprehensive maintenance of X-Ray baggage inspection system (XBIS) for registered baggage and hand

[1] Opinion finalised by the Committee on 13.6.2019.

baggage on BOT (Build, Own and Transfer) model for 06 years at various airports in India to the following 2 supplier companies:

	Name of the Company	Contract value
1	Company 1	Rs.110.41 crores
2	Company 2	Rs. 46.99 crores

(The copies of work orders in this regard have been separately supplied by the querist for the perusal of the Committee.)

5. *Accounting treatment given by M/s ABC for the contracts under reference:* As the ownership of the asset as well as risks and rewards relating to the assets remain with the supplier during the term of lease (though there is a provision for transfer of assets to M/s ABC on successful completion of lease period of six years free of cost), M/s ABC has treated these contracts as operating lease considering the substance and the stipulations under Accounting Standard (AS) 19, 'Leases'.

6. *C&AG Para on the accounting treatment given by M/s ABC for these contracts in 2017-18 accounts while conducting the audit of annual accounts of M/s ABC for the financial year (F.Y.) 2017-18:*

C&AG while conducting the audit of annual accounts of M/s ABC for the F.Y. 2017-18 has observed that the contracts under reference should have been treated as finance lease considering the substance of the contract instead of operating lease as reckoned by M/s ABC. The Comments of C&AG and the management reply thereon are as follows:

Comments of C&AG:

"Half Margin No: 03
Balance Sheet
Assets
Non-Current Assets

As per Accounting Standard 19 'Leases', a lease 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 lease may be finance lease or an operating lease and transaction and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

A lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations

which would normally lead to a lease being classified as a finance lease are:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) The lease term is for the major part of the economic life of the asset even if title is not transferred;

(c) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee; etc.

In case of finance lease, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the lease. Further, if there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; other asset is depreciated over the lease term or its useful life, whichever is shorter. If the above conditions are not fulfilled, the lease should be classified as operating lease.

(On review of records, it was noticed that M/s ABC vide its work order dated 22nd March 2017 awarded the work of supply, installation, testing, commissioning (SITC) & comprehensive maintenance of XBIS (Registered Baggage and Hand Baggage) on BOT (Build, Own and Transfer) model for six years to two foreign companies at a total cost of Rs.157.40 crore. Further, review of contract reveals that as per terms and conditions of the contract, on successful completion of six years, the assets in serviceable condition shall be taken over by M/s ABC at free of cost, the term of the lease is for major part of the economic life of the asset and in the event of termination of the contract due to unsatisfactory performance/ poor maintenance, the equipment shall be taken over by M/s ABC for which the contractor shall be paid depreciated cost of the equipment minus 30 *per cent* of the lease amount from the total lease amount already paid to the contractor as penalty. The depreciation would be at the rate of 20 *per cent* per annum on the original cost of the equipment. Thus, as can be seen from above and considering the substance over legal form as stipulated in AS 19, the aforesaid transaction of procurement of XBIS on BOT basis should have been classified as finance lease instead of treating the same as operating lease.

This has resulted in understatement of 'Non-Current Assets' and 'Liability' by Rs.157.40 crore. Consequently, depreciation is understated by Rs.0.89 crore (Depreciation – Rs.8.66 crore minus R&M Expenses on XBIS

already booked – Rs.7.77 crore) and profit for the year is also overstated to the same extent.

Moreover, the disclosure requirement as per AS 19 of disclosing the lease payments as not later than one year, later than one year and not later than five years and later than five years is also not made in the notes to the accounts.

The above facts and figures may please be confirmed, while furnishing the reply to the

Half Margins within three working days."

Management reply:

"In the given case the asset is owned by the supplier till the end of the lease term. Also, as per the terms of the Service Level Agreement (SLA) the risk attributable to the asset remains with the supplier. Attention is invited to the following clauses appearing in the SLA namely:

a) Paragraph 9.1 read with 9.2: Contractor shall provide the serviceability of 99% on all the equipment on monthly basis. Penalty shall be levied for delay, beyond the prescribed time for serviceability of the equipment. In case of partial/complete failure of the equipment, on expiry of prescribed limit, recovery shall be made @125% of daily lease maintenance charges per XBIS.

b) If the availability of the system or part thereof , is below 95% on monthly basis, continuously over a period 6 months, M/s ABC reserves right to terminate the contract…..'

