Part-I

COMPENDIUM OF OPINIONS

Volume XLI

(Containing Opinions finalised between February 12, 2021 and October 31, 2021)

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

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Foreword

The Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), since its inception, has endeavoured to provide independent and objective opinions to the membership and various Regulatory and Government authorities, such as Ministry of Corporate Affairs (MCA), Securities and Exchange Board of India (SEBI), and Comptroller and Auditor General of India (CA&AG), etc. Sometimes accounting professionals are posed with challenging situations requiring comprehensive guidance on specific facts and circumstances. These situations define the role of the Expert Advisory Committee, which undertakes in-depth study of the facts and circumstances for offering specific technical guidance.

I am happy that the Expert Advisory Committee (EAC) has brought out this Forty-first Volume (Part-I) of 'Compendium of Opinions' containing Opinions finalised from February 12, 2021 to October 31, 2021.

I congratulate CA. Pramod Jain, Chairman, EAC, CA. Vishal Doshi, Vice-Chairman, EAC and all the other members of the Committee for their impressive efforts in bringing out another useful volume.

I strongly believe that this Volume will provide a plethora of knowledge to the Chartered Accountants and other accounting professionals.

New Delhi
June 27, 2022

CA. (Dr.) Debashis Mitra
President

Preface

I am exultant to present to the profession, another educative volume of the Compendium of Opinions, viz., Volume Forty-first (Part-I) containing opinions finalised by the Expert Advisory Committee (EAC) during the Council year 2021-22, from February 12, 2021 to October 31, 2021 under the encouraging leadership of CA. Nandkishore C. Hegde, the then Chairman of the Committee. I am delighted to chair the EAC for the current Council Year, 2022-23.

I would like to highlight that an in-depth research and detailed deliberations take place at the Committee level before an Opinion is finalsied. Some of the opinions on varied subjects included in this Volume are as follows:

- Treatment of Investments in Subsidiaries/Associates held through Policyholders' Funds.
- Accounting treatment for backstopping arrangement for compulsorily convertible debentures (CCDs).
- Accounting treatment of construction of facilities for import of additional requirement of power.
- Accounting treatment in the Company"s standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being Parent Company to banks/suppliers/service providers on behalf of its Step-down subsidiary company.
- Accounting treatment of expenditure incurred on the assets not owned by the Company.
- Classification of business activity as operating activity or investing activity.

I would like to bring to the kind attention of the readers that the opinion or views expressed by the EAC represent the opinion or views of the members of the Committee and not the official opinion of the Council. I may also mention that the opinions are finalised on the basis of the facts and circumstances of the query as supplied to the Committee by the querist, considering the applicable accounting and/or auditing principles and the relevant laws and statutes, as prevailing on the date on which the opinion is finalised. The date of finalisation of each opinion is mentioned 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.

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

For the convenience of the members, all the published volumes of the Compendium of Opinions viz., volumes I to XL have also been hosted on the Website of the ICAI alongwith advanced search facility.

I am extremely overwhelmed by the constant support being offered to the Committee by CA. (Dr.) Debashis Mitra, President, ICAI and CA. Aniket Sunil Talati, Vice-President, ICAI. I would also like to acknowledge the exemplary efforts of CA. Vishal Doshi, Vice-Chairman EAC for sparing valuable time and sharing his knowledge and wisdom in finalisation of opinions of the Committee. I would also like to acknowledge the efforts of all the other members of the Committee, viz., CA. Chandrashekhar V Chitale, CA. Mangesh Pandurang Kinare, CA. Sridhar Muppala, CA. Sripriya Kumar, CA. Sushil Kumar Goyal, CA. Rohit Ruwatia, CA. Abhay Chhajed, CA. Anuj Goyal, CA. Gyan Chandra Misra, CA. Sanjay Kumar Agarwal, CA. (Dr.) Raj Chawla, CA. (Dr.) Sanjeev Kumar Singhal, CA. Hans Raj Chugh, Shri Manoj Pandey and Dr. P. C. Jain.

I am thankful to the Co-opted members of the Committee, namely, CA. Nilesh S. Vikamsey (Past President, ICAI), CA. G. Sekar, Dr. Bhaskar Banerjee, CA. Mohit Bhuteria, CA. Sashank Srivatsan S. and CA. Beeraka Vijay for their regular participation and contribution.

I am also grateful to the untiring support extended to the Committee by the Special Invitees of the Committee, namely, CA. Shyamal Kumar, CA. Darshan Chhajer, CA. Yogesh Kumar Gupta, CA. Meghdoot Balkisan Jajoo, CA. Vinesh Jain, CA. Vivek Newatia, CA. Parag Kulkarni, CA. Navneet Mehta, CA. Ashish Bansal, Dr. Avinash Chander, CA. Vishal Bansal, CA. Himanshu Kishnadwala, CA. K. Sairam, CA. Amit Somani, CA. Sanat Chitale and CA. Nitin Bajrangalal Gupta.

I would also like to acknowledge the continuous efforts and support of the entire team of EAC Secretariat, including CA. Parul Gupta, Secretary, EAC, CA. S. N. Gupta, Joint Director, CA. Khushboo Bansal, CA. Preeti Lakhera and Mr. Vishnu Kumar towards the activities of the Committee.

I am hopeful that this volume will enjoy extensive readership and will complement the knowledge of the accounting professionals.

New Delhi
June 25, 2022

CA. Pramod Jain
Chairman
Expert Advisory Committee

Contents

Query No. 1

Subject: Accounting treatment of expenditure relating to indirect expenses which are compulsorily required to be incurred for construction of the project.[1]

A. Facts of the Case

1. In order to enhance connectivity, improve access to citizens, reduce pollution, congestion and promote balanced sustainable growth in National Capital Region (NCR), NCR Planning Board (NCRPB) prepared 'Functional Plan on Transport for National Capital Region-2032', which recommended development of multi-modal transport system with special emphasis on dedicated rail based high-speed, high-frequency Regional Rapid Transit System (RRTS) for connecting major regional centres in NCR.

2. RRTS is a dedicated rail based inter-state high speed, high frequency, high throughput, reliable transit system with a design speed of 180 km/h and an average speed of around 100 km/h. Once operational, it will be the fastest, most comfortable and safest mode of commuter transport in NCR. Such high-speed seamless connectivity will not only reduce pollution and congestion in NCR, but will also drive balanced and sustainable urban development in the entire region.

3. The Government of India joined hands with four State Governments, Delhi, Uttar Pradesh, Haryana and Rajasthan to create a joint venture, N Corporation Limited (hereinafter referred to as 'the Company' or 'the Corporation') with 50% shareholding from Government of India (through Ministry of Housing and Urban Affairs (MoHUA), Ministry of Railways and NCRPB) and 12.5% from each participating State Governments of Haryana, NCT of Delhi, Rajasthan, and Uttar Pradesh. The Company has been formed in accordance with Government of India order dated 30.07.2013 and has been mandated for designing, developing, implementing, financing, operating and maintaining RRTS projects in the National Capital Region of India. Unlike metro rail projects, which are promoted by the respective State Governments, RRTS is a multi-state, central-sector project.

4. The first corridor of phase I, i.e. Delhi – Ghaziabad – Meerut RRTS, has been sanctioned for implementation vide MoHUA, Government of India Order No. K-14011/17/2017-MRTS-I (Vol.II) dated March 07, 2019. The corridor has a length of 82.15 Km and will have 24 stations. Construction of the corridor has started in May 2019 and is planned to be operationalised by the year 2025. Two other corridors, are under various stages of approval with the Government.

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[1] Opinion finalised by the Committee on 3.4.2021.

5. The querist has informed that at present, the construction phase of the Delhi-Ghaziabad-Meerut RRTS Project is going on and the Company does not have any operating income. The operating income shall commence with commercial operation of the RRTS. The Company has deployed its entire manpower for the sole purpose of construction of RRTS. Managing Director and other directors are actively involved in construction related activities of the project.

6. The querist has further informed that in order to facilitate the construction of the project, the Company has opened site offices and a corporate office which have been either taken on rent or got constructed. The details are as follows:

a) Site Offices:

i. Meerut
ii. Modi Nagar
iii. Ghaziabad
iv. Gurugram
v. Delhi

The site offices house the civil and electrical departments and are responsible for supervision of civil construction including elevated corridors, tunnels, tracks, stations, erection of viaducts, signal system and other electrical installations and plant & machinery at different locations of the project. Employees working in site offices are interacting with contractors and supervising the construction of the project**.** These offices are headed by the Chief Project Managers. The Company has 363 employees out of which 245 are posted at site offices as on 31st Jan 2021.

b) Corporate Office in Delhi:

The Corporate office has 118 employees and houses the following departments:

i. Design, Architecture and Drawings
ii. Track
iii. Electrical
iv. Traction
v. Electro-Mechanical
vi. Telecom
vii. Signalling
viii. Procurement
ix. Rolling stock

x. IT Infrastructure (for project planning and monitoring)

xi. Finance

xii. Human Resource (HR) and Administration

xiii. Company Secretariat

The Company has five full time directors namely Managing Director, Director – Finance, Director – Project, Director – System & Operation and Director – Electrical & Rolling Stock. Designing, Architecture, Track, Traction, Rolling Stock, and IT infrastructure, etc. are various proponents for the construction activities, as such Departments at serial no. (i) to (x) are exclusively involved in construction of projects. Further, employees working in finance department are majorly engaged in project related activities, like, bid evaluations, selections of contractor and suppliers, project monitoring and payment to contractors and suppliers etc. Out of 118 employees, 107 employees are working in departments at Serial No. 6(b) (i) to (x).

7. Besides making payments for purchase of land, payments to contractors for construction of project, payments to suppliers for procurement of construction material and plant and machinery, the Company has been incurring certain establishment expenses most of which are directly linked to the construction of the project and allied activities to support the construction. As project is in construction phase and the Company does not have any operating income and past reserves, the above expenses are being met out of the capital grants/subordinated debt received by the Company from its promoters and debt undertaken for the project.

8. The Company has identified the aforesaid expenses which are directly attributable to the construction of the project and proposes to capitalise those expenses in accordance with Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' (as shown in Table in paragraph 9 below), which provide that the costs directly attributable for bringing the project to the location and condition necessary for it to be capable of operating in the manner intended by management constitute the cost of an item of Property, Plant and Equipment.

9. The querist has stated that while identifying the direct expenses or expenses which are linked with the construction or to support the construction activities, the purpose of incurring such expenses have been kept in view. Details of such expenses are mentioned as under:

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
1.	Salaries and wages	The salaries and wages of employee include pay and allowances and are in line with the employee benefits as mentioned in Ind AS 19, 'Employee Benefits'. The Company has given following accounting treatment to

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
		salaries and wages: a) Salaries and wages of employees working in the site offices are capitalised since these employees are directly involved in various activities relating to construction of project (Refer paragraph 6(a) above. b) Salaries and wages of the employees in the following departments in Corporate Office are capitalised in terms of paragraph 17 (a) of Ind AS 16, since the employees working in these departments are exclusively performing the activities relating to construction and execution of the project (Refer paragraph 6(b) above): i. Design, Architecture and Drawings ii. Track iii. Electrical iv. Traction v. Electro-Mechanical vi. Telecom vii. Signalling viii. Procurement ix. Rolling stock x. IT Infrastructure c) Salaries and wages of employees in finance department in Corporate Office are capitalised as employees working in finance department are mainly involved in carrying out the responsibilities linked to project implementation as they essentially are the members of the committees formed for the purpose of evaluation of bids for procurement of construction material, appointment of contractors and project monitoring and are also involved in making payments to contractors, etc. d) Salaries and wages of Managing Director and functional directors have also been capitalised as they are mostly occupied in overseeing the project execution. e) Salaries and wages and travelling expenses of employees of HR, administration and company

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
		secretary departments are charged to revenue.
2.	Travelling Expenses	The travelling expenses of employees have also been accounted for in the manner in which salaries and wages of employee have been accounted for as stated in paragraph 9(1) above. Further, these expenses were incurred for inspection of materials, on site visits, for attending technical trainings, workshops held for project execution, for study tours and other travelling expenses incurred for construction/ project execution.
3.	Legal and Professional Fee a. Lawyers Fee	This includes fee paid to lawyers for making appearance before the Courts/Authorities/Tribunals to contest/defend/seeking order for removing various hazards coming in the way of construction activities from time to time like ban imposed to carry out the construction activities during night time/in extreme foggy conditions in winters or seeking permission for work in forest area/tree cutting, etc. This also includes fee paid to lawyers for arbitration and court cases with contractor on the contractual matters etc. The above matters have direct bearing on the construction activities. Accordingly, fee paid to lawyers for above purpose or similar purpose has been capitalised.
	b. Fee to Project PR Consultant	Citizen Centricity and Stakeholder Consultation drive the process of planning of RRTS. Because of transformative nature of the project, stakeholders' issue needs to be addressed. In a multi stakeholder environment, RRTS projects can become successful only if all the stakeholders are engaged effectively. The Company is working in a very complex multi-stakeholder environment and has been adopting proactive approach in stakeholder engagement. Stakeholders' consultations have been conducted at various stages of the DPR approval processes and concerns of these stakeholders have been addressed. At an institutional level, the primary stakeholders not only include the Governments of four States and Government of India and their concerned Ministries

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
		and Departments but also include local bodies, development authorities, utilities, civil and police administration, regulatory authorities, environmental authorities, NHAI, ASI, print and electronic media to name a few. At micro level, the stakeholders include the project affected persons due to land acquisition. With the progress of projects on ground, stakeholders' engagement requirements are expected to grow. The ongoing construction work of Delhi–Ghaziabad–Meerut corridor has also impacted local residents which the Company wants to address in a coherent manner. All the important processes including, development and implementation of traffic diversion plans, removal of encroachments, land acquisition, implementing innovative sources of financing, require public awareness and consultation besides engagement and consultation with different agencies/stakeholders involved in the process. The Company has engaged a Public Relations Agency on retainership basis for helping it in public relations work including social media management and stakeholder engagement for all its corridors and works, which is essential for seamless completion of the project. Since, the above activities are directly linked to construction of the project, the fee paid to Project PR Agency has been capitalised.
	c. Fee to Tax Consultants	Fee paid to Tax Consultant on retainership or otherwise for seeking advices on the levy of custom duties on import of items for project and applicability of GST on the works contracts has been capitalised. As GST and Custom duty form major part of the cost of the project, i.e. Rs. 2,510 crore against the total estimated cost of Delhi Meerut RRTS Corridor of Rs. 30,274 crore. It is therefore, necessary to obtain expert advice on these activities so as to properly comply with the provision of these laws and to avoid

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
		interest and penalties, which can affect the cost of the project.
4.	Training	Expenditure on trainings meant for upgradation of skills in the field of designing, signalling, telecommunication, track, tunnelling, etc. have been capitalised as this would directly benefit the construction of the project. Similarly, training on GST, FEMA and customs etc. have also been capitalised as these matters are directly linked to import of construction material and works contract for the project. However, expenses on training on Ind AS, HR, admin related issues are charged to expenses.
5.	Books and Periodicals	Expenditure incurred on procurement/subscription of manual and codes on Standards, engineering etc. are capitalised. These books and codes are essentially required for the construction of project with required standards and quality. There are major work items for which quality and methodology are based on certain codes, like BIS Codes, RDSO Codes, UIC Codes etc. However, expenditure incurred on general books, newspapers and non-technical magazine/literature is charged off to the expenses.
6.	Fee and Subscription	The Company and its employees are the members of certain technical and professional bodies. These institutions include International Union of Railways (UIC), I-Metro (Indian Forum of all Metro Rail Companies), Institution of Engineers, Indian Institute of Engineers, AMIE, Institute of Chartered Accountants of India etc. These institutes provide very useful literature and conduct various seminars and workshops in the related areas of construction of the project. The annual membership fee paid to such institutes has been capitalised as it helps in the professional development of employees engaged in the construction. However, fee and subscription for membership of India Habitat Centre and other non-technical institutions are charged off to the expenses.

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
7.	Office rent and office maintenance (Common expenses)	There are certain expenses which have been incurred on facilities which are commonly used by the employees directly involved in the construction of the project and other employees as well. These expenses include the following items: i. Office rent ii. Office maintenance which includes housekeeping, security, office repairs, electricity and power, printing and stationery, depreciation of office building, furniture and fixtures and telephone and internet charges. The above expenses are necessary to facilitate the construction of the project. In view of this, the Company has partly capitalised expenditure as a part of overall cost of the project. In order to derive the expenses attributable to the construction of the project, one way is to calculate it on actual basis which is very cumbersome, lengthy and costly process in comparison to the amount involved and the benefit that will accrue to the Company. Hence, for the sake of convenience, the Company has allocated these expenses in the ratio of area occupied by employees engaged in construction activities, i.e. employees working in departments at Sl. No. (i) to (x) of paragraph 6 (b) and employees engaged in Human Resource, Administration and Secretarial activities based on management estimate. However, some such expenses incurred for site offices have been capitalised as all employees at site are engaged in construction activities.
8.	Vehicle Running and Maintenance	Vehicles are provided to the employees for discharging the official duties and include operation and maintenance of hired and owned vehicles. a. Expenses incurred on running and maintenance of vehicles in use by the employees at all site offices are capitalised. b. Running and maintenance expenses of vehicles in use by the employees at Corporate Office have

Sl.	Account Head	Rationale for Capitalisation (View of the Company)
		been capitalised for employees working in departments at Sl. No. (i) to (x) of paragraph 6 (b) above. Further, vehicle expenses of Managing Director and functional directors have also been capitalised. (refer (1) and (2) above)
9.	Meeting and Conference	Expenses incurred on meetings and conferences with various stakeholders in connection with matters relating to construction activities like meeting with contractors/suppliers/Government officials/utility agencies etc. in relation to project implementation have been capitalised. However, meeting and conference expenses on administrative activities, like AGM, Board meeting, Committee of Directors meeting, meeting for administration and HR related issues etc. are charged to expenses.

B. Query

10. In view of above, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) has been sought as to whether the accounting treatment of the above-mentioned expenses incurred for the project is correct considering the requirements of Ind AS 16.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised in the query relates to accounting treatment of various expenses incurred during the construction of the RRTS Project (hereinafter referred to as 'the Project'). The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting for any other expense incurred by the Company in relation to the project, allocation of expenses to various departments, accounting for the joint venture agreement between the Government of India and participating State Governments, accounting treatment of capital grant/subordinate debt received by the Company, etc.

12. 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. Similarly, just because the only activity undertaken by the Company at present is the construction activity does not mean that every expense incurred by the Company is directly linked or attributable to

the construction activities. 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 (Ind ASs). The Committee notes from the Facts of the Case that the Company in the extant case has incurred various indirect expenses during the project implementation. In this context, 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)[2]; and
(f) professional fees."

[2] This paragraph has been subsequently revised through Companies (Indian Accounting Standards) Amendment Rules, 2022, notified vide Notification No. G.S.R 255(E) dated 23rd March, 2022 which came into force with effect from April 1, 2022.

"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."

13. 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 salaries and wages, travelling expenses, legal and professional fee, training expenses, books and periodicals expenses, fee and subscription, office rent and office maintenance, vehicle running and maintenance expenses and meeting and conferences expenses incurred by the Company can be capitalised only if these are directly attributable to bringing the project or the related PPE(s) to the location and condition necessary for it/them to be capable of operating in the manner intended by the management.

14. 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 view of above-mentioned requirements, the Committee examines the expenses as referred by querist in paragraph 9 above in the following paragraphs.

Salaries and Wages

15. With regard to salaries and wages, 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/PPE, such as, employee benefit costs of an entity's own employees, workers,

labourers, engineers, architects, etc. engaged in construction activity should only be capitalised and rest should be charged to the Statement of Profit and Loss as and when incurred.

Accordingly, if the employees working in the site office and employees in (i) Design, Architecture and Drawings, (ii) Track, (iii) Electrical, (iv) Traction, (v) Electro-Mechanical, (vi) Telecom, (vii) Signalling, (viii) Procurement, (ix) Rolling stock and (x) IT Infrastructure (for project planning and monitoring) departments in the Corporate Office are engaged in construction activity, the costs of employee benefits of these employees can be considered as directly attributable costs to the project and can accordingly be capitalised with the cost of the project/PPE concerned. The Company will however need to maintain detailed records to substantiate such claim.

However, the employees working in other departments at the corporate office, such as finance, HR and administration, and company secretariat, although may be engaged in activities in connection with construction, the cost of employee benefits in these departments cannot be considered to be arising directly from construction activities or acquisition of PPE or project. Therefore, these costs cannot be considered as directly attributable costs to the PPE or Project and cannot be capitalised.

Further, with regard to salaries and wages of Managing Director and functional directors, the Committee notes that it has been stated by the querist that the Company has 4 functional directors, viz., Director-Finance, Director-Project, Director-System & Operations and Director-Electricals & Rolling Stock and that the Managing Director and the functional directors are mostly occupied in overseeing the project execution. The Committee is of the view that normally, Managing Director and Director-Finance are involved in overall supervision and management of the activities of the Company and not only the construction related activities. Therefore, the costs of employee benefits incurred thereon cannot be ordinarily considered to be arising directly from the construction or acquisition of the PPE/Project; rather these expenses are in the nature of administrative and general overheads and should, ordinarily, not be capitalised with the item of PPE/Project. However in certain exceptional cases where it can be clearly demonstrated that these are directly attributable cost for bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management, these can be capitalised. With regard to other functional directors, the Committee is of the view that Directors Project, System & Operations and Electricals & Rolling Stock are normally engaged in the construction activities and the cost of employee benefits incurred thereon can be considered to arise directly from the construction/acquisition of PPE/Project. Therefore, to the extent these functional directors are engaged in construction activity, the costs of employee benefits incurred thereon are directly attributable costs and can be capitalised.

Travelling Expense

16. With regard to travelling expenses, the Committee notes that these expenses have been stated by the querist to be incurred for inspection of materials, on site visits, for attending technical trainings, workshops held for project execution, for study tours and other travelling expenses incurred for construction/ project execution. The Committee is of the view that it needs to be examined keeping in view the nature and purpose of such expenses so as to determine the accounting treatment of such expenses. These expenses can be capitalised with the cost of a PPE/project only to the extent these are directly attributable to the construction/acquisition of a PPE/project for bringing it to the location and condition necessary for it to be capable of operating in the manner intended by the management. The Committee is of the view that to the extent travelling expenses are incurred for visiting the construction site to enable or undertake construction activity, these can be considered to be directly attributable to the PPE/Project being constructed and can be capitalised. However, the travelling expenses for attending trainings, workshops held for project execution, for study tours etc. cannot be considered as incurred for construction of any PPE/Project or for bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management. Accordingly, these cannot be considered as directly attributable expenses and capitalised to the PPE/Project as per the requirements of Ind AS 16.