Hence, in effect the risk resides with the supplier and he has to maintain high standards of serviceability at all times (99% on all equipment on monthly basis and ensure availability of equipment too).

As per AS 19:

i) Paragraph 3.2: "A financial lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset."

ii) Paragraph 3.3: "An operating lease is a lease other than a finance lease."

Hence, as the ownership of the asset and the risk attributable to asset resides with the supplier during the term of lease and is obliged to ensure 99% serviceability of the equipment, the lease has been classified as operating lease in the books of M/s ABC.

As regards disclosing the lease payments it is assured that adequate disclosure as desired by the Audit will be made in the books of account from next F.Y. onwards.

In view of the above Audit is requested to kindly drop the Para."

7. The querist has informed that while discussing the audit paragraphs issued by C&AG, an assurance was given by M/s ABC that in view of difference of opinion between M/s ABC and C&AG on the accounting treatment given for the contracts under reference, M/s ABC will refer the issue to the ICAI for its considered opinion and necessary action as per the opinion given by ICAI in this regard will be taken by M/s ABC in its annual accounts for the F.Y. 2018-19. (The copies of relevant clauses of the Agreement containing salient features have been supplied separately by the querist for the perusal of the Committee)**.**

8. The querist has separately informed the following:

(a) The opinion is sought from the perspective of Accounting Standards, issued by the ICAI.

(b) The terms and conditions of the agreement/contract entered into in respect of XBIS with both the companies are same.

(c) With regard to whether at the inception of the lease, the present value of minimum lease payments amounts to at least substantially all of the fair value of the leased asset, the querist has stated that while considering the proposal of 'Supply, Installation, Testing, Commissioning and Comprehensive Maintenance (SITC)' of XIBS for administrative approval and expenditure sanctioned the present value of capital model cost and present value of BOT model cost were compared and the NPV of BOT model as worked out was economical. (Copy of the Board Note/Minutes in this regard has been provided separately by the querist for the perusal of the Committee.)

(d) The economic life of leased asset i.e. XBIS is nine years.

B. Query

9. In view of above, the querist has sought the opinion of the Expert Advisory Committee as to whether the work orders issued by M/s ABC on the two supplier companies and subsequent contract entered into for Supply, Installation, Testing, Commissioning and Comprehensive Maintenance of XBIS (Registered and Hand Baggage) on BOT (Build, Own and Transfer) model for 06 years at various airports in India should be treated as operating lease or finance lease by M/s ABC.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to whether the afore-mentioned arrangement with the two supplier companies for XBIS machines (hereinafter referred to as 'the asset') is operating lease or finance lease. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, measurement of fair value of the leased asset and minimum leased payment, appropriateness of calculations of net present value as performed by M/s ABC while considering the proposal of SITC of XBIS, accounting for the servicing and maintenance of the equipment component, as embedded in the contract, etc. Further, since AS 19, issued by the Institute of Chartered Accountants of India (ICAI) has been referred to in the Facts of the Case and the querist has also separately informed that mandatory Accounting Standards as issued by ICAI are being followed by M/s ABC, the Committee has expressed its views, hereinafter in the context of Accounting Standards, issued by the ICAI only and not the Accounting Standards or Indian Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 or Companies (Indian Accounting Standards) Rules, 2015. The Committee also wishes to point out that the query has been raised in the context of work orders/contract issued by M/s ABC to/with two supplier companies, however, as confirmed by the querist, all the terms and conditions of the Agreement/Contract entered into in respect of XBIS with both the companies are same. Therefore, the Committee has examined various terms and conditions of the agreement/contract with the company 1 only and not for company 2.

11. The Committee notes the following clauses of the Agreement with the supplier company, as submitted by the querist:

> *Clauses from Tender documents forming part of the contract agreement with Supplier:*
>
> Section B: Terms & Conditions
>
> 5 Delay & non-conformance
>
> 5.1 In case of time schedule including approved delay with or without levy of liquidated damage, for late delivery of supplies or late completion of training, whichever if applicable, as contained in Para 2 & 3 above, not being adhered to, M/s ABC has shall have the right to cancel the order wholly or in part thereof, without any liability of cancellation charges and shall have right to procure the goods / services elsewhere in which case the bidder firm shall pay for the loss to M/s ABC the difference in the cost of goods

procured elsewhere against price set forth in the purchase order with the bidder firm.

8. Termination of contract at purchaser's initiative

8.1 M/s ABC reserves the right to terminate the contract either in part or in full due to the reason other than specified herein in this tender, in fact not for convenience. Then M/s ABC shall in such an event give THIRTY calendar days' notice in writing to the bidder firm of their decision to do so.

13. PRICE

13.1 The bidder firm shall confirm that quoted prices shall be firm and subject to no escalation whatsoever till the validity period of the tender/contract.

16. TRANSFER OF ASSETS

M/s ABC shall take over all the equipment and accessories in fully serviceable condition at the end of the lease period at free of cost, and the successful bidder shall maintain the equipment and accessories for a period of SIXTY (60) days from the last date of end of lease period without any extra charges.

17.8 Even after supplementary FAT, if the equipment is found not in conformance to tender technical requirements stipulated in Section-C of this tender, then M/s ABC shall cancel the contract and shall resort to action given in Section B – Para 5, 6, 8 and 12.

Section C: SOW, Technical and Qualitative Requirements of Tender Document

1.4 The system shall be designed for continuous operation. The design life of the equipment shall be a minimum of SEVEN years.

2. Scope of Work

2.1 The Scope of work includes Supply, Installation, Testing, Commissioning & Comprehensive Maintenance of X-Ray Baggage Inspection (Registered and Hand Baggage) at various Airports in India for SIX years under BOT (Built Own and Transfer) model as per terms, conditions and specifications of this tender. …

…

The Lease period shall be for Six years. After successful completion of lease period, the equipments which shall be in serviceable condition, be taken over by M/s ABC at free of cost.

Scope of work also includes any up-gradation of the software, hardware for the equipments supplied, released by OEM during lease period. Any software patches required for satisfactory operation of the equipment shall be provided by the contractor, free of cost.

7.22 If at any stage the contractor fails to provide satisfactory service, M/s ABC shall terminate the contract by giving one month's notice and treated as unsatisfactory performance and dealt with as per the clause No. 7.32 (i) and 7.32 (ii).

7.32 i. In case of poor maintenance and unsatisfactory performance, M/s ABC shall terminate the contract by giving one month notice and debar the contractor for further participation in M/s ABC tender for the period of 03 (Three) years.

ii. In the event of termination of the contract due to unsatisfactory performance/ poor maintenance, the equipment shall be taken over by M/s ABC for which the contractor shall be paid depreciated cost of the equipment minus 30% of the lease amount from the total lease amount already paid to the contractor as penalty. The depreciation is at the rate of 20 % per annum on the original cost of the equipment.

Section I: Eligibility Requirements

8. Eligibility details and undertakings

8.2 In case of OEM firm, proof of being Original Equipment Manufacturer (OEM) for the offered X-ray Baggage Inspection System shall be submitted. OEM firm shall also submit an undertaking (Annexure- X) that the offered product(s) are not declared obsolete or end-of-life by OEM, and shall undertake to provide spares, sales, service and software support, in India for the life-time of the equipment i.e. estimated to be SEVEN years.

Clauses of work order with company 1:

9.0 Service level agreement (SLA)

9.2 Penalty: Penalty shall be levied for the delay, beyond the prescribed time for serviceability of the equipment. In case of partial/ complete failure of the equipment, on expiry of prescribed time limit. Recovery shall be made @125% of the daily lease maintenance charges per XBIS per day for each XBIS from the quarterly bill of running quarter.

9.3 However, if suitable fully functional replacement is provided in place of faulty equipment within prescribe time, no penalty shall be levied. The original equipment has to be reinstated at site after the repairs at the earliest. The total penalty within the scope of this contract shall not exceed 10% of the total contract value.

12. The Committee notes the following paragraphs from Accounting Standard (AS) 19, 'Leases', issued by the Institute of Chartered Accountants of India:

"5. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

6. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership."

"8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

   (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

   (b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

   (c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent."