Legal and Professional Fee

17. With regard to legal and professional fee paid to lawyers, project PR Consultants and tax consultants, the Committee is of the view that although in the extant case, some of these expenses are incurred for facilitating construction (or for compliance with the legal requirements in order to ensure seamless construction/completion of the project or to avoid unnecessary increase in the construction cost), these cannot be considered as directly attributable to construction of any PPE(s)/Project or for bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, these expenses cannot be capitalised as cost of an item of PPE/Project.

Training Expense

18. With regard to training expenses, the Committee notes from the Facts of the Case that it includes training for upgradation of skills in the field of designing, signalling, telecommunication, track, tunnelling, etc. and training on GST, FEMA

and Customs etc. The Committee also notes that paragraph 19 (c) of Ind AS 16 specifically states that the costs of staff training cannot be capitalised. Considering the nature of training expenses in the extant case, the Committee is of the view that though the imparting of training for construction purposes may facilitate the construction of the PPE/Project, these cannot be considered as directly attributable to construction of any PPE(s)/Project or for bringing the PPE/Project to the location and condition necessary for it/them to be capable of operating in the manner intended by management. Similarly, expenses of other trainings on GST, FEMA, customs etc. cannot be considered as directly attributable to construction activities as per the requirements of Ind AS 16. Therefore, these expenses cannot be capitalised as cost of an item of PPE/Project.

Books and Periodicals Expense

19. With regard to expenses on books and periodicals, the Committee is of the view that such expenses are not ordinarily directly attributable to construction/acquisition and therefore, are charged to the Statement of Profit and Loss unless it can be demonstrated that these are directly attributable to construction as aforementioned. In the extant case, the expense on general books, newspapers and non-technical magazine/literature should be charged to the Statement of Profit and Loss. Further, the Committee notes that the above expenses also include expenditure incurred on procurement/subscription of manual and codes on Standards, engineering etc. which have been stated by the querist to be capitalised as these books and codes are essentially required for the construction of project with required standards and quality and there are major work items for which quality and methodology is based on certain codes, like BIS Codes, RDSO Codes, UIC Codes etc. Accordingly, the Committee is of the view that to the extent expenses on such technical and quality/standards related books and periodicals are essential for the construction activity and can be considered as directly attributable to construction as aforementioned, these may be capitalised with the Project/PPE concerned. However, the Company will have to clearly demonstrate that the expenditure on such technical books and periodicals are directly attributable to construction of the Project/PPE concerned.

Fee and Subscription

20. With regard to expenditure on fee and subscription, the Committee notes from the facts submitted that the Company pays annual membership fees for various technical institutions for professional development of employees engaged in the construction as well as for membership of non-technical institutions. The Committee is of the view that although some of these expenses are for professional development of employees involved in construction, these expenses cannot be considered as essential for or directly attributable to

construction of PPE/Project or for bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, the same cannot be capitalised to the PPE/Project.

Office rent and Office maintenance

21. With regard to office rent, 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 till the time the item of PPE/Project 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 Corporate Office/other office, the Committee is of the view that it 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 Corporate Office/other office should not be considered as cost of the project. However, if the construction/project execution related activities are also being performed at Corporate Office/ other office and if these activities can be considered as 'directly attributable' as discussed above, then only to that extent, rent should be capitalised as the cost of the Project/PPE. Depreciation of building of Corporate Office/other office should also be considered for capitalisation with the Project/PPE only if and to the extent the office is being used for construction/project execution related activities, as discussed above.

Further, with regard to office maintenance (common expenses), which includes housekeeping, security, office repairs, electricity and power, printing and stationery, depreciation of furniture and fixtures, telephone and internet charges, 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 PPE/Project and therefore, these cannot be capitalised as cost of an item of PPE/Project.

Vehicle running and maintenance

22. With regard to vehicle running and maintenance expenses, the Committee notes from the facts supplied that it includes vehicle running and maintenance expenditure for vehicles used by employees for discharging their duties, vehicles used by employees at site office, some specific departments at Corporate Office and vehicle expenses of Managing Director and functional directors. The Committee is of the view of that generally vehicle running and maintenance expenses are in the nature of administrative and general overhead expenditure and should not be considered as 'directly attributable cost' of construction of the PPE/Project. However, to the extent the vehicles are used by

the employees who are engaged in the construction activity (as discussed in paragraph 15 above), the vehicle running and maintenance can be considered as directly attributable to the PPE/Project and can be capitalised as cost of an item of PPE/Project.

Meeting and Conference Expenses

23. With regard to meeting and conferences expenses, the Committee is of the view that these expenses are not ordinarily directly attributable to construction/acquisition and, therefore, are charged to the Statement of Profit and Loss *unless* it can be demonstrated that these are directly attributable to construction as aforementioned. The Company should examine expenses keeping in view the nature and purpose of such expenses as to whether or not these are directly attributable to the construction of the PPE/Project for bringing it to its working condition for its intended use so as to determine the accounting treatment of such expenses. These expenses can be capitalised with the cost of the PPE/Project only to the extent these are directly attributable to the construction of the PPE/Project for bringing it to its working condition for its intended use.

D. Opinion

24. On the basis of the above, the Committee is of the opinion that the Company's accounting treatment of various expenses incurred during the construction of the Project is not completely correct; the Company should follow the accounting treatment, as discussed in paragraphs 12 to 23 above.

Query No. 2

Subject: Allocation of manpower cost during project implementation phase.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company'), engaged in City Gas Distribution (CGD), is promoted by two Public Sector Unit (PSU) majors in the petroleum sector, namely A Ltd. and B Ltd. As per authorisation granted by Petroleum and Natural Gas Regulatory Board (PNGRB), the Company has the following Minimum Work Program (MWP) to be completed in the geographical

[1] Opinion finalised by the Committee on 3.4.2021.

areas (GA) of Ambala-Kurukshetra, Haryana and Kolhapur, Maharashtra within a 5-year period commencing from the respective authorisation dates.

Geographical Area (GA)	Date of PNGRB authorization	Minimum Work Program (MWP)	Date of completion of MWP
Ambala-Kurukshetra	22.02.2018	Laying of 1142 Inch – Km of pipeline #Infrastructure for 20624 Nos. of domestic PNG connections	21.02.2023*
Kolhapur	06.03.2018	Laying of 1800 Inch – Km of pipeline #Infrastructure for 38760 Nos. of domestic PNG connections	05.03.2023*

* PNGRB vide PNGRB/Monitoring/1/CGD-COVID-19/2020/Vol-II (P-1804) letter dated 24th November 2020 gave an extension on MWP target timeline by 129 days for Ambala – Kurukshetra GA and 251 days for Kolhapur. Accordingly target completion date is 07-Aug-2023 for Ambala GA and 7-Dec-2023 for Kolhapur.

\# Infrastructure includes City Gas Station (CGS), Mother Station (MS), facilities within domestic households for PNG connections apart from pipelines.

2. *Appointment of auditors and conduct of the audit:*

The appointment of auditors is done by the Comptroller and Auditor General of India as per powers conferred by section 139 of the Companies Act, 2013. The Comptroller and Auditor General of India reserves the power to conduct supplementary/test audit under sections 143(6) and (7) of the Companies Act, 2013.

Status of Implementation of MWP:

The table below shows implementation:

Geographical Area (GA)	Date of PNGRB authorization	Minimum Work Program (MWP)	Status of MWP completion till 30.09.2020
Ambala-Kurukshetra	22.02.2018	Laying of 1142 Inch – Km of pipeline Infrastructure for 20624 Nos. of domestic PNG connections	547.60 Inch-Kms 1981 connections
Kolhapur	06.03.2018	Laying of 1800 Inch – Km of	255.61 Inch-

		pipeline Infrastructure for 38760 Nos. of domestic PNG connections	Kms 218 Connections

3. The Company has three offices, which include head office (HO), Mumbai and two project Offices at each of GAs mentioned above. A Ltd. and B Ltd., by virtue of being the promoters, have entered into a Joint Venture Agreement under which officers on the payroll of the two companies have been posted on deputation in the Company. Each GA has three officers on deputation comprising the Head-GA, Head-Engineering and Head-Marketing. HO, Mumbai has three more officers on deputation comprising the CEO, CFO and Accounts Officer. The GA offices are primarily focused on implementation of the work programme. For this purpose, all technical, financial, commercial and administrative support and guidance are provided by HO to ensure smooth and timely completion of the work programme. As per agreement, the promoters raise debit notes on the Company in respect of manpower cost of their officers posted on deputation in the Company.

4. The querist has informed that the current practice being followed is as follows:

The Company prepares financial statements in accordance with the Indian Accounting Standards (Ind ASs), notified under section 133 of the Companies Act, 2013.

Depending on the nature of the job profile of each of the officers on deputation, the Company follows the following practice of booking the deputation cost of manpower:

(i) All costs in relation to the GA based officers are charged directly to Capital Work-in-Progress (CWIP) as the Company is currently engaged in the creation of facilities/infrastructure as per MWP.

(ii) As far as officers posted in HO are concerned, the Company, based on assessment/ evaluation of their job profile, charges 15% of the manpower cost to revenue and the balance 85% to CWIP.

5. *Observations of the Comptroller and Auditor General of India (CAG):*

The CAG while conducting the audit for financial year (F.Y.) 2019-20 has observed as below in their provisional comments:

Statement of Profit and Loss

<u>Expenses:</u>

<u>Manpower Deputation Expenses</u>: ₹ 23.58 lakhs

This does not include an amount of ₹116.07 lakhs (entire deputation expenses for Accounts Officer (AO) and 85 percent of deputation expenses in respect of Chief Financial Officer (CFO) situated in headquarters of the Company) which have been charged in Capital Work in Progress as on 31 March 2020. Similarly, an amount of ₹19.13 lakhs was also charged to CWIP during 2018-19.

In this regard, attention is invited to para 16 (b) of Ind AS 16, 'Property, Plant and Equipment', as per which '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' can only be considered as cost of the asset for capitalisation. As such, charging in the CWIP -as cost of asset - the manpower deputation expenses pertaining to Marketing heads of two geographical areas and AO & CFO situated in headquarters of the Company not being directly attributable cost of the asset- is thus not correct.

Charging the CFO and Accounts Officer related manpower costs in CWIP has resulted in overstatement of CWIP by ₹116.07 lakhs and understatement of Other Equity by ₹116.07 lakhs and Loss for the period by ₹ 96.93 lakhs.

The relevant paragraph of Ind AS 16, 'Property Plant and Equipment' referred to by the C&AG in their provisional comments is reproduced as under:

> **"Elements of Cost**
>
> 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.
>
> …"

6. The querist has informed that the Company's management's stand on the matter is as follows:

The Company is currently in project implementation phase which involves creation of various facilities in the two GAs, viz., Ambala-Kurukshetra and Kolhapur. As per PNGRB authorisation, all facilities must be created within a 5-year period commencing from the date of authorisation. The primary responsibility of implementing the work programme planned for the GAs lies with the manpower deployed on deputation basis by the promotor companies. Based on an assessment of the contribution made by different personnel on deputation, it was found that except for CEO and CFO, all others are fully involved in project implementation.

The top management, comprising the CEO and CFO, is responsible for accomplishment of the Company's objectives. Listed below are some of the broad activities of the CEO and CFO during the project implementation phase:

- Review and finalisation of consolidated GA budgets including that of the HO.
- Review of actual physical progress vis-a-vis approved budget.
- Direct interaction with different government agencies, viz., municipal authorities, forest, land revenue department etc. in connection with project work.
- Review meeting with suppliers/contractors including PMC consultant to ensure compliance with the stipulated timeline.
- Tendering bid evaluation and awarding of contracts for the GAs.
- Review of DOP & Procurement rules to meet the emerging requirement of GAs as well as HO.
- Meetings with suppliers/service providers of GAs /HO.
- Processing of all payments pertaining to the GAs/HO.
- Project financing and banking activity.
- Quarterly and annual audit.
- Responding to the queries of board, promoters and other outside agencies.
- Review and monitoring of human resource (HR) and administration policy and ensuring compliance.
- Holding of Board meetings, annual general meeting (AGM), finalisation of agenda, minutes etc.

7. With the project implementation phase continuing till 2023 and considering the involvement of CFO in all project activities, as discussed above, 85% of the manpower cost attributable to him has been capitalised and balance 15% has been charged to revenue. Since the CEO and CFO are equally responsible for all functional matters, the Company in its assessment treated them alike in 2019-20 and considered capitalisation of manpower expenses in the same proportion. None of the key business decisions can be taken by either of them alone. Hence, it is reasonable that manpower cost attributable to both should be treated similarly.

8. Accounts officer posted on deputation at HO handles all project related financial activities pertaining to both the geographical areas. The roles and responsibilities of the AO are evaluation of tenders floated for laying pipelines, procurement of various capital equipment, arranging for permission for laying pipelines, participating in price negotiation with bidders, helping in arranging debt financing, maintaining fixed assets/insurance and stores account of the project for the project apart from making vendor payments against all project activities.

As AO's functions are largely related to project implementation, manpower cost attributable to him is being capitalised to the extent of 85% and balance 15% is debited to revenue.

9. The Company will be able to supply domestic gas to the households only after all facilities and infrastructure required for the said purpose are created. This implies that the Company's revenue from Piped Natural Gas (PNG) sales will accrue after the requisite facilities are put to use.

10. Based on a careful analysis of the job profile of the afore mentioned officers, the Company concluded that 15% of the manpower cost of CFO and AO in terms of both time spent and nature of job may not be directly attributable to asset/facility creation. Accordingly, the Company decided for charging 85% of the cost to CWIP and balance 15% to revenue.

11. The querist has mentioned that the reasons for the Committee to address this issue is that a significant portion of manpower cost is capitalised every year and there is no clear guidance on the treatment as per Ind AS 16, 'Property Plant and Equipment' on this matter. The published literature of some of the large accounting firms also does not highlight the exact treatment of the cost and the ratio of allocation.

B. Query

12. In view of above, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) has been sought as to : (i) whether manpower cost of CFO and AO can be capitalised and if so, in what ratio; or whether the cost should be expensed off. (ii) The basis of changes (if required) to the current treatment and whether it can be done retrospectively or prospectively.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to accounting treatment of manpower cost of CFO and AO during the project implementation phase. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, analysis of status of implementation of MWP or accounting for any other expense incurred by the company in relation to the project, accounting for manpower cost in relation to other employees including other officers posted on deputation, such as, CEO, Head GA, Head Engineering, Head Marketing etc. Further, the Committee has not examined as to whether the costs incurred in relation to arrangement of borrowings (funds) for the Project in the extant case can be considered as 'borrowing costs' as per the requirements of Ind AS 23, 'Borrowing Costs'.

14. At the outset, the Committee notes that the querist has stated that 85% of manpower cost of Accounts Officer and CFO, deputed to the HO of the Company, has been capitalised to the capital work in progress by the Company. Further, although the query has been raised in respect of Accounts Officer and CFO on deputation, the specific details of the activities performed by the CFO have not been provided; rather the details of combined activities of CEO and CFO have been provided. In the absence of the separate details for the CFO, it is presumed that CFO performs all those activities, as provided by the querist in the Facts of the Case (paragraph 6 above).

15. 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;
>
> …"
>
> "19 Examples of costs that are not costs of an item of property, plant and equipment are:
>
> ...
>
> (d) administration and other general overhead costs."

16. 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. Further, 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 PPE/project, such as employee costs of an entity's own employees, workers, labourers, engineers, architects etc. engaged in construction activity should only be capitalised and the rest should be charged to the Statement of Profit and Loss.

17. As far as capitalisation of the manpower cost of Accounts Officer and CFO is concerned, the Committee notes that normally Accounts Officer is engaged in overall book keeping and accounting related activities and CFO of an organisation is generally involved in overall finance related activities of the Company as a whole.

The Committee is of the view that normally these activities cannot be considered to be arising directly from the construction or acquisition of the PPE/project and the costs thereof cannot be considered to be a directly attributable cost for the Project/PPE. The Committee is of the view that manpower cost of Accounts Officer and Chief Financial Officer 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 cost for bringing the Project/PPE to the location and condition necessary for it to be capable of operating in the manner intended by management, these can be capitalised.

As far as the ratio/proportion in which such expenses may be capitalised, the Committee is of the view that it needs to be determined by the Company itself considering the nature of expenses/activities and the extent to which these are directly attributable as per the requirements of Ind AS 16 in its specific facts and circumstances and using proper rationale.

18. In this context, the Committee notes that the roles and responsibilities of the AO in the extant case have been stated to be evaluation of tenders floated for laying pipelines, procurement of various capital equipment, arranging for permission for laying pipelines, participating in price negotiation with bidders,

helping in arranging debt financing, maintaining fixed assets/insurance and stores account of the project for the project apart from making vendor payments against all project activities. The Committee is of the view that although some of these activities are undertaken in connection with the construction or acquisition of PPE/project, the costs incurred thereon cannot be completely considered to be arising directly from the construction or acquisition of the PPE/Project. The Committee is of the view that the extent to which these costs are directly attributable to PPE/Project is a matter of judgement in the specific facts and circumstances, which should be exercised and demonstrated by the management of the Company. Accordingly, to the extent, such costs are directly attributable to bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management, should be capitalised to the PPE/Project by the Company and the rest should be charged to the Statement of Profit and Loss.

The Committee further notes the activities mentioned by the querist as the activities of the CFO in paragraph 6 above. The Committee is of the view that the activities, such as, review and finalisation of consolidated GA budgets including that of the HO, review of actual physical progress vis-a-vis approved budget, interaction with government agencies, meeting with suppliers, tendering bid evaluation and awarding contracts, project finance and banking activities, review of DOP & Procurement rules to meet the emerging requirement of GAs as well as HO, quarterly & annual audit, responding to the queries of board, promoters and other outside agencies, review & monitoring of HR and Admin Policy and ensuring compliance, holding of Board meetings, AGM, finalisation of agenda, minutes etc. are overall policy making and control and supervision related activities; and are in the nature of administrative and general overheads, which as per paragraph 19 (d) of Ind AS 16, are not costs of an item of property, plant and equipment. However, if in certain exceptional circumstances, where the management can clearly justify and demonstrate that some of the activities performed by the CFO are directly attributable to bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management, to that extent, the manpower costs incurred by the Company in relation to CFO should be capitalised to the PPE/Project and the rest should be charged to the Statement of Profit and Loss.

19. With regard to the issue raised by the querist as to whether changes required to the current treatment are to be done retrospectively or prospectively, the Committee notes that Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' states as follows:

> "41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind ASs if they contain

either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 42–47).

42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."

The Committee notes from the above that as per Ind AS 8, material prior period errors are corrected retrospectively by restating the comparative amounts for prior period(s) presented in which the error occurred. If the error occurred before the earliest period presented, the opening balance of assets, liabilities and equity for the earliest period presented are adjusted. Therefore, any changes in the accounting treatment required in the extant case due to above-mentioned discussion, should be considered and corrected by the Company as a prior period error retrospectively in the first set of financial statements approved for issue after the discovery of the error.

D. Opinion

20. On the basis of the above, the Committee is of the opinion on the issues raised in paragraph 12 above that although some of the activities of Accounts Officer are undertaken in connection with the construction or acquisition of PPE/project, the costs incurred thereon cannot be completely considered to be arising directly from the construction or acquisition of the PPE/Project. The extent to which these costs are directly attributable to PPE/Project is a matter of judgement in the specific facts and circumstances, which should be exercised and demonstrated by the management of the Company. Accordingly, to the extent, such costs are directly attributable to bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management, should be capitalised to the PPE/Project by the

Company and the rest should be charged to the Statement of Profit and Loss. Similarly, the activities undertaken by the CFO in the extant case are overall policy making and control and supervision related activities; and are in the nature of administrative and general overheads, which as per paragraph 19 (d) of Ind AS 16, are not costs of an item of property, plant and equipment. However, if in certain exceptional circumstances, where the management can clearly justify and demonstrate that some of the activities performed by the CFO are directly attributable to bringing the PPE/Project to the location and condition necessary for it to be capable of operating in the manner intended by management, to that extent, the manpower costs incurred by the company in relation to CFO should be capitalised to the PPE/Project and the rest should be charged to the Statement of Profit and Loss, as discussed in paragraph 18 above. Further, any changes, required in accounting treatment in the extant case due to above-mentioned discussion should be considered and corrected by the Company as a prior period error retrospectively in the first set of financial statements approved for issue after the discovery of the error, as discussed in paragraph 19 above.

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Query No. 3

Subject: Treatment of Investments in Subsidiaries/Associates held through Policyholders' Funds.[1]

A. Facts of the Case

1. A Corporation (hereinafter referred to as 'the Corporation') is a statutory corporation established under the Act of Parliament and is engaged in the business of life insurance in and outside India. The Corporation is governed by the provisions of the Act under which it is formed and notifications thereunder (the Governing Act); it is also registered with the Insurance Regulatory and Development Authority of India (IRDAI) and is subject to such provisions of IRDAI Act and regulations thereunder which are not inconsistent with the provisions of the Corporation's Governing Act.

2. The Corporation prepares its standalone annual financial statements in the format prescribed under the Governing Act as also under IRDAI (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002 (IRDAI FS Regulations) and as per the applicable framework of Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI). The Corporation is considering preparing and presenting

[1] Opinion finalised by the Committee on 3.4.2021.

Consolidated Financial Statements (CFS) under the provisions of applicable AS (i.e., AS 21) and other applicable Accounting Standards.

3. Prior to the enactment of Insurance Regulatory and Development Authority Act, 1999 (IRDA Act), the Corporation was governed by the provisions of Insurance Act, 1938 (the Insurance Act) and its Governing Act. The Corporation was operating as a corporation having a Single Fund. The bifurcation between policyholders' and shareholders' funds, as also bifurcation amongst policyholder of participating and non-participating bifurcation was not maintained for financial reporting purposes. In Pre-IRDAI period, some investments were made in group and other entities out of the said single fund. In the Post IRDAI period, the Corporation segregated the Shareholders and Policyholders funds in 2002 and few investments in group companies were allocated to Policyholders funds in the bifurcation done then. In Post-IRDAI period, the Corporation complies with the IRDAI Investment Regulations for all investments made subsequently, except for some specific investments out of policyholders' fund with specific dispensations from the Regulator.