13. From the above, the Committee notes that the classification of lease depends upon the extent to which risks and rewards incident to ownership of a leased asset lie with lessor or lessee. Therefore, a key criterion to determine the type of lease is whether or not it transfers substantially all the risks and rewards incident to ownership. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Further, paragraphs 8 and 9 of AS 19 contains certain examples of situations and indicators which would normally lead to a lease being classified as finance lease, such as, transfer of ownership of the asset by the end of lease term, option to purchase the asset at the end of the lease term at a price sufficiently lower than the fair value at the date the option becomes exercisable, major part of the economic life of the asset is covered by the lease term, present value of minimum lease payments amounts to at least substantially all of the fair value of the leased asset, conditions for cancellation, gains or losses from the fluctuation in the fair value of the residual, continuation of lease for a secondary period at a substantially lower rent etc. Thus, classification of an arrangement as operating or finance lease requires exercise of judgement based on evaluation of facts and circumstances in each case, by considering the indicators/factors enumerated above.

14. The Committee notes from the Facts of the Case that as per the terms and conditions of the work order/Agreement, M/s ABC shall take over asset at the end of lease period of six years, free of cost, as a result, the lease transfers ownership of the asset to the lessee by the end of the lease term, which is one of the key criteria of classification of leases into finance lease. Also, M/s ABC will use the asset for the entire economic life of the asset. Further, the payments decided in advance at the beginning of the lease are fixed and subject to no changes/escalation irrespective of any change in the value of the asset under lease. Thus, the resultant gain/loss from appreciation or depreciation in the value of the leased asset is borne by the lessee, viz., M/s ABC. Accordingly, the Committee is of the view that the rewards in the form of expectation of profitable

operation over the economic life of the asset and of gain from appreciation in value or realization of residual value as enumerated in paragraph 5 of AS 19 vest with M/s ABC (lessee). The Committee also notes that in the extant case, the risks in the form of idle capacity of the leased asset also apparently vest with M/s ABC. Accordingly, the Committee is of the view that considering the above factors, the lease in the extant case would, in substance, satisfy the tests laid down in paragraphs 8 and 9 of AS 19 and hence, would need to be classified as 'finance lease' by M/s ABC, the lessee. The Committee is further of the view that the right of the lessee to cancel/terminate the lease and the clauses relating to 99% serviceability of the leased asset during the lease term (as being contended by the querist in favour of the factors to be considered for operating lease) are only protective clauses to ensure satisfactory performance of the leased asset during the term of the lease and merely on that basis, it cannot be said that the risk attributable to the asset remains with the supplier. Further, the ownership of the asset during the lease term is not a relevant factor for determining the type of lease under AS 19.

D. Opinion

15. On the basis of above, the Committee is of the opinion that the arrangement with the two supplier companies for XBIS machines in the extant case would, in substance, satisfy the tests laid down in paragraphs 8 and 9 of AS 19 and hence would need to be classified as 'finance lease' by M/s ABC, the lessee, as discussed in paragraph 14 above.

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Query No. 22

Subject: Cash basis of accounting by Alternative Investment Fund (AIF).[1]

A. Facts of the Case

1. An Investment Advisory entity has proposed to launch a registered Alternative Investment Fund (AIF) under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.

Structure of AIF:

2. The querist has stated that the AIF is defined as any fund that is

- established or incorporated in India in the form of a trust or a company or a limited liability partnership (LLP) or a body corporate;

[1] Opinion finalised by the Committee on 10.2.2020.

- is a privately pooled investment vehicle;
- collects funds from investors (Indian or foreign investors);
- invests in accordance with a defined investment policy for the benefit of its investors.

The querist has informed that the AIF in the extant case is formed as a 'trust' under Indian Trusts Act, 1882 and is not a body corporate.

3. In relation to the method of accounting that needs to be followed by AIF, the querist has analysed various legal and regulatory requirements as follows:

Regulations/Act	**Requirements**
SEBI AIF Regulations	Nothing has been prescribed.
Indian Income-tax Act, 1961	As per section 145 of the Act: - Income chargeable under the head 'Profits and gains of business or profession' or 'Income from other sources' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. - The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.
Accounting Standards	Accounting Standard 1 - If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

	Accounting Standard 9 - It is reiterated that this Accounting Standard assumes that three fundamental assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of the financial statements. Accounting Standard 13 - Excludes Mutual Funds and venture capital funds and/or related asset management companies, banks …

4. The querist has also stated that the purposes of financial statements of AIF are:

- Filing of tax returns;
- Circulation to investors for recording their income and filing returns.

SEBI (AIF) Regulations require that "the books of accounts of the Alternative Investment Fund shall be audited annually by a qualified auditor". However, the Regulations do not have any prescriptive guidelines in respect of accounting i.e., accounting framework (AS or Ind ASs), accrual vs. cash basis of accounting, to be followed by the entity.

5. The querist has referred to the following Authoritative Guidance:

Accounting Standards

Accounting Standard (AS) 1, Disclosure of Accounting Policies:

"10. The following have been generally accepted as fundamental accounting assumptions:-

a. Going Concern

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

b. Consistency

It is assumed that accounting policies are consistent from one period to another.

c. Accrual

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this standard.)"

"27. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed."

As per the querist, it can be seen from the above that an entity is permitted to use cash basis of accounting as per AS 1. The only fact that needs to be ensured is that where cash basis of accounting has been followed by an entity that fact needs to be disclosed in the financial statements.

It is important to note that an AIF is a non corporate entity to which Companies Act, 2013 is not applicable.

Announcements of the Council Regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India:

"**V. Mandatory Application of Accounting Standards in respect of Certain Noncorporate Bodies**

1. In May 1991 issue of 'The Chartered Accountant', an announcement was carried regarding the decision of the Council of the Institute of Chartered Accountants of India to defer the mandatory application of Accounting Standards 1, 7, 8, 9, 10 and 11 to accounts for periods beginning on or after 1.4.1993, in respect of the following:

(a) Sole proprietary concerns/individuals

(b) Partnership firms

(c) Societies registered under the Societies Registration Act

(d) Trusts

(e) Hindu Undivided Families

(f) Associations of persons.

2. The matter was re-considered by the Council at its meeting held in September, 1993 and it was decided, in partial modification of the earlier decision, that the aforesaid Accounting Standards (except Accounting

Standard 11, which has already been withdrawn), shall mandatorily apply in respect of general purpose financial statements of the individual/bodies listed at (a) - (f) above for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. It may be reiterated that the Institute issues Accounting Standards for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term "General Purpose Financial Statements" includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/members, creditors, employees and public at large.

3. According to Accounting Standard 1, Disclosure of Accounting Policies, 'accrual' is one of the fundamental accounting assumptions. The Standard requires that if any fundamental accounting assumption is not followed in the preparation and presentation of financial statements, the fact should be disclosed. Accordingly, in respect of individual/bodies covered by para 1 above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no *statutory requirement* for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual' the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/ qualifications in his audit report accordingly.

4. An example of a disclosure in the audit report of an enterprise which follows cash basis of accounting is given below:

> "It is the policy of the enterprise to prepare its financial statements on the cash receipts and disbursements basis. On this basis revenue and the related assets are recognised when received rather than when earned, and expenses are recognised when paid rather than when the obligation is incurred.

> In our opinion, the financial statements give a true and fair view of the assets and liabilities arising from cash transactions of ..... at ..... and of the revenue collected and expenses paid during the year then ended on the cash receipts and disbursements basis as described in Note X.""

According to the querist, as can be seen from the above with respect to the accounting principles followed by an AIF:

- Being a trust, AIF can follow cash basis of accounting.
- Such financial statements prepared will be 'general purpose financial statements'.
- In cases where there is no mandatory requirement to prepare the financial statements on 'accrual' basis of accounting then such fact would need to be mentioned in the financial statements and in the audit report without it being the subject matter of a qualification in the auditors report.

The querist has stated that as can be seen that the Institute of Chartered Accountants of India has given detailed prescriptive guidelines on the use of cash basis of accounting for certain class of enterprises. As can be noted from the above that there is no regulation that mandates the use of 'accrual' basis of accounting for an AIF and hence the use of 'cash basis' of accounting should be permissible.