4. The IRDAI FS Regulations*, inter alia*, require insurers to prepare and present annually (i) 'Revenue Account' also known as Policyholders' Account, (ii) Profit & Loss Account (also known as Shareholders' Account), (iii) Balance Sheet, (iv) Receipt and Payment Account or cash flow statement and (v) notes including significant accounting policies. In the Balance Sheet, on 'Asset' side, the investments are shown under three schedules i.e., Schedule 8 "Shareholders' Investments", Schedule 8A "Policyholders' Investments (Non-linked)" and Schedule 8B "Policyholders' Investments (Linked)".

5. The Corporation as mentioned above, in course of its business as a life insurer, invests in various class of securities, including equity shares in other entities. The investments are made either from funds earmarked as 'Policyholders' fund' or from 'Shareholders' fund and are governed/regulated by Investment Regulations issued by IRDAI.

6. The Corporation, apart from holding investments in its subsidiaries and associates from its Shareholders' (SH) funds, has also allocated certain investments in some of its subsidiary and associates from its Policyholders' (PH) funds based on availability of funds. The investments from PH funds are generally made with a view to generate adequate periodic returns/gains therefrom so as to protect the interest of PH and to provide required liquidity for meeting claims, surrenders and other obligations on the life insurance policies written. These investments from PH Funds are broadly in nature of regulatory ring-fenced structure, being subject to several regulatory limits/ conditions and are required to be maintained separately from SH Funds under the provisions of

applicable law and regulations. In the balance sheet of the Corporation, PH funds are shown as liabilities' whereas SH funds represent equity.

7. The querist has stated that management of the Corporation proposes to prepare and present the Consolidated Financial Statements (CFS) under the framework of applicable Accounting Standards. The IRDAI FS Regulations or other rules/regulations of IRDAI do not provide any guidance pertaining to CFS; the technical material and provisions of applicable accounting standards also do not contain any specific guidance about consolidating the investments made through and held in PH funds.

8. The management of the Corporation evaluated the requirements of covering such of its Investments as are held in PH Funds while preparing the CFS under the applicable provisions of AS 21 or of AS 23; CFS are normally understood to be made and presented from the Group's owners' perspectives; whereas the Investments held in PH funds are not viewed as those of SHs or belonging to the owners, rather these are considered to be and shown as liabilities in the Balance Sheet of the Corporation.

9. For the investment made either from PH fund or SH fund, the rights, and obligations w.r.t. that investment is to be always borne by the insurance company (i.e., ultimately by the SH). For investments made from PH funds, the rights belong to PHs and for the obligations, if at all, at segment level shall be borne by SHs. For instance, if a deficit is created due to diminution in the fair value change of investment made in debenture instrument from PH fund impacting the solvency ratio, this deficit is required to be made good by the SH.

10. The insurance companies participate and engage with managements of investee company in capacity of owner of the investments held and not merely as a custodian of PH. There is no distinction in that sense being made as investment forming part of PH or that of SH.

11. As per the report of K P Narasimhan Committee (2005), the legislation requires the bifurcation of liabilities into PH funds and SH funds and envisages that PH fund is effectively held in trust for the benefit of the policyholders and that those exist to pay out benefits when the policies eventually result into claim or are surrendered. The income/gain or loss on investments held in PH funds are also accounted as part of the PH Funds (i.e., in the Revenue Account and not in Profit & Loss Account of the Corporation).

12. The regulatory requirement to maintain separate accounts is not merely to facilitate identification of investment held from PH funds or monies of the PHs but also to demonstrate that such funds are liability of the Corporation. The separation enables transferring the benefits accrued from such investments to

the PHs, hence, to facilitate identifying the liabilities explicitly and to be treated as security to meet the obligations arising on account of policy contracts.

13. The Corporation (owners or SH) does not derive economic benefits emanating from investments in PH funds except for the Surplus, as worked out under regulatory provisions, therefrom at portfolio level after fully reserving based on actuarial valuation of the liabilities from all insurance contracts. Specified percentage of such surplus at the reporting date gets credited to SH Funds, as per the provisions of section 28 of the LIC Act. The economic benefits like dividend, interest or profits/gains of Investments in PH fund belong to and are accounted for as part of PH Funds.

14. According to the querist, an important aspect to be considered in the extant issue is whether the Corporation (its owners or SH) exercises control over the PH funds, which are presented as 'Liability' in the financial statements of the Corporation. In absence of deriving direct economic benefits from investments out of such PH funds, as stated in paragraph 13 above, these funds and investments out of that are not controlled by the SH or owners of the Corporation; instead, these funds are merely managed by the Corporation on behalf of the PH in fiduciary capacity only.

15. A view emerged within the management of the Corporation as to whether it is exercising control over the PH funds or not in view of the fact that PH Funds are presented as 'liability' in the financial statements of the Corporation. Further question as to whether economic benefits accrue to the Corporation from investments made and held in PH funds is also debatable, considering the definition of 'asset' as per the Framework for Preparation and Presentation of Financial statements, i.e., *a resource controlled as a result of past events from which future economic benefits are expected to flow* (emphasis supplied by the querist). As per the querist, as discussed above, no direct economic benefits flow to SH of the Corporation out of investments held through PH fund. Moreover, having regard to the constraints in transfer of funds by life insurance companies under the applicable sectoral regulations, investment in PH is not to be considered for consolidation.

16. The querist has further stated in 2019, the Corporation has acquired 51% stake in ABC Bank Limited (Investee Bank). The investment in the Investee Bank was made from PH fund. The investments from PH fund are made to obtain sufficient returns for policyholders and are made with an objective to exit at appropriate time.

17. Prior to acquisition of stake in the Investee Bank, necessary approval from IRDAI was sought. While granting the approval for the said acquisition, IRDAI had put certain conditions subject to which such Investment was made. The relevant conditions imposed by the IRDAI are summarised below:

- The Corporation shall ensure that acquiring additional stake in the Investee Bank is done in a prudent manner such that the interests of the policyholders are safeguarded.
- The Corporation shall make all efforts to maximise returns from the deal so that the returns are commensurate to the average returns from overall investments of the querist.
- The Corporation shall progressively bring down the stake in Investee Bank within the Regulatory limits as mandated by IRDAI (Investment) Regulations, 2016 (i.e., within 15% of the outstanding equity share capital (face value) of the investee bank) over a period of time as may be stipulated by the IRDAI

18. Further in September 2020, IRDAI communicated that it has fixed a 6-year timeframe from the date of acquisition of 51% stake in the Investee Bank, for the Corporation to bring its stake within the regulatory limits.

19. Approval conditions stipulated by IRDAI, being in nature of restrictive covenants, the Board of the Corporation contemplated that the stake acquired in the Investee Bank should be gradually disinvested at the earliest permissible timeline, considering the interest of the policyholders. Accordingly, the Board of the Corporation at its meeting held in November 2020 discussed and decided the roadmap for reducing the stake in the Investee Bank within 15% i.e., maximum permissible limit under the IRDAI Investment Regulations. The summary of such roadmap is as under:

(i) Encouraging Investee Bank to raise capital from other sources, thereby bringing down the dependency on the Corporation to provide capital. [The stake of the Corporation, currently has already been reduced to 49.24% in this manner.]

(ii) If Investee Bank is able to find alternate sources of funding, Corporation's stake in Investee Bank would be automatically reduced due to expansion of the base, over a period of time.

(iii) Under conducive market conditions, the Corporation could sell some of its stake in Investee Bank.

20. In the process of evaluating the provisions of applicable Accounting Standards pertaining to Consolidation (i.e., AS 21), the querist has reproduced the relevant extracts from paragraph 11 of AS 21 as below:

"A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

As per explanation (a) to paragraph 11 of AS 21, "where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprises is considered to be temporary within the meaning of paragraph 11(a)".

Explanation (b) to paragraph 11of AS 21 further states that "the period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investments, such an investment is not excluded from consolidation, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention."

21. The Corporation being statutory corporation established under the Act of Parliament engaged in the business of life insurance, provisions of the Governing Act mandate the Corporation to confine its operations to life insurance business and only such other businesses which are in connection with its said business.

22. The basic objective of any investments made from the PH fund is to provide returns. IRDAI directive also envisages that the Corporation shall make all efforts to maximize returns from the acquisition of stake in Investee Bank so that the returns are commensurate with the average returns from overall investment of the Corporation under the said fund.

23. Pre-approval of IRDAI specifically mandated the Corporation to progressively bring down the stake in Investee Bank within the Regulatory limits as mandated by IRDAI (Investment) Regulations, 2016 [i.e., within 15% of the outstanding equity share capital (face value) of the investee bank] over a period of time as may be prescribed, which was subsequently prescribed by IRDAI to

be 6 years from the date of investment. Along with such gradual reduction in shareholding, the Corporation's control over the composition of Board of Directors of the Investee Bank would also correspondingly reduce. Hence, IRDAI approval for investment was subject to pre-conditions to dispose it within defined time period. Considering the size of investment and with an objective to maximise return for Policyholders, sufficient time period is given by the Regulator for disposal of investment. Irrespective of having such a stringent regulatory requirement, the Board of Corporation decided to invest, which clearly indicates the intent of the Corporation to dispose-off such investment at earliest possible opportunity. Such investments made by regulated entities in the given facts and circumstances need to be considered differently while interpreting the term 'near future'.

24. As per the intent at the time of making the said investment, in November 2019 the Board of the Corporation has framed a plan for gradual reduction of its stake in the investee bank.

25. The explanation to paragraph 11 of AS 21, takes cognizance of the nuances emanating for investments which are highly regulated and governed by the special framework. As can be noticed from explanation (b) above, "held for disposal in near future" is a relative term requiring to be interpreted in the light of given facts and circumstances. The said explanation recognises the fact that period of several years may also be considered to be "near future" on the basis of facts and circumstances of the case.

26. Considering the above, a view within the management of the Corporation emerged that the investment from PH fund in Investee Bank with binding pre-conditions from IRDAI was made exclusively with a view to dispose-off in the near future, hence, control is considered 'temporary'.

B. Query

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

(i) Whether the investment made through and held in PH funds qualify to be consolidated/equity accounted in the consolidated financial statements of the Corporation.

(ii) If the response to (i) is that the investments held through PH Funds is to be considered for consolidation/equity accounting, whether in the given facts and circumstances of the matter, the control held by the Corporation in the extant case can be considered as 'intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future' as mentioned in paragraph 11(a) of AS 21 and therefore to be excluded from consolidation.

(iii) If, the financial information of the Investee Bank is excluded from the consolidation:

(a) As per paragraph 11 of AS 21, investment in Investee Bank should be accounted for in accordance with Accounting Standard (AS) 13, 'Accounting for Investments' in the consolidated financial statements. However, paragraph 2 (c) of AS 13 states that "this standard does not deal with investments of retirement benefit plans and life insurance enterprises".

(b) The financial statements of the Corporation are prepared as per the IRDAI FS Regulations and Circulars issued thereafter and as per provisions of the Insurance Act, 1938, as amended from time to time. Part 1 to Schedule A of the Regulations envisages accounting principles for preparation of financial statements including accounting for investments in standalone financial statement. However, the said Regulations are silent about accounting for Investment in CFS.

Hence, if the financial information of the Investee Bank is excluded from consolidation, whether the same should be accounted as per the principles of AS 13 or as per the applicable Regulations in the CFS.

C. Points considered by the Committee

28. The Committee has analysed the issue raised in the query relating to whether the investment made through and held in PH funds including the investment acquired in 2019 in the Investee Bank (hereinafter referred to as PH investments) qualify to be consolidated under AS 21 or equity accounted as per AS 23 in the consolidated financial statements of the Corporation. The Committee has, therefore, considered only the issue placed before it for opinion and has not examined any other issue(s) that may arise from the facts of the Case. In other words, the Committee has examined, on the basis of mentioned facts, whether the Corporation is to consider the investments made out of PH funds in case the Corporation is liable to prepare CFS as per AS 21 or AS 23 and has not examined IRDAI FS Regulations or IRDA Act. Further, the opinion expressed hereinafter is purely from accounting perspective as per ICAI Accounting Standards and not from the perspective of legal interpretation of IRDA Act, 1999, IRDA Regulations, 2002, LIC Act, 1956, or under any other applicable law or regulation.

The Corporation submitted (in paragraph 3 above) that the bifurcation amongst policyholder of participating and non-participating bifurcation was not maintained for financial reporting purposes by the Corporation in the extant case. Therefore, the Committee presumes that from accounting or financial reporting purposes, these are similar and therefore, the Committee has not examined any distinctive feature existing between these types of policies that may impact the opinion of the Committee (*emphasis supplied*). It is also presumed that in the extant case the querist has referred the issue in the context of non-linked investments. At the outset, the Committee wishes to mention that this opinion is based on the specific facts and circumstances mentioned by the Corporation in the query of the Corporation, same shall not be applied by any other organisation under any circumstances.

29. The Committee notes that Footnote 1 in Accounting Standard (AS) 21, 'Consolidated Financial Statements' and AS 23, 'Accounting for Investments in Associates', issued by the ICAI provides as follows:

> *AS 21*
>
> "It is clarified that AS 21 is mandatory if an enterprise presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21."
>
> *AS 23*
>
> "It is clarified that AS 23 is mandatory if an enterprise presents consolidated financial statements. In other words, if an enterprise presents consolidated financial statements, it should account for investments in associates in the consolidated financial statements in accordance with AS 23 from the date of its coming into effect, i.e., 1-4-2002 …"

From the above, the Committee is of the view that the Corporation in the extant case shall apply the requirements of AS 21 and AS 23 only if it presents the consolidated financial statements under the governing statutes or laws applicable to it.

30. In the referred issue, the Committee considers the scope of Accounting Standard (AS) 21, 'Consolidated Financial Statements' as follows:

"1. This Standard should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent."

Therefore, in order to qualify for consolidation under AS 21, an investee shall be controlled by the reporting enterprise.

AS 21 further states as follows in paragraphs 5 and 10:

"5.1 <u>Control</u>:

(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities."

"10. The consolidated financial statements are prepared on the basis of financial statements of parent and all enterprises that are controlled by the parent, other than those subsidiaries excluded for the reasons set out in paragraph 11. Control exists when the parent owns, directly or indirectly through subsidiary(ies), more than one-half of the voting power of an enterprise. Control also exists when an enterprise controls the composition of the board of directors (in the case of a company) or of the corresponding governing body (in case of an enterprise not being a company) so as to obtain economic benefits from its activities. An enterprise may control the composition of the governing bodies of entities such as gratuity trust, provident fund trust etc. Since the objective of control over such entities is not to obtain economic benefits from their activities, these are not considered for the purpose of preparation of consolidated financial statements. For the purpose of this Standard, an enterprise is considered to control the composition of:

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director, if any of the following conditions is satisfied:

(a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

(b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

(c) the director is nominated by that enterprise or a subsidiary thereof.

(ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member, if any of the following conditions is satisfied:

(a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

(b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

(c) the member of the governing body is nominated by that other enterprise.

…"

"*11. A subsidiary should be excluded from consolidation when:*

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments.

The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

Explanation*:*

(a) ***Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprises is considered to be temporary within the meaning of paragraph 11(a).***

(b) ***The period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investments, such an investment is not excluded from consolidation, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention.***

Further, the Committee notes that in order to qualify for accounting under equity method, the investee shall be significantly influenced by the reporting enterprise. The Committee notes that AS 23, 'Accounting for Investments in Associates' states as follows:

"3.1 An <u>associate</u> is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

3.2 <u>Significant influence</u> is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies.

3.3 <u>Control</u>:

(a) The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities."

"4. For the purpose of this Standard significant influence does not extend to power to govern the financial and/or operating policies of an enterprise. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiary(ies), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

…

5. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(a) Representation on the board of directors or corresponding governing body of the investee;

(b) participation in policy making processes;

(c) material transactions between the investor and the investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information."

Therefore, the Committee notes that under AS 21, control is established either through control of majority of voting power or control over composition of the board of directors of the investee company. Further, under AS 23, an entity is an associate if the investor has significant influence, i.e., power to participate in the financial and/or operating policy decisions of the investee. If an investor, directly or indirectly (through its subsidiaries) holds 20% or more of the voting power of the investee (for example, by way of share ownership), it is presumed that the investor has significant influence, unless it can be demonstrated that this is not the case. In this context, the Committee notes that in the financial year 2019-20, the Corporation acquired 51% stake in ABC Bank Ltd. which was subsequently reduced to 49.24% in the subsequent financial year(s). Further, in this context, the Committee also notes that the querist has specifically stated in the facts of the case that the insurance companies participate and engage with managements of investee companies in capacity of owner of the investments held and not merely as a custodian of PH. There is no distinction in that sense being made as investment forming part of PH or that of SH. However, the Committee notes that facts provided by the querist are silent on control over composition of the board of directors of the investee company as per the requirements of paragraph 10 of AS 21 and other factors determining the existence of significant influence as per the requirements of paragraph 5 of AS 23.

Accordingly, the Committee is of the view that the Corporation appears to have 'control' over the ABC Ltd. in financial year 2019-20 by virtue of **the ownership of more than one-half of the voting power of the investee enterprise. Further, in subsequent year(s) when shareholding was reduced to 49.24%, by virtue of such shareholding, it can be presumed that the Corporation** has significant influence, unless it can be demonstrated that this is not the case. However, in that case also, considering the control over composition of board of directors of the investee company as per the requirements of paragraph 10 of AS 21, it may still be possible that the investee company is controlled by the Corporation. Furthermore, even if it can be demonstrated that inspite of having 49.24% shareholding, the Corporation does not have significant influence over the investee, it may still be possible due to other factors determining the existence of significant influence as per the requirements of paragraph 5 of AS 23 that the Corporation may still have significant influence over the investee in the extant case. Thus, the Committee is of the view that in the extant case, subsequent to reduction in shareholding to 49.24% also, the Corporation shall have control/significant influence over the investee (viz., ABC Bank Ltd.) as per the above-mentioned factors.

31. With regard to exclusion or exception from consolidation under paragraph 11 of AS 21 and related explanations, in cases where the Corporation has control over the investee as per the afore-mentioned discussion and the requirements of AS 21, the Committee is of the view that in the extant case, neither the investment in shares of ABC Bank Ltd. can be considered as stock-

in-trade nor held with a view to their disposal in near future as six-years' term can't be considered as near future or temporary; and therefore, the control cannot be considered to be temporary. Accordingly, the Committee is of the view that investment in ABC Bank Ltd. cannot be excluded from consolidation under paragraph 11 of AS 21.

32. With regard to the querist's contention in relation to 'control' over policyholders' funds, the Committee notes from the Facts of the Case that the investments by the Corporation from PH funds are generally made with a view to generate adequate periodic returns/gains therefrom so as to protect the interest of PHs and to provide required liquidity for meeting claims, surrenders and other obligations on the life insurance policies written. These investments are under regulatory ring-fenced structure, being subject to several regulatory limits/ conditions and are required to be maintained separately from SH Funds under the provisions of applicable law and regulations. In the balance sheet of the Corporation, PH funds are shown as liabilities.

Further, it has been specifically stated by the querist in the Facts of the Case, that for the investment made either from PH fund or SH fund, the rights, and obligations w.r.t. that investment is to be always borne by the insurance company (i.e., ultimately by the SH). For investments made from PH funds, for the obligations, if at all, at segment level shall be borne by SHs. For instance, if a deficit is created due to diminution in the fair value change of investment made in debenture instrument from PH fund impacting the solvency ratio, this deficit is required to be made good by the SH.

The Committee also analyses the nature of insurance business, where, when the Corporation received funds from policyholders on account of insurance policy written, it accepts a liability towards the policyholders to the extent of sum assured as per the terms of the insurance policy. If any contingent situation happens as per the terms and conditions of the policy, then the commitment towards the sum assured has to be honored/met whether the PH funds are sufficient or not. In other words, if PH funds are not sufficient, as per the terms of the policy, the same shall be met by the Corporation out of the SH funds.

Considering the above submissions made by the querist and considering the nature of insurance business, the Committee is of the view that in the extant case, the funds received from the policyholders create an obligation for the Corporation to provide adequate returns out of the investments made out of such funds as well as to provide required liquidity for meeting claims, surrenders and other obligations on the life insurance policies written and thus, results into liabilities in respect of obligations undertaken. In order to fulfill these obligations, the Corporation makes investments on its own account, which gives rise to a corresponding asset in terms of investment made out of such funds as the Corporation seems to have decision making rights in the investee companies.

The Corporation is managing the PH investments and a portion of the surplus of the PH investments is credited to SH funds. Thus, the Corporation would benefit as a consequence of creating surplus for the policyholders. Therefore, the Corporation has economic benefits arising from the PH investments.

33. Based on the above, it seems that, overall, the investments made out of PH funds would result in control/significant influence by the Corporation on its own account for the purpose of AS 21/AS 23 and therefore, the Corporation should consolidate or follow equity accounting as per the relevant requirements of AS 21 and AS 23 respectively.

D. Opinion

34. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 27 above:

(i) The investment made through and held in PH funds is an investment made by the Corporation on its account to meet its obligation/liability created as per the terms of the insurance policy on account of PH funds received and the same shall be consolidated/equity accounted in the consolidated financial statements of the Corporation, as discussed in paragraphs 30 to 33 above. The Corporation in the extant case shall apply the requirements of AS 21 and AS 23 only if it presents the consolidated financial statements under the governing statutes or laws applicable to it.

(ii) In the given facts and circumstances of the matter, the control held by the Corporation in the extant case cannot be excluded from consolidation under paragraph 11(a) of AS 21.

(iii) Since the financial information of the Investee Bank is not to be excluded from the consolidation, answer to this question does not arise.

Query No. 4

Subject: Presentation of change in non-current asset in Cash Flow Statement.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') has been incorporated as a Special Purpose Vehicle (SPV) by I Ltd., its holding company, on 11th May 2017, for executing the project works of 'Six-laning of Davangere – Haveri from km 260+000 to km 338+923 of NH-48 (old NH-4) in the State of Karnataka under Hybrid Annuity Model (HAM) under National Highway Development Project (NHDP) Phase – V' in accordance with the terms of the Concession Agreement (a copy of Concession Agreement has been supplied separately by the querist for the perusal of the Committee), signed with the National Highways Authority of India (hereinafter referred to as 'the Authority') on 19th June 2017. Concession period for the project is 15 years excluding the project construction period of 912 days.