> **"XVII. Applicability of Accounting Standards**
>
> The Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and Medium Sized Enterprises (SMEs). The Council decided the following scheme for applicability of accounting standards to SMEs. This scheme comes into effect in respect of accounting periods commencing on or after 1-4-2004.
>
> 1. For the purpose of applicability of Accounting Standards, enterprises are classified into three categories, viz., Level I, Level II and Level III. Level II and Level III enterprises are considered as SMEs. The criteria for different levels are given in Annexure I.
>
> 2. Level I enterprises are required to comply fully with all the accounting standards.
>
> 3. It has been decided that no relaxation should be given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements.

> Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements are given. The exemptions/ relaxations are decided to be provided by modifying the applicability portion of the relevant accounting standards. Modifications in the relevant existing accounting standards are given in Annexure II."

The querist has stated that it can be seen from the above, for all enterprises (i.e. Level I, Level II and Level III) there is no exemption from the recognition and measurement principles as laid down in the accounting standards. Hence, this Announcement would require that all enterprises need to follow the recognition and measurement principles of all Accounting Standards in their entirety.

Guidance Notes

The querist has stated that the concept of use of cash basis of accounting is well enshrined in the guidance notes issued by the Institute of Chartered Accountants of India. Relevant guidance notes which the querist has referred to in this regard are:

- Guidance Note on Accrual Basis of Accounting
- Guidance Note on Educational Institutes[2]
- Guidance Note on Accounting and Auditing of Political Parties

The querist has emphasised that as detailed above, AS 1 permits the use of cash basis of accounting. A footnote to AS 9 gives further context to applicability of other accounting standards in cases where cash basis of accounting is followed, which provides that "It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements."

Hence, the accounting standards mandated by the Institute envisage the scenario that other accounting standards may not have applicability where a fundamental accounting assumption is not followed.

A similar reference can also be drawn where another fundamental accounting assumption is not followed (viz. going concern). Where financial statements are prepared on other than going concern basis, there are departures from the accounting standards laid out by the ICAI.

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[2] It is noted that there is no such Guidance Note namely, Guidance Note on Educational Institutes; however, there is a Guidance Note on Accounting by Schools.

6. The querist also reproduced paragraph 3.3 of the 'Preface to the Statements of Accounting Standards', issued by the Institute of Chartered Accountants of India (ICAI), as follows:

> "3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature."

The querist re-iterates the views expressed above that, AS 1 permits the use of cash basis of accounting. A footnote to AS 9 gives further context to applicability of other accounting standards in cases where cash basis of accounting is followed – "It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements."

And hence, as per the querist, the use of cash basis of accounting cannot be construed as not following accounting standards. An entity following cash basis of accounting, follows accounting – by definition – on receipts and payments basis. Since, the entity does not follow accrual basis of accounting, rather follows cash basis of accounting, it cannot be said that an entity is not following the accounting principles as detailed by the Institute of Chartered Accountants of India.

Further, the option to not follow a fundamental accounting assumption is enshrined in AS 1 and an entity that follows cash basis of accounting necessarily cannot follow all the other accounting standards in its entirety. The fact is also acknowledged by the Institute by way of footnote to AS 9.

Hence, the querist is of the view that in respect of AIFs, it is permissible to follow cash basis of accounting and prepare general purpose financial statements with adequate disclosures in the financial statements.

B. Query

7. On the basis of above, opinion of the Expert Advisory Committee has been sought as to whether an alternative investment fund (AIF) can prepare and present general purpose financial statements by opting 'cash basis of accounting'.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether the Alternative Investment Fund (AIF) can prepare and present general purpose financial statements by opting cash basis of accounting. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, disclosures under AS 1, AS 9 and other standards, manner of reporting by auditor in the auditor's report, etc. Further, the opinion issued is purely from accounting perspective and not from the perspective of legal interpretation of Indian Trusts Act, 1882, Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012, Income-tax Act, 1961 etc. At the outset, the Committee wishes to point out that since the querist has referred to the Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) in the facts supplied, the Committee has expressed its views considering the same.