2. The querist has stated that the total project execution cost is Rs.1177.00 crores plus escalation wherein 40% project cost is reimbursable by the Authority and 60% is to be funded by SPV, viz., the Company. 40% of the bid project cost (BPC), adjusted for Price Index Multiple, shall be due and payable by the Authority to the Concessionaire in 5 equal instalments of 8% each during the construction period and the remaining bid project cost, adjusted for Price Index Multiple, shall be due and payable in 30 biannual instalments commencing from the 180th day of Commercial Operation Date (COD).

3. Further, interest shall be due and payable by the Authority to Concessionaire on the reducing balance of completion cost at the interest rate equal to the applicable bank rate plus 3%. Such interest shall be due and payable biannually along with each instalment.

4. Presently, the Company is recognising revenue using input method as per Appendix D of Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers', which states that the consideration received or receivable by the Company is a right to a financial asset. The Company recognises 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 (Authority) for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. Presently, 40% of BPC shall be due and payable by

[1] Opinion finalised by the Committee on 13.4.2021.

the Authority during construction period in 5 instalments on achievement of milestones and remaining 60% will be payable biannually during 15 years in the form of annuity. Here, financial asset represents the 60% amount payable by the authority. The Company presents amount receivable from the Authority within 12 months on achievement of milestone as current financial asset and remaining as non-current financial asset.

5. Accordingly, the Company presented the movement in non- current financial asset due to billing progress under 'cash flows from operating activity' in the cash flow statement for the financial year (F.Y.) 2018-19 as it is a non-cash adjustment and is required to be adjusted from profits only as per the indirect method stated in the relevant standard. However, during supplementary audit, Comptroller and Auditor General of India (CAG) had issued a paragraph that "the change in non-current financial asset has been disclosed in adjustment of working capital changes instead of disclosing the same under cash flow from investing activity in cash flow statement".

6. The Company continued the same treatment in F.Y. 2019-20 in its books of account. However, CAG has again issued the same paragraph, i.e., "The company during the current year has again disclosed the working capital changes in non-current financial assets (amounting to Rs. 12048.40 lakh) under cash flows from operating activities instead of showing under cash flow from investing activities as required under paragraph 16 of Ind AS 7." Further, change in current financial asset was also disclosed under cash flows from operating activity but CAG does not give any observation on it.

7. The querist has referred to the following provisions of Indian Accounting Standard (Ind AS) 7, 'Statement of Cash Flows':

> **"18 An entity shall report cash flows from operating activities using either:**
>
> **(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or**
>
> **(b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows."**
>
> "16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for

classification as investing activities. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged."

8. The querist has informed that the Company is of the view that during the F.Y. 2019-20, there was no receipt under the head 'other non-current financial assets' (Receivable). Hence, this represented transactions of a non-cash nature as per paragraph 18 of Ind AS 7 and required to be disclosed under operating activities under working capital change. The Company, accordingly, disclosed the same under working capital change.

B. Query

9. In view of above, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) has been sought by the querist on the issue as to whether change in non-current financial asset recognised in accordance with Ind AS 115 should be disclosed as cash flows from operating activity or under investing/financing activity as per Ind AS 7.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to classification of change in non-current financial asset in the cash flow statement. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting for the expenditure incurred on the project including classification of cash flows arising from such expenditure, classification of change in current financial asset in the cash flow statement, accounting for interest due/payable by the Authority, accounting for and classification of cash flows from interest and other finance costs incurred by the Company, appropriateness of classification of financial assets as current and non-current, accounting for Concession Agreement and application of Appendix D, 'Service Concession Arrangements' to Ind AS 115, 'Revenue from Contracts with Customers' in the extant case, recognition of revenue including the appropriateness of method used (input method), accounting for liquidated damages or penalty or bonus element, if any, included/adjusted in the annuity payments, etc. Further, the opinion expressed, hereinafter, is purely from accounting perspective and not from any legal perspective or interpretation of terms of Concession Agreement. The Committee notes from the Facts of the Case that the Company is recognising revenue as per the requirements of Ind AS 115. Further, it is also noted from the Annual Reports provided by the querist for the perusal of the Committee that the Company is following the requirements of Appendix D, 'Service Concession Agreements' to Ind AS 115, 'Revenue from Contracts with Customers' for the Concession Agreement in the extant case. Although the Committee has not examined the application of the same in the extant case, the Committee presumes that it is a service concession arrangement within the scope of the Appendix D to Ind AS 115.

11. The Committee further notes the following relevant extracts from the Concession Agreement, provided by the querist for the perusal of the Committee as follows:

> "2.1 **Scope of the Project**
>
> The scope of the Project (the **"Scope of the Project"**) shall mean and include, during the Concession period:

(a) construction of the Project on the Site set forth in Schedule-A and as specified in Schedule-B together with provision of Project Facilities as specified in Schedule-C, and in conformity with the Specifications and Standards set forth in Schedule-D;

(b) operation and maintenance of–the Project in accordance with the provisions of this Agreement; and

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

"3.1.1 Subject to and in accordance with the provisions of this Agreement, Applicable Laws and Applicable Permits, the Authority hereby grants to the Concessionaire the concession set forth herein including the exclusive right, license and authority to construct, operate and maintain the project (the **"Concession"**) during the Construction Period of 912 (nine hundred and twelve) days and Operation Period of 15 (Fifteen) years commencing from COD, and the Concessionaire hereby accepts the Concession and agrees to implement the Project subject to and in accordance with the terms and conditions set forth herein."

"5.8 Sole purpose of the Concessionaire

The Concessionaire having been set up for the sole purpose of exercising the rights and observing and performing its obligations and liabilities under this Agreement, the Concessionaire or any of its subsidiaries shall not, except with the previous written consent of the Authority, be or become directly or indirectly engaged, concerned or interested in any business other than as envisaged herein."

"15.1.1 … The Project shall enter into commercial service on COD whereupon the Concessionaire shall be entitled to demand and collect Annuity Payments in accordance with the provisions of this Agreement."

"23.1 Bid Project Cost

The parties expressly agree that the cost of construction of the Project, as on the Bid Date, which is due and payable by the

Authority to the Concessionaire, shall be deemed to be Rs. 1177.00 Crore (Rupees One Thousand One Hundred Seventy Seven Crore only) (The **"Bid Project Cost"**). The Parties further agree that the Bid Project Cost specified hereinabove for payment to the Concessionaire shall be inclusive of the cost of construction, interest during construction, working capital, physical contingencies and all other costs, expenses and charges for and in respect of construction of the Project, save and except any additional costs arising on accounts of variation in Price Index, Change of Scope, Change in Law, Force Majeure or breach of this Agreement, which costs shall be due and payable to the Concessionaire in accordance with the provisions of the Agreement. For the avoidance of doubt, the Bid Project Cost specified herein represents the amount due and payable by the Authority to the Concessionaire and may be less than, equal to, or more than the Estimated Project Cost."

"23.3.1 40% (forty per cent) of the Bid Project Cost, adjusted for the Price Index Multiple, shall be due and payable to the Concessionaire in 5 (five) equal installments of 8% (eight per cent) each during the Construction Period in accordance with the provisions of Clause 23.4.

23.3.2 The remaining Bid Project Cost, adjusted for the Price Index Multiple, shall be due and payable in 30 (thirty) biannual installments commencing from the 180th (one hundred and eightieth) day of COD in accordance with the provisions of Clause 23.6.

23.4 Payment during Construction Period

Upon receiving a report from the independent Engineer certifying the achievement of the below mentioned Payment Milestones, the Authority shall disburse, within 15 (fifteen) days of the receipt of each such report, an installment equal to 8% (eight per cent) of the Bid Project Cost, adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the date of that report.

For the purpose of this Clause 23.4, the Payment Milestone for release of payment during Construction Period shall be as under:

a) I (first) Payment Milestone – On achievement of 10% Physical Progress

b) II (second) Payment Milestone – On achievement of 30% Physical Progress

c) III (third) Payment Milestone – On achievement of 50% Physical Progress

d) IV (fourth) Payment Milestone – On achievement of 75% Physical Progress

e) V (fifth) Payment Milestone – On achievement of 90% Physical Progress

Provided that in case of Change of Scope, the Physical Progress shall be recalculated to account for the changed scope."

"**23.6 Annuity Payments during Operation Period**

23.6.1 The (the "**Completion Cost**" shall be summation of A, B, C, D, E and F below:

A. 10% of the Bid Project Cost adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the date of report confirming 10% Physical Progress.

B. Another 20% of the Bid Project Cost adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the date of report confirming 30% Physical Progress.

C. Another 20% of the Bid Project Cost adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the date of report confirming 50% Physical Progress.

D. Another 25% of the Bid Project Cost adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the date of report confirming 75% Physical Progress.

E. Another 15% of the Bid Project Cost adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the date of report confirming 90% Physical Progress.

F. Another 10% of the Bid Project Cost adjusted for the Price Index Multiple as applicable on the Reference Index Date preceding the COD.

The Parties acknowledge and agree that the Authority has paid a portion of the Completion Cost as payments during Construction Period pursuant to Clause 23.4 of this Agreement. The balance Completion Cost remaining shall be due and payable during the Operation Period in accordance with provisions of Clause 23.6.2.

23.6.2 The Completion Cost remaining to be paid in pursuance of the provisions of Clause 23.6.1 shall be due and payable in biannual installments over a period of 15 (fifteen) years commencing from COD, (the **"Annuity Payments"**). The 1st (first) installment of Annuity Payments shall be due and payable within 15 (fifteen) days of the 180th (one hundred and eightieth) day of COD and the remaining installments shall be due and payable within 15 (fifteen) days of completion of each of the successive six months ("the **Annuity Payment Date**"). For the avoidance of doubt, the last Annuity Payment Date would be adjusted to in such a way that it falls at the end of the Operations Period."

"23.6.4 Interest shall be due and payable on the reducing balance of Completion Cost at an interest rate equal to the applicable Bank Rate plus 3% (three per cent). Such interest shall be due and payable biannually along with each installment specified in Clause 23.6.3. … The Parties further agree that interest shall be calculated based on the number of days a particular Bank Rate was applicable during the period of calculation. For the purpose of illustration, assuming that the balance capital cost remaining to be paid is Rs. 100 crores on the 1st Annuity Payment Date, the applicable Bank Rate for the first 75 days is 8% and thereafter it is revised to 7.5% and remain unchanged till the 2nd Annuity Payment Date, the interest would be calculated as ((100*11%*75)/365)+((100*10.5%*105)/365). For the avoidance of doubt, the interest would be calculated on simple interest basis and no compounding of the same would be undertaken."

12. With regard to presentation in the statement of cash flows, the Committee notes the following paragraphs of Ind AS 7, 'Statement of Cash Flows':

"Operating activities **are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.**

Investing activities **are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.**

***Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.”**

“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.”

“14 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments from contracts held for dealing or trading purposes.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities. However, cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68A of Ind AS 16, *Property, Plant and Equipment*, are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.”

"Investing activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged."

"20 Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) changes during the period in inventories and *operating receivables* and payables;

…"

"**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."*

(Emphasis supplied by the Committee.)

From the above, the Committee notes that an entity classifies its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business and allows users to assess the impact of those activities on the financial position of the entity. Cash flows derived from the principal revenue-generating activities are classified as cash flows from operating activities e.g. cash receipts from the sale of goods and rendering of services, royalties, commission, cash payments to suppliers for goods and services etc. The cash flows which represent the extent to which expenditure have been made for resources intended to generate future income and result in a recognised asset in the balance sheet are presented as cash flows from investing activities e.g. cash payments to acquire property, plant and equipment, intangibles, equity or debt instruments of other entities etc. In other words, in case of investing activities, the intent is to make expenditure for or invest in the resources/assets to generate future income and cash flows.

13. The Committee notes from the Facts of the Case and the Concession Agreement that the Company has been set up mainly for the purpose of construction, operation and maintenance of the Project for the Authority and other incidental activities under the Concession Agreement; and not for the purpose of investment in any asset to generate future income. The primary main revenue of the Company in the extant case arise from the construction, operation and maintenance services provided by the Company under the Concession Agreement. The Committee further notes that as per the terms of the Agreement, in lieu of the services rendered by the Company, it is entitled to 40% of the bid project cost in five equal instalments during the construction period. The remaining completion cost of the Project, viz., 60% of the bid project cost is payable in 30 biannual instalments over a period of fifteen years commencing from COD. Thus, the Committee notes that the consideration in lieu of rendering construction, operation and maintenance services by the Company is in the form of a financial asset, viz., a contractual right to receive cash. In other words, the financial asset (viz., the receivable due from the Authority) in the extant case is consideration for the services rendered by the Company and represents the outcome of principal revenue-producing activities of the Company. Accordingly, it can be considered as an operating receivable for the Company in the extant case. Consequently, since under indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of changes during the period in operating receivables as per paragraph 20 of Ind AS 7, changes in non-current financial asset (receivable from the Authority) should be adjusted as 'changes in operating receivables' to determine the cash flow from operating activities under indirect method.

However, the Committee notes from the Facts of the Case and the Concession Agreement that interest shall be due and payable on the reducing balance of Completion Cost at an interest rate equal to the applicable Bank Rate plus 3% (three per cent) and that such interest shall be due and payable biannually along with each instalment. Thus, a portion of the financial asset, viz., receivable from the Authority contains an interest element also which is a financing component in the transaction. The Committee is of the view that such financing component which represents payment due to time value of money should be separated from the financial asset as per the relevant applicable Standard and should be considered and classified as cash flows from investing activities, considering the requirements of paragraphs 31 and 33 of Ind AS 7, as reproduced above.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that in the statement of cash flows of the Company, as per the requirements of paragraph 20 of Ind AS 7, changes in non-current financial asset (receivable from the Authority) should be adjusted as 'changes in operating receivables' to determine the cash flow from operating activities under indirect method. Further, since a portion of the financial asset, viz., receivable from the Authority contains interest element also which is a financing component in the transaction; such financing component which represents payment due to time value of money should be separated from the financial asset as per the relevant applicable Standard and should be considered and classified as cash flows from investing activities, considering the requirements of paragraphs 31 and 33 of Ind AS 7, as discussed in paragraph 13 above.

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Query No. 5

Subject: Accounting treatment for backstopping arrangement for compulsorily convertible debentures (CCDs).[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a schedule 'A' Miniratna, Central Public Sector Enterprise (CPSE) under the Ministry of Petroleum & Natural Gas. The Company owns a 15.0 MMTPA (Million Metric Tonne per annum) refinery, which has got a versatile design with complex secondary processing units and a high flexibility to process crudes of various API, delivering a variety of quality products. The shares of the company are listed and traded on stock exchanges of India.

2. The Company has promoted another company, ABC Ltd., jointly with another joint venture (JV) partner, XYZ Ltd., which is a public sector undertaking engaged in exploration, development and production of crude oil and natural gas and value-added products across India and abroad. The shares of the company are listed and traded on stock exchanges of India. The Government of India owns 68.07% of its shares through the President of India. The JV partner is the largest crude oil and natural gas company in India, contributing around 75 per cent to Indian domestic production. Crude oil is the raw material used by several downstream companies to produce petroleum products like petrol, diesel, kerosene, naphtha, and cooking gas-LPG.

[1] Opinion finalised by the Committee on 13.4.2021.

3. ABC Ltd. owns a green field petrochemicals project, promoted by XYZ Ltd. (joint venture partner) and the Company. ABC Ltd. is subsidiary of the Company and was incorporated on 19th December 2006. It operates an Aromatics Complex, which is the largest single stream unit in Asia to produce 914 KTPA Para-xylene and 283 KTPA Benzene. This aromatic complex is situated in 442 acres of land in the Mangalore Special Economic Zone (MSEZ), and is fully integrated with the Company with feed streams predominantly supplied by the Company.

4. The Company acquired control over ABC Ltd. on 28.02.2015 by acquiring 51.0017 % equity shares, thus making it a subsidiary of the Company. The balance equity shares were held by the JV partner and other individual shareholders (0.0002%). Subsequently, Board of Directors of the Company at its 232nd meeting held on 19.10.2020 approved the acquisition of 48.9981% stake in the subsidiary company from the JV partner. The additional shares purchased from the JV partner were transferred in the name of the Company on 01.01.2021. With this, shareholding of Company in the subsidiary company has increased to 99.9998%.

5. The Aromatics Complex was commissioned by the subsidiary company (ABC Ltd.) in October 2014. Due to initial year challenges and market conditions, the subsidiary company incurred losses upto the financial year (F.Y). 2017-18 and during 2019-20 (during F.Y. 2018-19, earned profit). One of the group entities of the JV partner had issued CCDs which enabled it in net-worth shoring-up.

Therefore, in order to shore-up the net-worth of the subsidiary company, reduce the debt levels and strengthen the subsidiary company's balance sheet during F.Y. 2019-20, the subsidiary company embarked on Capital Realignment Plan (CRP) with due approvals from the Board followed by the Promoter Company's (the Company & the JV company) Board's approvals. CRP among other arrangements, comprised of issuance of Compulsorily Convertible Debentures (CCDs) to investors with backstop support from Sponsors (Promoter Companies) with CCDs convertible into equity shares in the hands of Sponsors. Accordingly, during March 2020, the subsidiary company issued CCDs to investors (NBFCs and Bank) to the extent of Rs. 1,000 crore with backstop support from the Promoter companies.

The JV partner and the Company held shareholding in the subsidiary company in the ratio of 49% and 51%, respectively (with 0.0002% held by individuals) at the time of issue of compulsory convertible debentures (CCDs) by the subsidiary company.

The subsidiary company has the obligation to service the interest payouts during the tenure of the CCDs. It is also sponsors' (the Company and the JV Company) obligation to ensure that the subsidiary company meets the interest obligations on time.

The CCDs are not convertible in the hands of investors under any circumstance. Investors have an un-conditional irrevocable put option, which can be exercised by investors only on the sponsors and not on the issuer (the subsidiary company). These CCDs are convertible only in the hands of sponsors at the end of the tenure/buy out option or exercising of put option by the investors (mandatory and irrevocable put option available to investors on sponsors only) and the subsidiary company would be required to convert the same into equity shares of the subsidiary company ranking pari-passu with existing shares at the time of conversion by reckoning share price at that time as per conversion formula defined in the transaction documents.

6. *Existing Disclosures in the standalone financial statements of the Company for the year ended 31st March 2020:*

In view of the Company being sponsors to the CCDs of the subsidiary company, in the standalone financial statements of the company for the year ended 31st March 2020, the following disclosures were made:

a. **Notes to the financial statements (Under Note No. 11: Financial Assets: Non-Current Investments)**

11.1.2 The Company has entered into an arrangement for backstopping support towards repayment of principal and cumulative coupon amount for three years compulsorily convertible debentures (CCD) amounting to Rs. 5,100 million (As at March 31, 2019 Rs. Nil) issued by the subsidiary Company and outstanding interest for the year ended March 31, 2020 amounting to Rs. Nil (As at March 31, 2019 Rs. Nil)

b. **Disclosure under Related party (Under Note No. 43: Related Party Disclosures)**

(Rs. in Million)

Commitments	As at March 31, 2020	As at March 31, 2019
(b) Backstopping support by the company for Compulsorily Convertible Debentures issued by the subsidiary company.	5,100.00	-
(c) Backstopping support for interest accrued on Compulsorily Convertible Debentures issued by the subsidiary company.	-	-

c. Disclosure under Other Commitments (Under Note No. 47: Commitments)

47.2.3 The Company has entered into an arrangement for backstopping support towards repayment of principal and cumulative coupon amount for three years Compulsorily Convertible Debentures (CCD) amounting to Rs. 5,100 million (As at March 31, 2019 Rs. Nil) issued by subsidiary Company and outstanding interest for the year ended March 31, 2020 amounting to Rs. Nil (As at March 31, 2019 Rs. Nil).

7. *Existing Accounting and Disclosures in the Consolidated Financial Statements of the Company as a Group for the year ended 31st March 2020:*

As per the requirements of Ind AS 110, the Company consolidates the accounts of subsidiary company by combining like items of assets, liabilities, equity, income, expenses and cash flows.

As on 31st March, 2020, the subsidiary of the company has disclosed the liability towards CCDs as Compound Financial Instrument and the same is segregated into debt and equity component as per the requirement under Ind AS 32, Financial Instruments: Presentation. Equity and debt components of compound financial instrument presented in the subsidiary company financials for Rs. 7,740.67 million (gross of deferred tax adjustments) (refer Note No. 18 (c) of the subsidiary company's financials) and Rs. 2,196.46 million (refer Note No. 19 (d) of the subsidiary company's financials (shown as non-current and current for Rs. 1,507.59 and Rs. 688.87 million respectively)) respectively.

Upon recognition of equity component of compound financial instrument, the subsidiary company has also recognised Deferred Tax Asset amounting to Rs. 785.69 million and the same was adjusted against equity component and shown as deferred tax impact on equity component of compound financial instrument (refer Note No. 18 (c) of the subsidiary company's financials).

While consolidating the above figures of compound financial instrument in the company's group's consolidated financials, 49% (i.e. non-controlling interest) of equity component of compound financial instrument has been assigned to non-controlling interest (gross of deferred tax adjustments) and balance has been shown as equity component of compound financial instrument in the company's group's consolidated financials for Rs. 3,947.74 million and further to that, the adjustment on account of deferred tax on the same for Rs. 785.69 million has been recognised in group's other equity component and nothing has been assigned to the non-controlling interest (refer Note No. 21 (vi) of group's consolidated financials).

In addition to above, the entire portion of borrowings shown as a part of compound financial instrument in the financials of subsidiary company, has been consolidated in the group's financials (refer Note 22.7 of the consolidated financials) by combining like items.

8. *Observations of the Comptroller and Auditor General of India (C&AG) to the company's Standalone Financials Statements:*

During the audit of the accounts of the Company for the year ended 31st March 2020, the C&AG made the following observations regarding the accounting treatment of the CCDs in standalone financial statements:

"These CCDs are issued to private firms and the company has contractual obligation to discharge the debentures and simultaneously, get it converted into equity of the subsidiary company. The contractual obligation to deliver cash to another entity is not recognised as financial liability as per Ind AS 32. Further Accounting Policy (Note 3.20) of the company states, "***Financial Assets and Financial Liabilities are recognised when Company becomes a party to the contractual provisions of the instruments***".