9. In order to address the basic issue raised, the Committee considers it appropriate to first evaluate the legal and regulatory requirements applicable to the entity. Secondly, the Committee also considers it necessary to evaluate the purpose and objective of financial statements. As far as legal and regulatory requirements are concerned, the Committee notes from the Facts of the Case that the AIF in the extant case has been formed as Trust and the Trust has been formed under the Indian Trusts Act, 1882. The Committee notes that section 19 of the Indian Trusts Act, 1882 states as follows:

> "19. Accounts and information.-A trustee is bound (a) to keep clear and accurate accounts of the trust-property, and (b), at all reasonable times, at the request of the beneficiary, to furnish him with full and accurate information as to the amount and state of the trust-property."

From the above, the Committee notes that the Act does not provide anything in this respect of accounting standards or basis of accounting to be followed.

The Committee also notes that the AIF in the extant case is also regulated by Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (hereinafter referred to as AIF Regulations), of which clause 20(5) under Chapter IV, 'General Obligations and Responsibilities and Transparency' provides as follows:

> "(5) The books of accounts of the Alternative Investment Fund shall be audited annually by a qualified auditor."

Thus, the AIF Regulations require the books of account of AIF to be audited. The Committee also notes that the said AIF Regulations are silent on the basis of accounting or Accounting Standards to be followed by AIF.

The Committee also notes the prescriptions of Securities and Exchange Board of India (SEBI) in relation to similar asset or fund management schemes, for example, SEBI (Mutual Funds) Regulations, 1996 requires mutual funds to follow various accounting standards issued by the ICAI, such as, Accounting Standard (AS) 9, Accounting Standard (AS) 10, Accounting Standard (AS) 29, etc.; prescribe to measure certain assets at their fair value; and also prescribe to provide for bad and doubtful debts, depreciation, etc. Similarly, SEBI Regulations for Real Estate Investment Trusts (REITs) prescribe that the financial information for the purpose of offer document as well as for continuous disclosure of financial information to stock exchanges, shall be prepared in accordance with Indian Accounting Standards as defined in Companies (Indian Accounting Standards) Rules, 2015. This indicates that SEBI policies are directed towards use of high quality accounting standards aligned with the global best practices.

As far as the purpose and objectives of financial statements are concerned, the Committee notes paragraphs 12 and 22 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, as follows:

> "12. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions."

> "22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions."

From the above, the Committee notes the objective of financial statements will be met only when these are prepared using accrual basis of accounting.

10. The Committee further notes that the Announcement issued by the ICAI on 'Mandatory Application of Accounting Standards in respect of Certain Non-

corporate Bodies', which was published in the ICAI's Journal, 'The Chartered Accountant' in January 1994, inter alia, provides as follows:

> "1. In May 1991 issue of 'The Chartered Accountant', an announcement was carried regarding the decision of the Council of the Institute of Chartered Accountants of India to defer the mandatory application of Accounting Standards 1, 7, 8, 9, 10 and 11 to accounts for periods beginning on or after 1.4.1993, in respect of the following:
>
> (a) Sole proprietary concerns/individuals
>
> (b) Partnership firms
>
> (c) Societies registered under the Societies Registration Act
>
> (d) Trusts
>
> (e) Hindu Undivided Families
>
> (f) Associations of persons.
>
> 2. The matter was re-considered by the Council at its meeting held in September, 1993 and it was decided, in partial modification of the earlier decision, that the aforesaid *Accounting Standards (except Accounting Standard 11, which has already been withdrawn), shall mandatorily apply in respect of general purpose financial statements of the individual/bodies listed at (a) – (f) above for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law.* It may be reiterated that the Institute issues Accounting Standards for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term "General Purpose Financial Statements" includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/members, creditors, employees and public at large. (Emphasis supplied by the Committee.)
>
> 3. According to Accounting Standard 1, Disclosure of Accounting Policies, 'accrual' is one of the fundamental accounting assumptions. The Standard requires that if any fundamental accounting assumption is not followed in the preparation and presentation of financial statements, the fact should be disclosed. Accordingly, in respect of individual/bodies covered by para 1 above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and

> presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no *statutory requirement* for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual' the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/ qualifications in his audit report accordingly."