The Company neither recognised the liability nor asset which has resulted in non-compliance of Ind AS 32 and Company's own accounting policy."

9. *Response of the Company to C&AG:*

The Company along with its joint statutory auditors, have responded as follows:

"The key feature in determining the instrument as a financial liability as per Ind AS 32 is the contractual obligations to pay cash or other assets to third parties. In this case, the compulsory convertible debentures are issued by the subsidiary company and hence primarily the contractual obligation also lies with the subsidiary company. Being a compound financial instrument, which is later convertible to equity, the liability component and equity component should also be recognised by the subsidiary company in its books.

However in terms of the Put Option Agreement, the obligation of sponsors, i.e., the Company and XYZ Ltd. would arise in future, upon Put Option Exercise date, subject to transfer of CCDs and other applicable conditions. Mere serving of put-option notice cannot be considered as giving rise to liability to the sponsors at present. We would also refer to Para 3.6 of the option agreement dated 28th February, 2020 which states that "In the event the investors are unable to transfer the put securities free and clear of all encumbrances then nothing in this agreement shall be deemed to require the sponsors to put the put securities". Hence there is no liability but only a Commitment as on current date which has been duly disclosed under Note 11.1.2.

This view also emerges from the legal opinion and expert views obtained by the subsidiary company and produced before the Company and Joint Statutory Auditors of the Company as mentioned in our reply to the preliminary enquiry.

In view of the above facts, we (the Company) are of the opinion that the accounting treatment followed is in compliance with the provisions of Indian Accounting Standard (Ind AS 32) and there is no non-disclosure of liability nor asset in the financial statements of the company.

We (the Company) also note that similar accounting treatment w.r.t. CCDs were followed along with disclosures made in annual accounts by holding company while giving backstopping support to the subsidiary during F.Y. 2018-19. We (the Company) are also informed that the Company will advise its subsidiary company to take further opinion from Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India for the same and incorporate the necessary changes, if any, as per expert opinion in the accounts of the Company in the ensuing financial year."

10. To address the C&AG observations in the Company's standalone accounts, EAC opinion is intended to be sought on the correctness of the above accounting treatment/disclosures, in the accounts of the Company being Sponsor providing backstop support to CCDs issued by its subsidiary.

The CCDs are not convertible in the hands of investors under any circumstance and the put option can be exercised by investors only on the sponsors and not on the issuer (the subsidiary company). These CCDs are convertible only in the hands of Sponsors (the Company and the JV partner) at the end of the tenure/Buy out option or exercising of put option by the investors (mandatory and irrevocable put option available to investors on Sponsors only) and the subsidiary company would be required to convert the same into equity shares of the subsidiary company ranking pari-passu with existing shares at the time of conversion by reckoning share price at that time as per conversion formula defined in the transaction documents.

11. *The key terms of CCDs as follows:*

Sponsor	The two promoter shareholders of the Company
Company/Issuer	The Company

Sponsor	Oil and gas extraction company and OMC
Type of Instrument	Compulsorily Convertible Debentures (CCD)
Nature of the Instrument	The Debenture shall mean an instrument which is compulsorily convertible into equity capital of the Company by the Sponsor/nominees of the Sponsors in accordance with the terms mentioned herein.
Mode of Issue	Private Placement on a fully paid up basis
Listing	Unlisted
Issuance Mode	Demat only. Demat credit to be received within 15 days of the Debentures Pay-in-Date.
Depository	NSDL or CDSL
Debenture Trustee	S Trustee Company Limited
Use of Funds	The Company shall use the proceeds for repayment of existing credit facility(ies), availed by the Company and general working capital purposes.
Face Value	Rs. 1 Crore per Debenture.
No. of Units	1,000
Tenure	36 (thirty-six) months from the Deemed Date of Allotment; with mandatory Put/Call Option at the end of the 35th month.
Coupon Payment Date	shall mean with respect to the first coupon period 31 March, 2020 thereafter on 30th June, 30th September, 31st December and 31st March of each year.
Rating of Instrument	The Debentures are expected to be assigned a rating of AAA (CE).
Accelerated Buy Out Option with the Sponsor	▪ Upon signing of a binding term sheet for equity infusion in the Issuer at any time prior to the expiry of 35 months from the Deemed Date of Allotment, the Sponsor may, with a prior written notice of 15 days to the Debenture Trustee, buy–out Debentures at Face Value ("Accelerated Buy Out of Securities") from the Investor (s); ▪ Coupon amount accrued and due but unpaid till the date of the Accelerated Buy Out shall be paid to the Investor (s) as on the date of the Accelerated Buy Out. ▪ The Sponsors will have a right to buy-out the CCDs (partly or fully at Face Value) at any point of time. On exercising such accelerated buy-out option prior to the 12th month of the instrument, the Investors will be compensated through Yield Protection Premium for the

	balance period until the end of 12 months from the Pay-in date. ▪ The Yield Protection Premium will be calculated as follows for each Debenture – [(Face Value of a Debenture) X (Coupon rate – 1 yr. G-sec rate) X (No. of days till end of 12 months /365)] / [(1+ 1 yr. G-sec rate) ^ (No. of days till end of 12 months /365)]
"Put Option" or "Mandatory Buy-out by the Sponsor"	a) In the event that the Sponsor has not procured a Nominee who has, or the Sponsor by itself has not, acquired all the Debentures from the Investor (s) prior to the expiry of 35 months from the Deemed Date of Allotment of Debentures, the Sponsor will mandatorily, and without requiring any notice or intimation in this regard, buy the outstanding Debentures for the aggregate Face Value of the Debentures and the accrued/outstanding but unpaid amounts (including but not limited to unpaid coupon amount), if any, at the end of 35th month from the Deemed Date of Allotment ("Mandatory Buy-out"). Purchase of Debentures shall be undertaken mandatorily by the Sponsor for the entire outstanding Debentures amount; b) The Mandatory Buy-out set out above, shall be binding on the Sponsor and not optional in nature and shall not be dependent on any notice being delivered to the Sponsor; and c) The Debenture Trustee shall give a prior notice of 60 days to the Sponsor in regards to the Mandatory Buy-out. However, the obligation of the Sponsor under the Mandatory Buy-out shall remain, independent of any such notice being given to the Sponsor. d) Sponsors' liability: The liability of each Sponsor shall be limited to its proportionate shareholding in the Company, i.e. the Sponsors will not be joint and severally liable.
Accelerated Put Option available to the Investor(s)	a) Accelerated Put Option may be exercised by the Investor(s) on the Sponsor in case of non-payment of coupon amount due and payable on the applicable Coupon Payment Dates wherein such default continues for a period of 1 (one) Business Days (including the Coupon Payment Date) from such Coupon Payment Date; and b) Accelerated Put Option shall be applicable on the entire

	outstanding principal amount of Debentures and any other dues due to the Investor(s).
Transfer	a) In case of exercise of Accelerated Buy-out Option, the Sponsor, by itself, or through any other affiliate or Nominee(s) nominated by the Sponsor, may acquire the outstanding Debentures. b) In case of Mandatory Buy-out and/or the Accelerated Put Option, the Sponsor or its Nominees shall be mandatorily required to buy the outstanding Debentures held by the Investor(s). c) The Debentures, if required by the Principal Investor (s), maybe transferred only to the Permitted Investor at any time during the Tenure. Provided that such Permitted Investor (s) shall be permitted to transfer the Debentures to any of the Principal Investor (s)/ other Permitted Investor(s).
Conversion Option	The Debentures will not have any conversion option for the period it is held by the Investor(s). On exercise of any of the following, the conversion option shall be effective: a) Accelerated Buy-out Option; b) Mandatory Buy-out; c) Accelerated Put Option; Sponsor/Nominee shall have the unilateral right to convert the Debentures held by them to equity of the Company.
Conversion Terms for Debentures	Debentures shall be automatically and compulsorily converted into ordinary equity shares of the Company at the end of the Tenure; provided however in the event that the Investors continue to hold the Debentures at the end of the Tenure, for any reason whatsoever, the conversion of the Debentures shall not happen until such time as the Sponsor has acquired the Debentures from the Investor. Further, in the event, the Sponsor exercises the Accelerated Buy-out Option or when the Debentures are transferred to Nominee(s), the Sponsor may require the Company to convert the Debentures including the coupon amount and any other fee paid to the Investor (s) by the Sponsor into ordinary equity shares of the Company, before the end of the Tenure of the Debentures. Such conversion shall occur at the Conversion Price.
Conversion Price	To be decided 35 months from date of issuance or within 30 days of the exercise of the following, whichever is

	earlier: a) Accelerated Buy-out Option; b) Mandatory Buy-out; c) Accelerated Put Option.
Ranking of shares	The equity shares issued upon conversion of the Debentures shall rank pari-passu in all respect with the equity shares existing at the time of such conversion, including with respect to voting rights, bonus and rights shares.
Transaction Documents	Customary documents for such Debenture issuance, including: ▪ Debenture Trust Deed (DTD) setting out the terms of issuance of Debentures set out in this term sheet; ▪ Option Agreement setting out the terms of the Mandatory Buy-out, Accelerated Put Option, and the Accelerated Buy-Out Option; ▪ Debenture Trustee Agreement setting out the terms of appointment of Debenture Trustee and the rights and duties of the Debenture Trustee; and ▪ Service Account Agreement setting out the terms of operation of the Service Account. ▪ Private Placement Offer Letter (PAS-4) Pricing Supplement setting out the applicable coupon rate in respect of each series of debentures.

B. Query

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

(i) Whether the Company has to account for the back-stopping arrangement provided by it for the issue of CCDs by the subsidiary company as a liability and asset in its books of account and whether in the event of non-disclosure of asset and liability in the Company's standalone financial statements will attract non-compliance of Ind AS 32. If yes, what should be the disclosure/ presentation (head-wise along with nomenclature) in the standalone financial statements of the Company?

(ii) Whether the current accounting treatment and disclosures (refer paragraph 6 above) made by the Company of the backstopping arrangement are in compliance with Ind AS requirements. If the same is not in compliance with Ind AS requirements, what should be additional/changed accounting treatment and disclosures required under the Company's standalone financial statements?

(iii) While doing consolidation of the Company's groups' financial statements as referred to in paragraph 7 above, the Company consolidates the subsidiary company's financials as per Ind AS 110, 'Consolidated Financial statements' by combining like items of assets, liabilities, equity, income, expenses and cash flows. Whether any further adjustments in the Company's consolidated financial statements are required in the accounting treatment/presentation currently followed by the subsidiary company on account of CCDs or subsequent changes based on the EAC opinion.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the obligations arising out of the CCDs issued by the subsidiary company of the Company in the separate/stand-alone financial statements of the Company under Ind AS. 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 including classification of the CCDs from the perspective of the issuer (the subsidiary company), accounting treatment of the financial guarantee obligation provided by the Company in the financial statements of the subsidiary company and the Investor of the CCDs, valuation of the CCDs, measurement of CCDs by the issuer/ investor, accounting for the conversion option which gets triggered on exercise of put option by the investor or Accelerated/Mandatory Buy-out option by the Company, deferred tax implications, valuation of financial guarantee obligation, related party disclosures, etc. The Committee has only examined the issue from Ind AS perspective and has not examined the regulatory or legal classification and implications, including those arising under Income-tax Act and FEMA.

14. The Committee notes that Ind AS 109, 'Financial Instruments' states as follows:

"3.1.1 An entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs B3.1.1 and B3.1.2). When an entity first recognises a financial asset, it shall classify it in accordance with paragraphs 4.1.1–4.1.5 and measure it in accordance with paragraphs 5.1.1–5.1.3. When an entity first recognises a financial liability, it shall classify it in accordance with paragraphs 4.2.1 and 4.2.2 and measure it in accordance with paragraph 5.1.1."

The Committee notes that the Company is a party to the Option agreement entered into with the investors and has entered into an arrangement for backstopping support towards repayment of principal and cumulative coupon amount for three years in respect of CCDs amounting to Rs. 5,100 million (As at March 31, 2019 Rs. Nil) issued by the subsidiary company. Further, the Company is identified as one of the 'promoters/sponsors' in the Debenture Offer letter/Agreement.

Based on the above, it is clear that the Company is a party to the Debenture Offer letter/ Agreement and the Option Agreement. Therefore, the Company shall recognise the financial instrument.

15. The Committee notes that Ind AS 32, 'Financial Instruments: Presentation' states as follows:

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

(a) a contractual obligation:

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

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

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

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

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any

> > **currency. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.**
>
> **As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D."**

The Committee notes from the above that the key feature in determining whether a financial instrument is a liability is the existence of a contractual obligation of one party to deliver cash or another financial asset to another party. When an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at redemption exists and, therefore, the instrument includes, and is presented as, a financial liability.

In the extant case, as per the Debenture Offer letter/Agreement, there is Put Option/Mandatory Buyout clause, which read with clauses 3.1-3.4 of the Option Agreement require that, if the promoters/sponsors have not acquired the debentures issued by the subsidiary company from the investor prior to the expiry of 35 months from the Deemed date of Allotment of Debentures, the promoter/sponsor will mandatorily buy the outstanding debentures (including the outstanding interest). The purchase of debentures shall be undertaken mandatorily by the promoter/sponsor for the entire outstanding debenture amount. The Company has entered into an arrangement for backstopping support towards repayment of principal and cumulative coupon amount. This results in a contractual obligation on the Company. Therefore, the Company shall recognise a financial liability under Ind AS 109. Para 3.6 of the Option Agreement states that in the event the investors are unable to transfer the put securities free and clear of all encumbrances then nothing in this agreement shall be deemed to require the sponsors to put the put securities. This clause relieves the sponsors from the put obligation only when the investors are unable to transfer the put securities free and clear of all encumbrances. Although this clause is conditional, but does not give an unconditional right to the Company to avoid delivering cash or another financial asset. Therefore, there would be a financial liability to be recognised by the Company. The nature of the financial liability has been dealt with in the subsequent paragraph.

16. Further, the Committee notes that Appendix A to Ind AS 109 defines a financial guarantee as:

"financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument."

In the extant case, the Committee notes that the subsidiary company has the obligation to service the interest payouts during the tenure of the CCDs. However, it is the Sponsors' obligation to ensure that the subsidiary company meets the interest obligations on time and if there is default by the subsidiary, the investors have a put option for the outstanding interest on the sponsor.

Further, the Committee notes that in the extant case, Accelerated Put Option may be exercised by the Investor on the Sponsor in case of non-payment of coupon amount due and payable on the applicable Coupon Payment Dates wherein such default continues for one business day (including the Coupon Payment Date) from such Coupon Payment Date. The Accelerated Put Option shall be applicable on the entire outstanding principal amount of Debentures and any other dues due to the Investor(s).

The Committee is of the view that these obligations that arise in case there is a default by the subsidiary company, would be a financial guarantee obligation and should be recognised and measured (initially and subsequently) as per the requirements of Ind AS 109 by the Company in its separate financial statements.

Since the Company is not charging any consideration from the subsidiary company for undertaking the obligation towards the investor, the obligation has been undertaken by the Company in its capacity as promoter/shareholder of the subsidiary company. The Company has a right to future economic benefits arising from its overall investments in the subsidiary. Therefore, upon initial recognition of the financial liability, the Company shall recognise deemed investment in the subsidiary as per the requirements of Ind AS 27.

The financial liability is settled/derecognised when the Company buys out the CCDs from the investor. Subsequently, when the Company converts the CCDs in equity shares of the subsidiary company, the deemed investment in the subsidiary company as discussed above would get derecognised and the Company shall recognise investment in subsidiary company. The Company shall comply with the relevant presentation and disclosure requirements of Ind AS 107 and Division II of Schedule III to the Companies Act, 2013 for financial liability.

17. Further, the Committee notes that Ind AS 110 states as follows:

"19 A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances."

"B86 Consolidated financial statements:

(a) combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.

(b) offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (Ind AS 103 explains how to account for any related goodwill).

(c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. Ind AS 12, *Income Taxes,* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions."

The Committee notes that Ind AS 110 requires a parent company to consolidate the financial statements of the subsidiary company using uniform accounting policies and eliminating in full intragroup assets, liability, equity, income and expenses.

Ind AS 109 requires the guarantor to recognise the financial guarantee contract initially at its fair value. Since the Company is the parent company of the beneficiary, viz., the issuer/subsidiary company, there will be no impact of the financial guarantee obligation recognised in the separate financial statements of the Company, at the consolidated level. The financial guarantee obligation and the corresponding deemed investment in the stand alone financial statements of the Company (described in paragraph 16 above) shall be eliminated upon consolidation.

18. The Committee also notes that Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' states as follows:

"41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind ASs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 42–47).

42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."

The Committee notes from the above that as per Ind AS 8, material prior period errors are corrected retrospectively by restating the comparative amounts for prior period(s) presented in which the error occurred. If the error occurred before the earliest period presented, the opening balance of assets, liabilities and equity/retained earnings for the earliest period presented are adjusted. Therefore, the Company shall correct the accounting treatment of the CCDs as a prior period error retrospectively in the first set of financial statements approved for issue after the discovery of the error.

D. Opinion

19. The Committee is of the opinion that:

(i) The current accounting treatment in the financial statements of the Company is not in line with the requirements of Ind AS 32, as discussed in paragraphs 14-16 above. The disclosures in the financial statements shall be provided based on the classification as financial liabilities, as discussed in paragraph 16 above. The Company shall comply with the relevant presentation and disclosure requirements of Ind AS 107 and Division II of Schedule III to the Companies Act, 2013.

(ii) The Company shall correct the accounting treatment of the CCDs as a prior period error retrospectively in the first set of financial statements approved for issue after the discovery of the error, as discussed in paragraph 18 above.

(iii) The Company shall follow the consolidation and elimination procedures under Ind AS 110 in its consolidated financial statements, as discussed in paragraph 17 above.

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Query No. 6

Subject: Treatment of dredging and reclamation (site grading) cost on leased land.[1]

A. Facts of the Case

1. A public limited company (hereinafter referred to as 'the Company') is a Maharatna public sector undertaking under the administrative control of the Ministry of Petroleum and Natural Gas, Government of India and is engaged in the business of refining and marketing of petroleum products. Together with 2 other public sector undertakings in the Industry, it is also known as one of the Oil Marketing Companies (OMC).

2. The Company conceived a project to set up a 9 Million Metric Tonne Per Annum (MMTPA) Grass-root oil Refinery at Paradip for which land was taken on lease for the period of 90 years in year 2001 from Orissa Industrial Infrastructure Development Corporation (OIDC) established under the OIIDC Act, 1980. The land for Paradip Refinery site was taken on lease for Rs. 79 crores.

3. The querist has informed that during execution of lease contract, it was known that allotted land is in a very low-lying area and could not be used as it is for its intended purpose. Since its height had to be increased by 4 meters approximately above the mean sea level, heavy dredging and reclamation cost was required to be incurred to make it ready for intended use.

4. The querist has further informed that the dredging of the river basin was carried out as per the dredging plans prepared by National Institute of Oceanography (NIO), Goa. Since the area site is a low-lying area, reclamation by filling with sand was done. Reclamation area was elevated from +1.0m to +4.0m spread over the entire low-lying land exposed to subsoil

[1] Opinion finalised by the Committee on 6.5.2021.

waters during tidal variations. Therefore, heavy land filling cost was incurred to bring the land to useable condition. Land filling costs to the tune of Rs. 741 crores was incurred on that land to bring the land in usable condition.

5. The querist has also informed that during the commencement and capitalisation of project, accounting as per the then applicable Indian GAAP was followed as Indian Accounting Standards (Ind AS) were not introduced. Under the erstwhile Accounting Standard (AS) 19, 'Leases', land leases were specifically excluded, hence, citing the principles of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', the cost of land was capitalised alongwith the cost of land development expenditure under the category of leasehold land in the financial year (F.Y.) 2012-2013 after execution of lease deed.

6. After implementation of Indian Accounting Standards, land leases were covered under Ind AS 17, 'Leases'. This lease was categorised as operating lease and carrying value of the land as on 01.04.2015 was transferred to prepaid rentals. Further, after implementation of Ind AS 116, 'Leases', the remaining amount of prepaid rentals as on 01.04.2019 was transferred under Right of Use asset for remaining lease period under the provision of the revised Ind AS, viz., Ind AS 116.

7. The querist has mentioned that besides above, to bring more clarity to the readers of the financial statements, appropriate disclosure in Note -2, Property, Plant and Equipment has been given as "Leasehold Land (included in ROU asset) includes an amount of Rs. 716.41 crore for Land Development Cost."

8. The querist has given below the accounting treatment followed by the Company in past periods as per the requirements of Standards:

1. <u>At the time of execution of lease deed:</u>

   Under AS 19, 'Leases', lease agreements for use of land are excluded. As per AS 10, 'Accounting for Fixed Assets', the cost of fixed asset should comprise the purchase price and any attributable cost of bringing asset to the working condition for the intended use. Cost of land should generally include:

   - Acquisition cost
   - Cost incurred in obtaining title
   - Cost of surveys
   - Cost incurred in preparing the land for its particular use.

   Based on the principles of Accounting Standards, it was concluded that the very purpose of development activity is to make the asset ready for intended use. As evident from the facts above, the development cost was incurred to prepare the land for setting up of the plant (intended/ ultimate use), the dredging and reclamation cost was capitalised under the fixed asset as land. Accordingly, leasehold land was capitalised in books along with the cost of dredging and reclamation for Rs.820 crores (including Rs.741 crores as land development cost) with useful life of lease period.

2. Transition to Indian Accounting Standards

As per Ind AS 17, 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.

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.

As per paragraph 33 of Ind AS 17, lease payments under an operating lease shall be recognised 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.

Hence, agreement with OIDC for Paradip Refinery site land is a lease under Ind AS 17 and was accounted for as per the provisions of the Standard.

Transition provisions of Indian Accounting Standard provides an option to a first-time adopter at the date of transition to continue with carrying value of PPE measured as per previous GAAP and use it as deemed cost. This option was opted by the Company and carrying value (WDV) of land as on the date of transition was considered as the deemed cost for any further accounting.