From the above, the Committee notes that the above Announcement, inter alia, requires that the Accounting Standards specified in the Announcement, shall mandatorily apply in respect of *general purpose financial statements* of the Trusts for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. Thus, since the books of account of AIF in the extant case are required to be audited as per the AIF Regulations, Accounting Standards based on accrual basis of accounting are mandatorily applicable on the AIF. Further, the Committee notes that the above Announcement was issued in 1993 and since then, there has been a paradigm shift in the accounting standards framework, which now contains various Accounting Standards apart from those given in the above Announcement, which are necessarily based on accrual basis of accounting. The Committee is of the view that cash basis of accounting is considered to be an inappropriate basis for general purpose financial statements of entities carrying on commercial activities. Besides, the Announcements issued subsequent to the above Announcement and the Preface to the Statements of Accounting Standards, issued by the ICAI also acknowledge/support this fact and require all enterprises which are engaged in commercial, industrial or business activities to follow Accounting Standards issued by the ICAI. In this regard, the Committee also notes the requirements of the ICAI's Announcement on Applicability of Accounting Standards, (which was published in November 2003 issue of the ICAI's Journal), as also reproduced by the querist, which is applicable to all enterprises including trusts and which while categorising the enterprises into Level I, II and III requires to follow the Accounting standards issued by the ICAI, which are necessarily based on accrual basis of accounting.

The Committee further notes that the 'Preface to the Statements of Accounting Standards' (revised 2004), issued by the Institute of Chartered Accountants of India (ICAI) provides as follows:

> "3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.
>
> 3.4 The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public. References to financial statements in this Preface and in the standards issued from time to time will be construed to refer to General Purpose Financial Statements."

Further, with regard to the applicability of Accounting Standards issued by the ICAI to the Trust, the Committee also notes that paragraph 40 of Technical Guide on Accounting for Not-for-Profit Organisations (NPOs), issued by the Research Committee of the ICAI, states as follows:

> "40. As far as non-company NPOs (including trusts, societies registered under the Societies Registration Act, 1860) carrying on even a very small proportion of commercial, industrial or business activities are concerned, Accounting Standards, formulated by the Institute of Chartered Accountants of India, are mandatory for the members of the Institute in the performance of their attest functions as per the relevant announcements made by the Institute of Chartered Accountants of India from time to time."

From the above, the Committee notes that even NPOs which are formed as trusts, if carrying on commercial, industrial or business activities are required to follow Accounting Standards issued by the ICAI. Similarly, Guidance Note on Accounting by Schools, issued by the ICAI also prescribes to follow accrual basis of accounting.

It is amply clear from the Facts of the Case that the Trust in the extant case is formed to carry out commercial and business activities. Thus, on a harmonious reading of the above requirements, the Committee is of the view that the AIF in the extant case should follow the accounting standards issued by the ICAI, which are based on accrual basis of accounting, for its general purpose financial statements.

Incidentally, in the above context, the Committee also wishes to point out that since as per AIF Regulations, Alternative Investment Fund may be established or incorporated in the form of a trust or a company or a limited liability partnership or a body corporate and since an AIF incorporated or established as a company or body corporate is required to follow Accounting Standards or Indian Accounting Standards as per their respective governing laws, which are based on accrual system of accounting, it is not desirable/rational that an AIF which is not a company or body corporate would follow a system of accounting other than accrual basis of accounting.

11. The Committee also does not agree with the view of the querist that the use of cash basis of accounting cannot be construed as following accounting standards due to the requirements of AS 1 and AS 9, as reproduced by the querist. The Committee is of the view that AS 1 and AS 9 paragraphs reproduced by the querist are inherently in the context of accrual basis and require to follow accrual basis of accounting, without which the financial statements shall not provide true and fair view. Cash basis of accounting is not enshrined in the ICAI's authoritative literature on accounting because it neither permits nor give any elaborative framework on cash basis of accounting. It only defines the same to differentiate from well recognised and extensively applied accrual basis of accounting. The Committee also wishes to point out that the Exposure Draft of Guidance Note on Accounting of Political Parties has also disregarded the cash basis of accounting.

D. Opinion

12. On the basis of above, the Committee is of the opinion that the AIF in the extant case should follow the accounting standards issued by the ICAI, which are based on accrual basis of accounting, as discussed in paragraph 10 above.

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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.