During implementation of Ind AS, subject land lease for a period of 90 years was classified as an operating lease and accordingly, carrying value of land capitalised earlier under AS 10 as on 01.04.2015 of Rs. 764 crores was shifted under the head prepaid rentals which were to be charged to expenses on straight line basis over the remaining lease period.

3. After Implementation of Ind AS 116

As per Ind AS 116, 'Leases', a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Hence, agreement with OIDC for Paradip Refinery site land is a lease under Ind AS 116 and should be accounted for as per the provision of the standard.

As per paragraphs 22 and 23 of Ind AS 116, at the commencement date, a lessee shall recognise a right-of-use asset and a lease liability at cost.

Further, under paragraph C8 of Appendix-C of Ind AS 116, transition provisions related to leases previously classified as operating leases are provided. According to paragraph C8 (b) (ii), the lessee shall recognise a right-of-use at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to the lease recognised in the balance sheet immediately before the date of initial application. In the instant case, the land cost was classified as prepaid rentals hence, the right-of-use was recognised equal to the remaining amount of prepaid rentals as on 01.04.2019 Rs.736 crores for the remaining period of the lease, i.e., 72 years.

Besides above, to bring more clarity to the readers of the financial statements, appropriate disclosure in Note - 2 Property, Plant and Equipment has been given as below:

> *"Leasehold Land (included in ROU asset) includes an amount of Rs. 670.27 crore for Land Development Cost."*

B. Query

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

(i) Whether the treatment of cost of land development as leasehold land is correct or whether it should be capitalised as Property, Plant and Equipment of the Refinery.

(ii) What should be the life of right-of-use asset created for land development expenditure?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to accounting treatment of cost of land development incurred on leasehold land. 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, any other expenditure incurred in relation to project, accounting as per previous GAAP (viz., under Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006) and accounting as per Ind AS 17, accounting treatment on transition to Ind ASs (from Accounting Standards) and transition to Ind AS

116 from Ind AS 17, accounting for prior period errors (if any) under Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', presentation of leasehold land/right-of-use asset in the financial statements, etc. The Committee has restricted the opinion only to the accounting issues under Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' and Ind AS 116, 'Leases', and has not examined from the perspective of AS 19, AS 10 and Ind AS 17.

11. The Committee notes from the Facts of the Case that the Company conceived a project to set up Grass-root Oil Refinery for which land was taken on lease for Rs. 79 crores for a period of 90 years from OIDC. Further, since the land taken on lease was in a very low-lying area and could not be used as it is, heavy dredging and reclamation cost (consisting of land development/filling cost) was required to be incurred to increase the height of land by 4 meters approximately above the main sea level to make it ready for its intended use, i.e., for setting up of Refinery.

12. The Committee first examines whether the land development expenditure results into an asset (tangible or intangible) for the Company. In this regard, the Committee notes the definition of 'asset' and the other requirements of Ind AS 38, 'Intangible Assets' as follows:

> **"An *asset* is a resource:**
>
> **(a) controlled by an entity as a result of past events; and**
>
> **(b) from which future economic benefits are expected to flow to the entity."**
>
> **"An *intangible asset* is an identifiable non-monetary asset without physical substance**."
>
> **"12 An asset is identifiable if it either:**
>
> > **(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or**
> >
> > **(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.**
>
> **Control**
>
> 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."

The Committee notes from the above-reproduced requirements of Ind AS 38 that in the extant case, the land development cost although results in future economic benefits in the form of improved utility of leased land, however, it neither gives rise to a separately identifiable asset nor a resource controlled by the Company. Therefore, it cannot be recognised as an individual asset (either tangible or intangible) by the Company.

13. Now, with regard to the accounting for the land development cost in the extant case, the Committee further examines whether such costs should be included in the cost of the land or the Refinery. In this regard, 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."**

"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."

"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)[2]; and

(f) professional fees."

The Committee notes from the above that Ind AS 16 does not prescribe as to what should constitute as a unit of measure or an item of PPE and a judgement is required to be exercised in applying the recognition criteria to an entity's specific circumstances. Further, paragraph 16 of Ind AS 16, inter alia, states that the cost of an item of property, plant and equipment comprise 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.

The Committee notes that land filling/development cost in the extant case is not arising as a consequence of acquisition of land rather is post-acquisition of land which is not essential for acquisition of leased land and therefore, cannot be considered as directly attributable to acquisition of leased land. Further, the leased land, being of the nature of operating lease, cannot be considered as an

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[2] This paragraph has been subsequently revised through Companies (Indian Accounting Standards) Amendment Rules, 2022, notified vide Notification No. G.S.R 255(E) dated 23rd March, 2022 which came into force with effect from April 1, 2022.

item of PPE under Ind AS 16. The land development cost in the given case is, in substance, required to facilitate the construction of the Refinery and for its operations. Expenditure on land development is in the nature of site preparation costs for the Refinery and is required to be incurred in order to get future economic benefits from the Refinery Project as a whole. Although the expenditure on land development leads to increasing utility of land but the purpose of such expenditure is to use the land for the ultimate Refinery Project. Therefore, the Committee is of the view that such expenditure is in the nature of directly attributable expenditure incurred for bringing the Refinery Project to the location and condition necessary for it to be capable of operating in the manner intended by management. Accordingly, such expenditure should be considered as directly attributable to the Refinery Project in the extant case and should be capitalised as a part of cost of the Refinery/other Refinery related plant and machinery being recognised as per the principles of Ind AS 16.

14. As far as depreciation on the land development expenditure is concerned, since the same is part of the cost of the Refinery/other Refinery related plant and machinery, the Committee notes the requirements of Ind AS 16, which are reproduced below:

> **"43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.**
>
> 44 An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.
>
> 45 A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.
>
> 46 To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques

may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts."

From the above, the Committee notes that the amount initially recognised in respect of an item of property, plant and equipment is allocated to its significant parts and each such part is depreciated separately if they have a useful life which is different from the useful life of the item of property, plant and equipment to which they relate. Accordingly, in the extant case, the amount initially recognised as cost of Refinery/other Refinery related plant and machinery (including the land development expenditure) should be allocated to its various significant parts having a different useful life and should be depreciated separately as per the above-reproduced requirements of Ind AS 16.

15. The Committee also analyses the possibility of capitalisation of the cost of land development as part of 'right-of-use asset/land' under Ind AS 116, 'Leases'. In this regard, the Committee notes the following requirements of Ind AS 116:

"22 At the *commencement date*, a lessee shall recognise a right-of-use asset and a lease liability."

"23 At the commencement date, a lessee shall measure the right-of-use asset at cost.

24 The cost of the right-of-use asset shall comprise:

(a) the amount of the initial measurement of the lease liability, as described in paragraph 26;

(b) any lease payments made at or before the commencement date, less any *lease incentives* received;

(c) any *initial direct costs* incurred by the lessee; and

…"

"**Initial direct costs**	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease.**

From the above, the Committee notes that on initial recognition, a right-of-use asset is recognised at cost, which comprises of initial measurement of lease liability, any lease payment made at or before the commencement of lease, any initial direct cost incurred by the lessee, etc. The Committee further notes from the definition of initial direct costs that it includes only incremental costs of obtaining a lease, such as, commissions, legal fees, etc. The Committee notes from the nature of items included as a part of cost of right-of-use asset that these are generally the costs incurred to obtain the lease at or before the commencement of lease. In this context, the Committee notes that the land development cost is not an expenditure to obtain the lease or right-of-use of land; rather is an expenditure subsequent to the acquisition of right-of-use to make the land useable for the Refinery Project. Therefore, the Committee is of the view that the cost of land development in the extant case cannot be included in the right-of-use of asset as per Ind AS 116.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the expenditure on land development of leased land should be considered as directly attributable to the Refinery Project in the extant case and should be capitalised as a part of cost of the Refinery/other PPE being recognised as per the principles of Ind AS 16, as discussed in paragraph 13 above. Such cost cannot be included in the right-of-use of asset as per Ind AS 116 as discussed in paragraph 15 above. As far as depreciation on the land development expenditure is concerned, the same being part of the cost of the Refinery/other Refinery related plant and machinery should be depreciated as the cost of Refinery/other Refinery related plant and machinery, considering the depreciation provisions as per Ind AS 16, as discussed in paragraph 14 above.

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Query No. 7

Subject: Capitalisation of borrowing cost during lockdown period.[1]

A. Facts of the Case

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

2. The Company constructs hydropower projects and operates them on Build, Own, Operate & Maintain (BOOM) basis. Electricity being a regulated product, tariff for each power station is determined by the Central Electricity Regulatory Commission (CERC) based on the CERC Tariff Regulations issued

[1] Opinion finalised by the Committee on 6.5.2021.

for a period of five years at a time. The currently applicable tariff period is 2019-20 to 2024-25, i.e., 2019-24.

3. Tariff is fixed by the CERC based on the Capital Cost incurred for the Power Station. Tariff Regulations provides for recovery of costs incurred on running & maintenance of the Power Station, depreciation of Property, Plant & Equipment, interest on loans & borrowings for construction of the Plant and interest on working capital, plus a specified rate of return on equity invested in the Plant.

4. *Half-Margin raised by the office of the C&AG:*

During supplementary audit of accounts for the financial year (F.Y.) 2019-20, the office of the C&AG had raised an issue regarding capitalisation of borrowing cost during lockdown period due to Covid-19 at one of its under-construction power projects. The half-margin (HM) raised in this regard is quoted hereunder:

> ***Profit & Loss Account for the year 2019-20***
>
> ***Note No.27 Finance Cost***
>
> ***Transferred to expenditure attributable to construction Rs.661.79 crore***
>
> (A) As per Ind AS 23, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. Other borrowing costs are recognised in profit or loss (P/L) as incurred. Further, Paragraph 20 of the above Ind AS stipulates that an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.
>
> Due to outbreak of Covid-19 pandemic, Ministry of Home Affairs vide order dated 24th March 2020 imposed nationwide lockdown for a period of 21 days to prevent the spread of Covid-19 in India and subsequently vide order dated 15th April 2020 and 1st May 2020 extended the lockdown period across the country till 3rd May 2020 and 17th May 2020 respectively. All the construction activities were on hold during this lockdown period and no work was allowed at construction sites.
>
> During the review of records, it was noticed that two projects of the Company, i.e., Parbati-II HEP and Subansiri Lower HEP are under construction and borrowing costs of Rs. 411.76 crore for Parbati-II

HEP and Rs. 227.96 crore (October 2019 to March 2020) for Subansiri Lower HEP respectively were capitalised for the financial year 2019-20 utpo 31 March 2020. As the construction work was completely halt at these projects during the lockdown period as per the orders issued by the Govt. of India, therefore, the borrowing cost of Rs. 16.61 crore capitalised for the period from 25 March 2020 to 31 March 2020 should have been transferred to rate regulated assets account. This has resulted in overstatement of Capitalisation of borrowing cost and understatement of rate regulated assets account to the tune of Rs.16.61 crore.

(B) Similarly, Corporate Office/Regional Office expenses attributable to construction capitalised for the period from 25 March 2020 to 31 March 2020 in respect of above under construction projects should also be transferred to rate regulated assets account.

Facts and figures may please be confirmed and reply to HM be furnished to Audit within three days.

5. Reply of the Company's Management to the half-margin is reproduced hereunder:

Reply to points (A) & (B) are as under:

Relevant extracts from Ind AS 23- Borrowing Costs are quoted below:

Para 20: An entity shall suspend capitalisation of borrowing costs <u>during extended periods</u> in which it suspends active development of a qualifying asset.

Para 21: An entity may incur borrowing costs during <u>an extended period</u> in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work.

Hydroelectric projects are long gestation projects which typically take between 5-10 years to complete. Since these projects involve use of diverse resources like manpower, material, construction equipment, etc., project construction activities may be stalled from time to time due to various factors, like labour unrest, geological surprises, strikes, natural calamities, etc. The determining factors as to whether capitalisation of borrowing cost should be suspended are whether:

a) Active development of the qualifying asset has been suspended at the instance of the entity,

b) Whether the period of suspension is an extended one, and

c) Whether technical and administrative work were also suspended during the period of suspension of active development of the qualifying asset.

In the current situation, the temporary suspension of active development was due to an order by the Government of India and not at the instance of the Company. Further, the period of suspension as applicable to F.Y. 2019-20 is for a period of 8 days only, which is neither an extended period, nor material in the context of a hydroelectric project. As far as technical and administrative work is concerned, the Company had implemented work from home during the lockdown period including systems like e-office and access to ERP through secure VPN. Further, these Projects are located in remote areas where technical and administrative staff including Head of Project reside at project townships. Accordingly, there was no cessation of technical and administrative work at the Projects during the lockdown period.

Further to the above, the following works were being executed at Subansiri Lower Project throughout the lockdown period:

a) Emergency works of Power House, HRT/ST, Stores and dewatering works at different work sites were being executed throughout the lockdown period.

b) Completion works of Bailey Bridge providing access & connection to the work site at Right Bank were being executed.

c) In addition to above, all associate services of Finance/HR/IT services/Medical services linked to construction activity were working round the clock.

d) All preparatory and office works/documents works- directly related to construction works as well as award of contract for LOT SSL-6 were being carried out.

In view of above, it is submitted that borrowing cost and Corporate Office/ Regional Office expenses attributable to construction qualify for capitalisation during the lockdown period from 25th March to 31st March, 2020.

In view of above, the HM may please be dropped.

6. The above reply was considered, but the HM was not dropped. Subsequently, management had to give an assurance that borrowing cost capitalised as CWIP during the period of lockdown during F.Y. 2019-20 shall be recognised as Regulatory Deferral Accounts (Debit) balances during the F.Y. 2020-21.

7. *Further representation to the office of the C&AG:*

The matter was further reviewed during F.Y. 2020-21 and a representation was made to the C&AG to review their stand on the matter. The same is quoted as under:

View taken by the C&AG is based upon FAQ No. 39 of the 'ICAI Covid-19 FAQs on Ind AS' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India which provides as under:

> ***FAQ 39***
>
> An entity is in the process of development of power generation facility which is expected to take three years for the facility to get ready for its intended use. In order to fund this huge expenditure, the entity has borrowed substantial amount of money and has been capitalising the borrowing costs as per Ind AS 23, Borrowing Costs. *In view of the reduced demands for its products over next one year and also the lockdown of its manufacturing units due to onset of global pandemic recently, the entity has suspended the active work on the development of this power generation facility since one month before the end of the current financial year. The entity has decided to keep this project in abeyance for another six months,* however, it continues to incur the borrowing costs. In view of the fact that the suspension of active development of the power generation facility is caused by Act of God and Nature, can the entity continue to capitalise the borrowing costs that it continues to incur?
>
> **Answer**
>
> Borrowing costs that are attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of that asset. All other borrowing costs should be expensed in the period incurred. Ind AS 23, Borrowing Costs, has specific requirements as to qualifying assets, borrowing costs eligible for capitalisation and their method of computation and commencement, suspension and cessation of capitalisation.
>
> Paragraphs 20 and 21 deal with the suspension of capitalisation. In particular, paragraph 20 states that an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends the active development of the qualifying asset. Considering the entity's decision to suspend the active development of the qualifying asset for 7 months, it cannot continue to capitalise the borrowing costs during this extended period regardless of the fact that the situation is caused by factors beyond its control.

Paragraph 21 elaborates on certain situation of temporary suspension where the entities are not required to suspend the capitalisation of borrowing costs. For example, when a temporary delay is a necessary part of the process of preparing an asset for its intended use. The suspension of construction activity due to COVID-19 pandemic does not fall under this situation.

The facts in the FAQ are different from those of the Company in the following aspects:

a) As per the FAQ, the project has been put on hold at the instance of the Company itself for a period of six months anticipating reduced demand. In the case of the Company, the stoppage of work was due to extraneous factors, namely lockdown declared by the Government of India.

b) As per facts of the FAQ, stoppage is for a period of 6 months, apprehending reduced demand for the output. Original construction period was 3 years. Accordingly, period of stoppage is significant w.r.t. the anticipated completion time. In the case of the Company, stoppage is for a period of one month which is insignificant when compared to the construction period of hydro power projects, which generally take 6-7 years for completion. Further, considering the must-run status for Run-of-the-River (ROR) projects and scheduling to the extent possible by RLDCs in case of ROR with Pondage and Storage Projects, there is no impact of the COVID-19 pandemic on the demand for power generated by the Company and neither does the Company anticipate any reduction in demand for power to be generated by its Projects currently under construction.

Accordingly, the facts of the FAQ do not match those prevailing in Subansiri Lower and Parbati-II Projects where physical construction was halted only during the initial lockdown period, i.e. 25th March 2020 till 24th April, 2020. As already stated in the reply to HM 17, there was no cessation in technical and administrative work at either of the projects during this period. In the case of Subansiri Lower Project, works including dewatering, completion works of Bailey Bridge, etc. were also being executed, as stated in the Management reply to the Half Margin.

It is thus apparent that in view of difference in the facts of the case, the opinion expressed by the ASB in FAQ 39 does not apply to the Company.

(Emphasis supplied by the querist.)

8. After considering the above representation, the Office of the C&AG has reiterated that the assurance given by the Company be ensured, i.e., Regulatory

Deferral Account (Debit) Balance be created for borrowing cost for the lockdown period from 25th March 2020 till 24th April, 2020.

B. Query

9. Accordingly, the opinion of Expert Advisory Committee has been sought as to whether the borrowing cost incurred at the project during the lockdown period from 25th March, 2020 to 24th April, 2020 qualifies for capitalisation?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to whether the borrowing cost incurred at the project during the lockdown period from 25th March, 2020 to 24th April, 2020 qualifies for capitalisation. 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, creation of deferred regulatory balance in respect of the said borrowing cost, accounting treatment of other expenditure incurred during the said period of lockdown, considerations of materiality, etc. Further, this opinion is restricted to the financial reporting requirements under Ind AS and does not deal with the regulatory aspects of the CERC tariff regulations or any other related regulations. Furthermore, the Accounting Standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time.

11. With regard to accounting for borrowing costs incurred during the lockdown period, the Committee notes the following paragraphs from Indian Accounting Standard (Ind AS) 23, 'Borrowing Costs':

"**Suspension of capitalisation**

20 An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

21 An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water

> levels are common during the construction period in the geographical region involved."

From the above, the Committee notes that the Standard requires an entity to suspend capitalisation of borrowing costs during extended periods during which it suspends active development of a qualifying asset. The Standard does not indicate or define 'extended period' and therefore the application of the Standard requires judgment and the opinion could differ on a case to case basis based on facts.

12. The Committee notes that in the extant case, Government actions to fight the COVID-19 outbreak caused the physical development of the project to pause because project workers had to stay at home. One needs to apply judgement and consider both the length/expected length, the nature of the suspension and the period required to complete the construction of the project when evaluating whether an interruption caused by the COVID-19 outbreak is 'temporary' or may be considered as an 'extended period'. In the extant case, the lockdown extends from 25th March to 17th May (i.e. not more than 2 months if events after the balance sheet date are considered).

The Committee is of the view that the suspension of construction activity may be considered 'temporary' and the company need not suspend capitalisation of interest considering the following:

(a) The suspension was caused because of an external common event affecting the whole of India,

(b) The event and therefore the suspension was not in control of the management,

(c) As represented by the Company, the Projects are located in remote areas where technical and administrative staff including Head of Project reside at project townships. Accordingly, there was no cessation of technical and administrative work at the Projects during the lockdown period, and

(d) The period of suspension may be considered a short duration especially when considered together with the time required to complete the project.

D. Opinion

13. On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 9 above that in the extant case, the suspension of construction activity may be considered 'temporary' and the company need not suspend capitalisation of interest, as discussed in paragraphs 11 and 12 above.

Query No. 8

Subject: Accounting treatment of Government Grants.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a wholly owned undertaking of Government of Gujarat, domiciled and incorporated in India. The Company is a Power Sector company. The Company including its subsidiaries are involved in generation, transmission and distribution of power in the State of Gujarat. The Company along with its group companies came into operation w.e.f. 1st April, 2005 after restructuring of State Electricity Board under the provisions of Gujarat Electricity Industry (Reorganisation and Regulation) Act, 2003 and Electricity Act, 2003. The following restructured corporate entities came into operation w.e.f. 1st April, 2005:

(a) State Electricity Corporation Ltd., the Generation Company

(b) State Energy Transmission Corporation Ltd., the Transmission Company

(c) Dakshin State Vij Company Ltd., the Distribution Company

(d) Madhya State Vij Company Ltd., the Distribution Company

(e) Paschim State Vij Company Ltd., the Distribution Company and

(f) Uttar State Vij Company Ltd., the Distribution Company

(g) The Company, the residual entity and the holding company of above-mentioned 6 companies

Entities listed at (c), (d), (e) and (f) are collectively referred as Distribution Companies (DISCOMs).

2. The querist has stated that as per the Roadmap and the Notification dated 16th February 2015, issued by the Ministry of Corporate Affairs, the Company and its group companies adopted and prepared their financial statements as per Indian Accounting Standards (Ind ASs) notified under section 133 of the Companies Act, 2013 read with Companies (Indian Accounting Standards) Rules, 2015 (Rules) in the phase 1 of the transition from Accounting Standards (referred to by the querist as 'Indian GAAP' (IGAAP)) to Ind ASs. These being the group's first financial statements prepared and presented under Ind ASs, as per Rules, Ind ASs are to be applied retrospectively. Hence, even the comparative period for the first Ind AS financial reporting period, i.e., Financial Year (F.Y.) 2015-16 is required to be transitioned to Ind AS. The transition date in case of the Company and group companies, therefore, was 1st April 2015.

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[1] Opinion finalised by the Committee on 31.5.2021.

3. According to the querist, the above referred retrospective application of Ind AS is subject to certain mandatory exemptions and voluntary exceptions as specified in the Rules; one of the relevant rule for the extant case, is that accounting estimates cannot be based on hind sight, i.e., an entity's estimates in accordance with Ind AS at the date of transition and for the comparative period to the first Ind AS financial statements shall be consistent with estimates made till the same date in accordance with IGAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were 'in error'. Paragraphs 14-17 of Ind AS 101, 'First-time Adoption of Indian Accounting Standards', are reproduced below for reference:

> "**14 An entity's estimates in accordance with Ind ASs at the date of transition to Ind ASs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.**
>
> 15 An entity may receive information after the date of transition to Ind ASs about estimates that it had made under previous GAAP. In accordance with paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with Ind AS 10, *Events after the Reporting Period*. For example, assume that an entity's date of transition to Ind ASs is 1 April 2015 and new information on 15 July 2015 requires the revision of an estimate made in accordance with previous GAAP at 31 March 2015. The entity shall not reflect that new information in its opening Ind AS Balance Sheet (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 March 2016.
>
> 16 An entity may need to make estimates in accordance with Ind ASs at the date of transition to Ind ASs that were not required at that date under previous GAAP. To achieve consistency with Ind AS 10, those estimates in accordance with Ind ASs shall reflect conditions that existed at the date of transition to Ind ASs. In particular, estimates at the date of transition to Ind ASs of market prices, interest rates or foreign exchange rates shall reflect market conditions at that date.

> 17 Paragraphs 14–16 apply to the opening Ind AS Balance Sheet. They also apply to a comparative period presented in an entity's first Ind AS financial statements, in which case the references to the date of transition to Ind ASs are replaced by references to the end of that comparative period."

4. The querist has informed that the Company and its subsidiaries being government entities, are subject to Comptroller and Auditor General (C&AG) audit including appointment of the independent auditors under the Companies Act for all the entities involved. C&AG conducts a supplementary audit over and above the audit as required under the Companies Act, 2013 (earlier Companies Act, 1956) and issues a supplementary audit report/note on the financial statements prior to its issuance to the shareholders, i.e., the Government of Gujarat in this case.

5. The querist has stated that the Company gets grants from the Government of Gujarat for various purposes including against acquisition/creation/construction of depreciable assets, subsidies for power supply to various category of consumers, etc. The grants received against depreciable assets are usually for a part of the cost of the asset, other sources of funding the cost through an appropriate debt: equity proportion. The Company has followed deferred grant approach for grants related to depreciable assets as its accounting policy in compliance with Accounting Standard (AS) 12, 'Accounting for Government Grants' under IGAAP framework and later under Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance' under the Ind AS framework.

6. All depreciable assets (including against which grants are received) are depreciated as per the relevant Electricity Supply Act requirements which provide for depreciation of assets on Straight Line Method (SLM) at a fixed percentage for the first 12 years and thereafter the remaining depreciable value to be depreciated over the remaining useful life of the assets as specified by the Electricity Supply Rules.

7. Government grants against depreciable assets which are deferred, are recognised as per Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance', i.e., are recognised on deferred basis and are recognised in the Statement of Profit and Loss on a systematic basis over the useful life of assets. The accounting principles specify 'systematic basis' as against an arbitrary/ad-hoc basis of recognising such grants in the Statement of Profit and Loss. This requirement is the same under both Ind AS and IGAAP.

8. The Company and the group companies had assessed that Reducing Balance Method (RBM) or Written Down Value (WDV) to be an appropriate systematic basis to recognise government grants in the Statement of Profit and

Loss based on relevant considerations in case of the Company and the group companies. One of the important considerations for selection of RBM/WDV method was the mismatch/difference in the timing when the asset is created/ acquired and the recognition of grants on compliance of the conditions to recognise grant. Usually, the asset would be created/acquired first before becoming reasonably assured of complying with the conditions for receipt of grant and hence the grant recognition to the Statement of Profit and Loss would be in a period different from when the depreciation is charged to the Statement of Profit and Loss. The selection and application of RBM would lead to a sort of catch-up adjustment over the period of the assets. Hence, RBM was selected in the given backdrop and applied from F.Y. 2004-05 i.e., from the year when the State Electricity Board (SEB) was unbundled into the Company and group companies. This method was consistently applied till F.Y. 2015-16.

9. It may be further pointed out that IGAAP did not have a general concept of catch-up adjustment as is the case under Ind AS in the relevant years nor does it have a catch-up adjustment even now. Hence, in order to address the matter of timing mismatch and its consequential effect on the Statement of Profit and Loss where the cumulative depreciation as against the cumulative government grants recognised in the Statement of Profit and Loss would have been significantly different, RBM was selected so as to ensure that higher grant recognition in the initial years would lead to sort of a catch up adjustment as against the accumulated depreciation of the assets against which the grants have been received. This was assessed and understood to be an acceptable systematic basis as required under AS 12, given the facts as obtained at the time and the subsequent period when this was applied.

10. Selection of RBM was also noted as complying with the Accounting Standards by the independent auditors of all the concerned entities. The selection of RBM was reviewed by the independent auditors not only initially in F.Y. 2004-05 but also the continued selection of RBM during the years from F.Y. 2004-05 till F.Y. 2015-16 was also reviewed by not less than 15 independent auditors in light of the facts and circumstances as obtained for such selection. All the independent auditors noted the selection to be in compliance with the extant Accounting Standards.

11. The supplementary audits of C&AG right from the initial year of selection of RBM, i.e., F.Y. 2004-05 and during the continued period of selection of RBM i.e., from F.Y. 2004-05 till F.Y. 2015-16, did not note such selection and application either to be an error nor as a non-compliance with the extant Accounting Standards.

12. The Company and group companies revisited, reviewed, assessed, analysed and evaluated all accounting policies/methods/estimates in addition to

presentation and disclosure requirements in F.Y. 2016-17 in the light of applicable Ind AS transition and implementation. The Company and group companies noted the facts and circumstances as obtained in F.Y. 2016-17 during Ind AS implementation and noted that Straight Line Method (SLM) was a more appropriate basis of recognising government grants in the Statement of Profit and Loss given the facts currently obtained, primarily as the mismatch or the timing difference as discussed in paragraph above has reduced. Hence, the Company and group companies selected and applied SLM from F.Y. 2016-17. It may be pointed out that recognition of grants in the Statement of Profit and Loss every year on SLM basis would reduce the variation with the depreciation charged to the Statement of Profit and Loss but not eliminate the variation. The change was made after assessing the present status and the expected future timing of asset creation/acquisition and recognition of grant against the assets.

13. The Company and group companies noted that the timing mismatch in the earlier years has reduced significantly over the period, though not completely eliminated. The Company also noted that the need for the consequential catch-up adjustment required due to such mismatch has also reduced. Hence, the method was changed due to change in the circumstances. This change is in compliance with the relevant accounting standards i.e., it is allowed to be made as well as how such change should be accounted.

14. The Company's group assessed that the change in the method is determined to be a change in accounting estimate and not a change in accounting policy. The group's assessment was reviewed, assessed and evaluated by the independent auditors of all the concerned group companies and they also concluded the change to be change in accounting estimate arising on account of changed circumstances and more experience.

It may be further pointed out that the C&AG office also concludes that the change in the method is a change in accounting estimate.

15. The Company and group companies had clearly disclosed facts of the case and the group's assessment of the change being the change in accounting estimate and effected the accounts accordingly, in the year of change i.e., F.Y. 2016-17. Further, the Company and group companies also disclosed in F.Y. 2018-19, the possible impact if the change were to be made retrospectively (as per C&AG view), with a clear indication that this is for disclosure purpose only and has no impact on the financials.

16. C&AG office, though accepting that the change is a change in accounting estimate, believes it to be a correction of prior period error and hence any correction of prior period error should be applied retrospectively. C&AG's contention is that the RBM selected and applied earlier from F.Y. 2004-05, though noted and found to be in compliance with the accounting standards by all

the auditors of the individual companies over the years as well as by C&AG, is to be considered as an error which is being corrected now by applying SLM. As may be noted from the C&AG office comments reproduced verbatim in paragraph 18 below, the C&AG office has noted that any change to reduce mismatch to be acceptable, but such change would mean that the earlier method was an error.

The issue for consideration is whether the selection and application of the RBM be considered as a prior period error which is being corrected now.

17. The company had also obtained an independent opinion relating to this matter on the urging of C&AG in the year 2020. The independent opinion obtained also supports the company's position, opining that it is not an error and such changes are to be considered as change in estimates and to be applied prospectively and opinion was also submitted to C&AG and has been appropriately disclosed in the notes to the financial statements for the financial year ended 31st March 2020. However, C&AG has insisted for Expert Advisory Committee opinion on the matter and hence, the Company seeks opinion of the Committee on the matter.

18. The querist has given extracts from Observations of the C&AG as follows:

> "With effect from 01 April 2016, the group companies have changed the method of computing the grants/consumer contribution received against depreciable assets to be recognized in Statement of Profit and Loss from reducing balance method to the straight-line method and consequently the rates at which grant is recognized in the Statement of Profit and Loss. The Company has determined that the change to recognize grants in proportion of the depreciation expenses is a change in accounting estimates and is to be applied prospectively.
>
> As per Accounting Standard 12, grants related to depreciable assets are treated as deferred income which is recognised in the Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset. Indian Accounting Standard 20 also states that, grants related to depreciable assets are usually recognised in the Statement of Profit or Loss over the periods and in the proportions in which depreciation expense on those assets is recognised.
>
> The above change in method was made by the group companies as there was a mismatch of the grants recognized in the Statement of Profit and Loss versus the related depreciation expense. Thus, the company has changed the method of recognition of deferred income in order to align the recognition of deferred income with the related depreciation expense. As the provisions for treatment of deferred income to be recognised in the

Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset are same in AS 12 and Ind AS 20, the change was not mandated by Ind AS 20. *Hence, the company changed the method in order to correct an error.*

Since the depreciable assets related to which grants/ consumer contribution received have been capitalized in the books of account, the effect of such change should have been worked out retrospectively and accounted for in the opening balance of Deferred Government Grants, Subsidies and Consumer contribution."

19. The querist has also given the summary of the Company's Management Response as follows:

(i) The Company has been following RBM or WDV method from its inception in F.Y. 2004-05 and continued it till F.Y. 2015-16; and kept on recognising income from year to year out of its government grant, accumulated in deferred income on that basis.

(ii) Useful lives of fixed asset as also expected pattern of consumption of future economic benefits embodied in such assets are estimates; (paragraph 32 of Ind AS 8); use of such estimates, made reasonably being an essential part of preparation of the financial statements, does not undermine the reliability of such financial statements. The differentiation of accounting policy vis-a-vis accounting estimate is dealt with in paragraph 35 of the said Standard.

(iii) Being an estimate, circumstances or new information or more experience may necessitate suitable revision therein in forthcoming year(s), as clearly recognised by paragraph 34 of Ind AS 8, which also states that revision of estimate does not relate to prior period and is not the correction of error.

(iv) As per paragraph 48 of Ind AS 8, the accounting estimates by their very nature are approximations that may need revision as additional information becomes known or when better presentation of financial statements warrant; such revisions when made, are clearly distinct from errors and these require rectifications. Thus, all the revisions of accounting estimates are not necessarily rectifications of an error of prior years. *Errors are meant to be act of omissions, oversight or lapses (including the effects of mathematical mistakes, mistakes in applying accounting policies, misinterpretations of facts, and fraud) in recognition and measurement principles of the reported items of financial statements.* (Emphasis supplied by the querist.)

(v) As informed, in all the years, all the independent auditors of the concerned group companies noted the selection and the application of RBM to be in compliance with the extant Accounting Standards. It may be further emphasised that the selection of a method whether it be for depreciation or deferred grants in the current instance is a part of the significant accounting principles/practices which were consciously selected based on detailed deliberations after careful assessment of the facts and circumstances in light of the acceptable accounting principles and practices. This selection was assessed and evaluated by the independent auditors and found to be in compliance with the extant Accounting Standards.

(vi) Further, the C&AG supplementary audit neither had any comments on the independent auditors' opinion on compliance of accounting standards in all the years nor did the supplementary audit raised any questions or observations about the said treatment.

(vii) The above position reflects that the Company and group companies' assessment and consequential selection of RBM was found to be compliant with the extant accounting standards in light of the facts and circumstances obtained on initial selection and the continued selection over the years.

(viii) The contention of CAG's observations implies that, had the Company continued its method and consequently continued recognising grant based on RBM, it would have been considered compliant with the accounting framework; but a change in the said methodology would deem to be a correction of error of earlier years. In the view of the querist, this appears to be a contradiction.

(ix) Hence, in the view of the querist, the revision of an estimate, based on availability of some new information/development or for the reason of better presentation of financial statements, is far from being an error of earlier years; change in estimate has to be applied prospectively and not retrospectively.

(x) In the financial year 2016-17, the Company changed its method of recognising government grants from RBM to SLM for better presentation of the carrying value of the assets. Consequently, the Company recognised the government grant related to the concerned assets in proportion of its depreciation charge, which is also a systematic basis of recognising such deferred income as per the principle of Ind AS 20. In the year of such change, the Company is observed to have duly disclosed the fact and quantified effect of such change, as required by the applicable Standard.

(xi) It is reiterated that the selection of method or its change is based on the facts and circumstances as obtained. The Company's group noted that there is a change in the facts and circumstances as relating to reduction in the timing difference between asset acquisition/creation and government grant recognition over the period occasioning reconsideration of the method to be selected.

20. In addition to the Company's management detailed replies to C&AG, the auditors of certain group companies had replied to C&AG with the specific considerations of relevant Ind AS as basis in which the auditors concluded the change of method to be change in accounting estimate.

B Query

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

(i) Is the selection and application of RBM (or WDV) for recognising government grants in the previous years i.e., from F.Y. 2004-05 to F.Y. 2015-16 an error?

(ii) If the above, is in affirmative, then what are the implications on the audit opinions including supplementary audit on the compliance of accounting standards in the earlier years as well as on the truthfulness and fairness of the financial statements?

(iii) If conclusion to question 1 is that it is not an error, can the selection and application of SLM from F.Y. 2016-17 be considered as a correction of prior period error?

C. Points considered by the Committee

22. The Committee notes that the basic issue raised in the query relates to the method of recognition of government grants followed by the Company in the previous years i.e., from F.Y. 2004-05 to F.Y. 2015-16 and change in such method of amortisation from WDV to SLM from F.Y. 2016-17. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, appropriateness of the accounting/adjustments arising due to transition to Ind AS, nature of grant under Ind AS 20, accounting for grants received in the form of subsidies for power supply to various category of consumers, timing of recognition of grant and the appropriateness of the reason for the mismatch as stated by the querist due to difference in the timing when the asset is created/acquired and the recognition of grants on compliance of the conditions to recognise grant, accounting for the catch-up adjustment required due to the afore-mentioned timing difference, amount of grant to be recognised, accounting in the books of

group companies, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the perspective of interpretation of any Act/Rules such as Electricity Supply Act/Rules etc. The Committee wishes to point out that the Indian Accounting Standards referred to in the opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

23. The Committee notes from the Facts of the Case that the Company had been following the Reducing Balance Method (RBM) or Written Down Value (WDV) to recognise deferred income in respect of government grants related to assets in the Statement of Profit and Loss from F.Y. 2004-05 till F.Y. 2015-16. Thereafter, in the F.Y. 2016-17, which was the first year of implementation of Indian Accounting Standards as per the requirements of the Companies Act, 2013, the Company changed the method of such recognition of deferred income from RBM/WDV to straight line method.

Further, the Committee notes that one of the considerations for selection of RBM /WDV method was the mismatch/difference in the timing when the asset is created/acquired and the recognition of grants on compliance of the conditions to recognise grant. Usually, the asset would be created/acquired first before becoming reasonably assured of complying with the conditions for receipt of grant and hence the grant recognition to the Statement of Profit and Loss would be in a period different from when the depreciation is charged to the Statement of Profit and Loss. The selection and application of RBM would lead to a sort of catch-up adjustment over the period of the assets. Hence, RBM was selected in the given backdrop. From these facts, it appears that the above change in method was made by the Company as there was a mismatch of the grants recognised in the Statement of Profit and Loss versus the related depreciation expense. Thus, the Company has changed the method of recognition of deferred income in order to align the recognition of deferred income with the related depreciation expense. The Committee also notes that the Company noted the facts and circumstances as obtained in F.Y. 2016-17 during Ind AS implementation and noted that Straight Line Method ('SLM') was a more appropriate basis of recognising government grants in the Statement of Profit and Loss, primarily as the mismatch or the timing difference as discussed above has reduced and the SLM basis would reduce the variation with the depreciation charged to the Statement of Profit and Loss. Thus, for better presentation of the carrying value of the assets, the Company changed its method of recognising government grants from RBM to SLM and recognised the government grant related to the concerned assets in proportion of its depreciation charge.

24. With regard to the depreciation charge, the Committee notes that the Schedule II to the Companies Act, 2013 and Ind AS 16, allow both the methods of depreciation, viz., straight line and WDV. However, Part B to schedule II,

states that "The useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of this Schedule." Thus, where a Regulatory Authority prescribes useful life, rate of depreciation or residual value for any specific asset for accounting purposes, the company should use that useful life, rate of depreciation or residual value even though it is different from that as estimated by the management.

The Committee further notes that the querist has stated that the relevant Electricity Supply Act requirements provide for depreciation of assets on Straight Line Method (SLM) at a fixed percentage for the first 12 years and thereafter the remaining depreciable value is to be depreciated over the remaining useful life of the assets as specified by the Electricity Supply Rules. Further, the querist has stated that as per the above requirements, all depreciable assets (including against which grants are received) are depreciated at SLM. Thus, considering the regulatory requirements, the Company has been following straight line method consistently and there has been no change in the method of depreciation. The Committee notes that method of depreciation represents the pattern of consumption of economic benefits embodied in the asset and is considered as an accounting estimate. However, since there has been no change in the method of depreciation, it cannot be considered that there has been a change in the estimate due to change in the pattern of consumption of economic benefits.

25. Further, with regard to method of recognising deferred income to the Statement of Profit and Loss in respect of grants related to depreciable assets in previous years till financial year 2015-16 and thereafter, the Committee notes the following paragraphs of Accounting Standard (AS) 12, 'Accounting for Government Grants', which was applicable for accounting years 2004-05 till 2015-16 and Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance', which was applicable thereafter:

> *AS 12*
>
> "5.5 It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption (see Accounting Standard (AS) 1, Disclosure of Accounting Policies).
>
> 5.6 In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable

and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses."

"8. Presentation of Grants Related to Specific Fixed Assets

8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged…"

"14. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. ..."

Ind AS 20

"16 It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. …

17 In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. Thus grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised."

"24 [2]**Government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset**.

25 [2]Two methods of presentation in financial statements of grants or the appropriate portions of grants related to assets are regarded as acceptable alternatives.

26 [2]One method recognises the grant as deferred income that is recognised in profit or loss on a systematic basis over the useful life of the asset.

27 [2]The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognised in profit or loss over the life of a depreciable asset as a reduced depreciation expense."

From the above, the Committee notes that AS 12 and Ind AS 20 contain similar requirements in respect of recognition of deferred income in relation to grants related to depreciable asset and therefore, there is no change in the accounting requirements that required a change in the method of allocation of deferred income over the useful life of the asset to which the grant pertains.

The Committee notes that paragraph 14 of AS 12 specifically provides that, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, *i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged*. Thus, as per the requirements of AS 12, till financial year 2015-16, for grants received in respect of depreciable assets, the Company should have allocated the deferred income to the Statement of

[2] Substituted vide Notification No. G.S.R. 903(E) dated 20th September, 2018.

Profit and Loss, in the proportion in which depreciation was charged over the useful life of the asset. Since straight line method of depreciation has been followed by the Company for the asset to which the grant relates, the grant should have also been recognised in proportion, depreciation was charged over the useful life, i.e., on a straight line basis. Similarly, Ind AS 20 (paragraph 17) also requires to amortise deferred income on a systematic basis over the useful life of the asset and in the proportions in which depreciation expense on those assets is recognised. However, since the same has not been followed while recognising the grant in the earlier years till financial year 2015-16 (when AS 12 was applicable to the Company), it results into an error in the recognition of grant.

Further, the Committee notes from the above that both the standards prescribe two methods for *presentation of grants* related to depreciable assets. Under one method, the grant is deducted from the gross value of the asset concerned in arriving at its book value/carrying amount. Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset and in proportion, the depreciation is charged. Thus, under both the methods of presentation, the grant is recognised in the profit and loss statement over the useful life of a depreciable asset; under one method, by way of a reduced depreciation charge and as per the other method, as income in proportion to depreciation over the useful life of a depreciable asset, resulting into similar impact in the Statement of Profit and Loss. The Committee notes that if for recognising the depreciation, one method, say straight line is followed while for amortising deferred income, another method, say WDV is followed, the result/impact under both the methods will not be the same, as discussed above and therefore, the Standard does not prescribe to follow different methods to be followed for charging depreciation and for amortising deferred income.

The Committee also notes from the above-reproduced requirements of AS 12 and Ind AS 20 that grants should be recognised in the income statement on a systematic basis that matches with the related costs that they are intended to compensate. Further, depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. Thus, in a way, depreciation represents the allocation of cost of depreciable asset over its useful life. Therefore, in case of grants related to depreciable assets, the grant should be recognised in the income statement on a systematic basis that matches with the depreciation charged which represents the related costs of the depreciable asset. Accordingly, the Committee is of the view that as per the requirements of AS 12 as well as Ind AS 20, both the grant as well as depreciation should be charged in the same proportion over the useful life of the depreciable asset.

26. On the basis of the above discussion, the Committee is of the view that, since the Company in the extant case, did not follow the above-mentioned requirements of AS 12 till financial year 2015-16, the same should have been rectified and the method of amortisation or recognition of deferred income should have been changed to the SLM (as the method of depreciation followed for the asset to which the grant relates is the SLM), considering it as an accounting error, as per the requirements of the then applicable AS 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (till F.Y. 2015-16) and Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'(from F.Y. 2016-17). Accordingly, the Committee is of the view that in the financial year 2016-17, the change in the method of recognising deferred income/grant should be considered as prior period item and not a change in an accounting estimate. In this regard, the Committee notes the following paragraphs of AS 5 and Ind AS 8:

> *AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*
>
> ***"4.3. Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."***
>
> **"Prior Period Items**
>
> ***15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.***
>
> 16. The term 'prior period items', as defined in this Standard , refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.
>
> 17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight."

Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'

"***Prior period errors*** **are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:**

(a) was available when financial statements for those periods were approved for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud."

"41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind ASs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 42–47).

42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."

Further, the Committee is of the view that since the method of recognition of recognising deferred income from straight line to WDV was changed in F.Y. 2016-17, which is the first year of implementation of Ind ASs on transition to Ind ASs, the Company should also follow the requirements of Ind AS 101, 'First-time

Adoption of Indian Accounting Standards'. In this regard, the Committee notes the following requirements of Ind AS 101:

"10 Except as described in paragraphs 13–19 and Appendices B–D, an entity shall, in its opening Ind AS Balance Sheet:

(a) recognise all assets and liabilities whose recognition is required by Ind ASs;

(b) not recognise items as assets or liabilities if Ind ASs do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind ASs; and

(d) apply Ind ASs in measuring all recognised assets and liabilities.

11 The accounting policies that an entity uses in its opening Ind AS Balance Sheet may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to Ind ASs. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to Ind ASs."

"24 To comply with paragraph 23, an entity's first Ind AS financial statements shall include:

(a) reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with Ind ASs for both of the following dates:

(i) the date of transition to Ind ASs; and

(ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP.

(b) a reconciliation to its total comprehensive income in accordance with Ind ASs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.

(c) if the entity recognised or reversed any impairment losses for the first time in preparing its opening Ind AS Balance Sheet, the disclosures that Ind AS 36, *Impairment of Assets*, would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to Ind ASs.

25 The reconciliations required by paragraph 24(a) and (b) shall give sufficient detail to enable users to understand the material adjustments to the Balance Sheet and Statement of profit and loss. If an entity presented a Statement of cash flows under its previous GAAP, it shall also explain the material adjustments to the Statement of cash flows.

26 If an entity becomes aware of errors made under previous GAAP, the reconciliations required by paragraph 24(a) and (b) shall distinguish the correction of those errors from changes in accounting policies."

The Committee notes from the above that adjustments arising from events and transactions before the date of transition to Ind ASs should be recognised directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to Ind ASs. Further, in accordance with paragraph 26 of Ind AS 101, if an entity becomes aware of errors under the previous GAAP, the reconciliations and disclosures required by paragraph 24(a) and (b) should distinguish the correction of those errors from changes in accounting policies.

D. Opinion

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

(i) Yes, the selection and application of RBM (or WDV) for recognising government grants in the previous years, i.e., from F.Y. 2004-05 to F.Y. 2015-16 is an error, as discussed in paragraphs 25 and 26 above.

(ii) The audit opinions including supplementary audit are the opinions/views of the respective auditors and therefore, the Committee does not wish to express its opinion on the same.

(iii) In view of (i) above, answer to this question does not arise.

____

Query No. 9

Subject: Estimation of Final Mine Closure Plan and treatment of the same in the books of account on year-on-year basis.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a Government of Karnataka undertaking Company, incorporated under the Companies Act, 1956 and is having its registered office at Bangalore. Aim of the Company is primarily to explore the available mineral sources in various regions of the Karnataka State to cater to the needs of local industry and to create employment opportunities to the local community. The Company is one of the largest producers of iron ore, chromite, magnesite, limestone, dolomite, clay and granite in the state of Karnataka. The Company is engaged in scientific and eco-friendly exploration and marketing of various minerals in the state of Karnataka. The details of mine/quarry leases held by the Company are as follows:

Particulars	Mines		Quarries	
	In No's	Lease area In Hectares	In No's	Lease area In Acres
Working	5	919.56	2	42.37
Non-working	32	4856.14	20	481.62
Surrendered	3	119.09	16	161.95
Cancelled	2	648.59	-	-
Total	**42**	**6543.38**	**38**	**685.94**

2. The querist has stated that as per the provisions of 'Indian Bureau of Mines and Mineral Conservation and Development Rules (MCDR), 2017', the holder of a mining lease shall submit a Final Mine Closure Plan (FMCP) to the competent authority for approval, two years prior to the proposed closure of the mine.

3. The querist has further stated that if the Company wants to submit the plan and make provision in the last two financial years before the closure of the lease of mines/quarries, the expected expense will be so huge that it will have huge impact on profits and will affect fair presentation as the expenditure that will be booked, pertain to several years.

4. As a prudent accounting practice, it requires that the Company shall estimate and account for the estimated cost of Final Mine Closure Plan (FMCP) and spread the same across the life of the mine/quarry for presentation of

[1] Opinion finalised by the Committee on 15.6.2021.

financial statements as per the applicable financial reporting framework and to give true and fair view.

5. As the Company is involved in mining activities, it needs to follow the Rules laid down by Indian Bureau of Mines. Accordingly, the management has decided to provide for the liability of FMCP and amortise it over the remaining leasehold period.

6. The querist has reproduced paragraphs 45 to 47 of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' as follows:

> **"45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.**
>
> 46 Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.
>
> **47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted."**

7. The brief description of accounting practices followed by the Company along with the facts and figures is listed below:

a. **In the year 1**: The Company estimates the Final Mine Closure Plan. This is usually done by the concerned technical department, in the year one, based on the current scheduled rate prepared by the Public Works Department, Government of Karnataka. The amount so arrived will be converted into present value using the discounting factor @7.5% and amortised over the lease period of the mine/quarry.

b. **In the year 2**:

- i. The present value of the Final Mine Closure Plan will be arrived for the year 2,
- ii. The difference between the present value of the year 2 and present value arrived for the year 1 will be treated as 'Interest/Finance Cost'.

c. The detailed worksheet computed for the financial year (F.Y.) 2018-19 is furnished for a better understanding, which is briefly summarised as follows:

Particulars	Amount (INR in lakhs)
Final Mine Closure Plan arrived during the year 2017-18	24,383.46
Present Value of Final Mine Closure Plan for the year 2017-18	8,627.29
Present Value of Final Mine Closure Plan for the year 2018-19	9,274.34
Difference of PV of FMCP of 2018-19 and 2017-18 is treated as interest charge/finance cost	647
Amortisation charged to Asset (Present Value of FMCP for year 2017-18 divided by life of the mines calculated for each individual mine)	833.74

d. Scheme of journal entries in the books of account:

i. During the year 2017-18 ` Rs. (In Lakhs)

a) Creation of Final Mine Closure Plan as an Asset:

Particulars	Debit	Credit
Lease Hold Land A/c dr	8627.29	
To Provision for Mine Closure Plan A/c		8627.29

b) Amortisation of Final Mine Closure Plan:

Particulars	Debit	Credit
Depreciation and Amortization Expenses A/c dr	833.74	
To Lease hold Land A/c		833.74

ii. During the year 2018-19 Rs. (In Lakhs)

a) Providing for difference in present values as finance cost:

Particulars	Debit	Credit
Finance Cost A/c dr	647	
To Provision for Final Mine Closure Plan A/c		647
(Being the difference in present value of FMCP for 2018-19 and Present value of FMCP 2017-18 accounted)		

b) Creation of Final Mine Closure Plan as an Asset:

Particulars	**Debit**	**Credit**
Lease Hold Land A/c dr	8627.29	
To Provision for Final Mine Closure Plan A/c		8627.29

c) Amortisation of Final Mine Closure Plan:

Particulars	**Debit**	**Credit**
Depreciation and Amortisation Expenses A/c dr	833.74	
To Lease hold land A/c		833.74
(Being depreciation and amortisation of 2018-19)		

8. *Audit observation by the Indian Audit and Accounts department:*

a) The Indian Audit and Accounts Department (Comptroller & Auditor General (C&AG)), which conducts the supplementary audit of the annual accounts of the Company in accordance with the provisions of the Companies Act, 2013, is not in agreement with the accounting policy followed by the Company, and they are of the view that the Final Mine Closure Plan estimated by the Company is based on the current scheduled rates and as such, the need for discounting does not arise and hence present value of Final Mine Closure Plan should be Rs. 24,383.46 Lakhs and not 8,627.29 Lakhs.

b) The Company in its reply to the audit observation, has given assurance to the C&AG that the matter will be referred to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) and will take the expert advice to follow the suitable accounting policies consistently.

9. The querist has separately informed that the estimate of Final Mine Closure Plan for the period 2017-18 is the expenditure to be incurred towards closure activities at the end of mine life, which is considered as per the current scheduled rate of the Public Works Department, Government of Karnataka.

B. Query

10. 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 practices followed by the Company is in accordance with the Generally Accepted Accounting Principles or not.

(ii) Whether the audit observation made by the C&AG is valid or not.

(iii) Whether there is any best practice to be followed by the Company in respect of Mine Closure obligation.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to accounting for Mine Closure obligation by the Company under Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time. The Committee has, therefore, restricted the opinion only to this issue and has not examined any other issue that may arise from the Facts of the Case, such as, appropriateness of the accounting for Final Mine Closure Plan expenditure under Accounting Standards notified under Companies (Accounting Standards) Rules, 2006, compliance with Mines and Mineral Conservation and Development Rules, determination/ estimation/measurement of mine closure cost, accounting for leasehold land, amortisation of leasehold land, the appropriateness of the discount rate used by the Company, accounting for the mines which are closed/surrendered and provision in respect thereof, etc. The opinion, expressed hereinafter, is purely from accounting perspective and not from the perspective of interpretation of any Act/Rules, such as, Indian Bureau of Mines and Mineral Conservation and Development Rules (MCDR), 2017 etc. The Committee also presumes from the Facts of the Case that mine closure expenditure in the extant case is not of the nature of stripping costs during the production phase of the mine. Furthermore, the Committee has looked at the issue raised only from accounting principles guidance perspective and has not looked at the appropriateness of accounting/journal entries passed by the Company.

12. At the outset, the Committee notes the nature of expenditure incurred under Final Mine Closure Plan from the following definitions under 'Mineral Conservation and Development Rules, 2017':

"(a) "abandonment of mine" means the final closure of a mine, either whole or part thereof, when the mineral deposits within the mine or part thereof have been fully extracted or when the mining operations thereon have become uneconomic;"

"(m) "final mine closure plan" means a plan for the purpose of decommissioning, reclamation and rehabilitation of a mine or part thereof after cessation of mining and mineral processing operations, that has been prepared in the manner specified in the standard format and guidelines issued by the Indian Bureau of Mines or the Director, Atomic Minerals Directorate for Exploration and Research in respect of minerals specified in Part B of the First Schedule to the

Act where the grade of such atomic minerals is equal to or above the threshold value limits declared under Schedule-A of the Atomic Minerals Concession Rules, 2016;

(n) "final mine closure" means steps taken for reclamation and rehabilitation of a mine or part thereof commencing from cessation of mining or processing operations in a mine or part thereof;"

The Committee notes from the Facts of the Case that the querist has stated that as per the provisions of 'Indian Bureau of Mines and Mineral Conservation and Development Rules (MCDR), 2017', the holder of a mining lease shall submit to the competent authority for approval, two years prior to the proposed closure of the mine, a Final Mine Closure Plan (FMCP) which means a plan for the purpose of decommissioning, reclamation and rehabilitation of a mine or part thereof after cessation of mining and mineral processing operations. Thus, there is a legal obligation for the Company in the extant case to incur decommissioning, reclamation and rehabilitation expenditure due to mining operations or extraction activities of the Company.

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

"5 An entity shall not apply this Ind AS to expenditures incurred:

(a) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area.

(b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable."

"10 Expenditures related to the development of mineral resources shall not be recognised as exploration and evaluation assets. 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 and Ind AS 38, *Intangible Assets*, provide guidance on the recognition of assets arising from development."

"11 In accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets* an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources."

"15 An entity shall classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired and apply the classification consistently.

16 Some exploration and evaluation assets are treated as intangible (eg drilling rights), whereas others are tangible (eg vehicles and drilling rigs). To the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset."

The Committee notes that Ind AS 106 provides that obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources are governed by the requirements of Ind AS 37. Further, as per the Standard, exploration and evaluation assets are treated as property, plant and equipment or intangible assets according to the nature of assets; and the expenditure related to development of resources shall also be governed by the Conceptual Framework and Ind AS 38.

The Committee now notes that Ind AS 16, 'Property, Plant and Equipment' contains following guidance for initial measurement of an item of property, plant and equipment:

"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."

Similarly, Ind AS 38, 'Intangible Assets' also contains the following guidance for initial measurement of a separately acquired intangible asset:

"27 The cost of a separately acquired intangible asset comprises:

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

(b) any directly attributable cost of preparing the asset for its intended use."

The Committee notes from the above that both Ind AS 16 and Ind AS 38 require costs that are directly attributable to acquire the asset or to bring the asset to the location and condition necessary for it to be capable of operating in the intended manner to be included in the initial measurement. Further, Ind AS 16 specifically provides that 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) shall be included in the cost of an item of property, plant and equipment.

14. The Committee further notes the requirements of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' as follows:

"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."

"19 It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. *Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused*. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised." (Emphasis supplied by the Committee.)

"36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

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

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

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

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

Present value

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

46 Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

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

"60 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost."

In this regard, Committee also notes following paragraphs of Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable) although the Guidance Note may not be strictly applicable for mineral resources other than oil and gas:

"Accounting for Abandonment Costs

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

34. In accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources. Thus, an entity should capitalise as part of property, plant and equipment or intangible asset, as the case may be, the amount of provision required to be created for subsequent abandonment. *The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc.*

Where the effect of the time value of money is material, the amount of the provision should be the present value of the expenditures expected to be required to settle the obligation. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect current market assessments of the time value of money and the risks specific to the liability. The discount rate should not reflect risks for which future cash flow estimates have been adjusted. … However, the change in the estimated provision due to the periodic unwinding of the discount should be recognized in statement of profit and loss as it occurs. Since abandonment costs do not reflect borrowed funds, the unwinding cost would not be a borrowing cost eligible for capitalization."

(Emphasis supplied by the Committee.)

15. As discussed in paragraph 12 above, the Committee notes that the Company is under a legal obligation to incur costs on site restoration and mine closure work as per its governing laws. Under Ind AS 37, a provision is required to be recognised in respect of such costs since there exists an obligation to perform the site restoration and closure of the mine. However, the relevant regulations should be taken into account when determining the existence and extent of the obligation. Thus, the Company in the extant case should recognise a decommissioning or restoration provision in respect of the mine closure obligation and this obligation may arise even before any production takes place. The Committee further notes that the accounting for decommissioning provision will depend on how the related costs have been accounted for. If the related costs are capitalised, the associated decommissioning costs should also be capitalised and included in the initial measurement of the related tangible or intangible asset. However, if the related costs are expensed (such as certain exploration and evaluation costs that do not meet the capitalisation criteria under Ind AS 106), any associated decommissioning or restoration costs should also be expensed.

16. With regard to measurement of the provision, the Standard provides that the provision shall be recognised at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period. Thus, the Committee is of the view that the provision for estimated expenditure should be made at current prices at the reporting date considering the relevant conditions and obligation. Further, since the mine closure costs are towards the closure activities at the end of the mine life, the obligation is a long-term obligation and therefore, if the effect of time value of money is material, the provision should be discounted. Accordingly, the initial cost of the related asset should include the present value of the expenditure

expected to be required to settle the obligation. Thus, although the estimates are made at current prices on the reporting date, since the estimates are for the expenditure to be incurred in the future at the end of mine life, these are discounted if the effect of time value of money is material.

Subsequently, where discounting is used, the carrying amount of a provision is increased in each period to reflect the passage of time. This increase is recognised as borrowing cost. Further, the cost of the related asset, including the initial estimate of mine closure costs, should be depreciated/amortised based on the pattern in which the related asset's future economic benefits are expected to be consumed in accordance with the requirements of the relevant Standards.

D. Opinion

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

(i), (ii) & (iii) The Company should follow the accounting for mine closure obligation, as detailed in paragraphs 13 to 16 above. The appropriateness of the accounting practices followed by the Company in accordance with the generally accepted accounting principles and validity of C&AG observations would depend on the above-mentioned accounting.

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Query No. 10

Subject: Treatment of incentive to wallet users under Ind AS 115.[1]

A. Facts of the Case

Company and the business model:

1. A Company (hereinafter referred to as 'the Company') is a leading fintech platform, operating businesses in consumer payments, financial services and payment gateway.

2. The querist has stated that the business model under consideration comprises of use of the Company's online platform for (i) paying bills including mobile recharge, broadband, TV, electricity, gas, credit card, etc. (ii) spending on e-Commerce websites/apps, (iii) shopping at physical retailers including mom & pop shops, (iv) availing credit facility and (v) transferring money to Bank. For providing these facilities, the Company enters into contracts with various e-commerce and physical retailers (hereinafter called as 'merchants') whereby it

[1] Opinion finalised by the Committee on 15.6.2021.

provides the wallet facility to the end user for purchasing goods and services of merchants. In return for this facility, the Company charges a percentage commission on the transaction value from merchants.

Cashback/Supercash to users on transactions through the Company's platform:

3. In order to increase the end-user base and to incentivise the existing and new end-users, the Company provides incentives in the form of cashback and supercash on availing certain services from the Company's wallet. Cashbacks are credited to the user's wallet which can be used in any future transaction on the Company's platform or can also be transferred to the user's bank account. Supercash are credited to user's wallet as well but shown separately from cashback and can only be used by user in future transactions on the Company's platform and cannot be transferred to user's bank account. At times, supercash is also given for completing activities like completing KYC documentation or other promotional activities.

<u>E.g. 1 – Cashback credit to user's wallet on transaction made through the Company's wallet</u>

Cashback - A mobile wallet user has a Nil balance in his wallet. He recharges the wallet with an amount of INR 1,000. He makes XYZ mobile bill payment of INR 800 using his wallet with the Company. As per the prevailing offer, he was entitled to receive a cashback of 5% of transaction value subject to a capping of INR 50. The wallet balance of the user after this transaction will be INR 240 (1000 - 800 + 40) as he has received a cashback of INR 40 on this transaction. The Company will earn a commission from XYZ mobile company (the merchant) on this transaction of the bill being paid by the end user. According to the querist, the cashback to the wallet of the user and receipt of commission from merchant vendor are two separately settled transactions as the cashback to the wallet of the user is not dependent on the Company getting the payment from the merchants.

<u>E.g. 2- Supercash given to user on transaction made through the Company's wallet</u>

Supercash - A mobile wallet user has Nil balance in his wallet. He recharges the wallet with an amount of INR 1,000. He makes XYZ mobile bill payment of INR 800 through his wallet with the Company. As per the current offer, he was entitled to receive a supercash of 10% of transaction value. The wallet balance of user after this transaction will be INR 200 + supercash (shown separately) of INR 80 (received on the transaction). This supercash is available for utilisation in future transactions with certain restrictions. To take this example further, if he makes an electricity payment of INR 120, he will be able to utilise supercash only up to a specified % as per the prevailing offer (say 5%) which in this case, shall be INR 6. After the transaction, the user balance in the wallet shall be INR 86 (200-114) + supercash of INR 74 (80-6). The Company will earn commission from XYZ mobile company and the electricity company (the merchants). According to the querist, the supercash given to the wallet user and receipt of commission from merchants are separately settled transactions as the supercash given to the wallet user is not dependent on the Company receiving the payment of commission from the merchants.

<u>E.g. 3 - Supercash given to user through promotional activities</u>

Supercash – INR 100 supercash given to users on account of completion of KYC documentation of their account on the Company's wallet. This supercash is available for utilisation on future transactions with certain restrictions. To take the example further, if he makes an electricity payment of INR 120, he will be able to utilise supercash only to a specified % as per the prevailing offer (say 5%) which in this case, shall be INR 6. After the transaction, the user's balance in the supercash will be INR 94 (100-6). The Company will earn commission from the electricity company (the merchant). According to the querist, the supercash given to the wallet user and receipt of commission from merchant will be treated as two separately settled transactions as the supercash given to the wallet user is not dependent on the Company getting the payment from the vendor.

4. Querist's assessment - Accounting for cashback and supercash:

Issues under consideration:

Whether paragraphs 70 and 71 of Ind AS 115 (i.e., consideration payable to a customer) are applicable on above transaction. To analyse the same, assessment is required with respect to following questions:

1) Who is the customer - merchant vendor or wallet user?
2) Whether the transactions with merchant vendor and wallet users are distinct or not.
3) Whether the cashback/supercash offered to wallet user should be charged as promotional expense or netted from the commission earned from the merchant vendor.

<u>View - I</u>

<u>Technical guidance under Ind AS:</u>

Customer

As per paragraph 6 of Ind AS 115, 'Contracts with Customers', A customer is a party that has contracted with an entity to obtain goods or services that are an *output of the entity's ordinary activities in exchange for consideration.*

Variable consideration

As per paragraph 51 of Ind AS 115, an amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

Consideration payable to customer

As per paragraph 70 of Ind AS 115, "Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the *customer (or to other parties that purchase the entity's goods or services from the customer).* Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 26–30) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 50–58."

As per paragraph 71 of Ind AS 115, "If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price."

As per paragraph 72 of Ind AS 115, "Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:

(a) the entity recognises revenue for the transfer of the related goods or services to the customer; and

(b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

Issue 1 - Who is the customer - merchant vendor or wallet user?

- According to the querist, as per Ind AS 115, to be a customer, following criteria must be satisfied:
  - (i) Customer should have contracted with the Company;
  - (ii) to obtain goods or services that are an output of the Company's ordinary activities; and
  - (iii) in exchange for consideration.
- The Company is providing services to both merchant vendor and wallet user that are part of its ordinary activities. As a consideration for its services, the Company earns a commission from merchants when users buy products and services of merchant through the Company's wallet. The Company generally does not charge from users except for few services where a convenience fee is charged.
- It should be noted that, with respect to the payment services rendered by the Company to merchant, i.e., marketplace services, a user is not a customer of the merchant for said payment marketplace services but the user is a customer of the merchant for the goods and services of the merchant.
- *As per the above definition, only merchant vendor should qualify as customer of the Company and not wallet user as in case of wallet user, there is no consideration attached. However, in case of those services wherein a fee is charged from wallet user, users are considered as customers of the Company.*

Issue 2 - Whether the transactions with merchant vendor and wallet user are distinct or not.

- As per the querist, with respect to the application of paragraphs 70 to 72 of Ind AS 115, the Company needs to analyse whether the transactions with merchant vendor and wallet user are two distinct transactions or they are highly interrelated and should be accounted for as a single transaction.
- Commission is earned from the merchant based upon contractual agreement entered with them on every transaction done through the Company's platform, whereas incentives are offered to users from time to time based on different schemes launched by the Company. In general, these incentives are not offered on every transaction but are launched at different points in time and the schemes are for short duration of time. The intent of

cashback/supercash offered is not to give discount/credits to customer but to promote the usage of the app/platform. The cashback offered to user can also be more than the commission earned from merchant as the cashbacks are purely sales focused and not for any particular transaction. The contractual agreement with merchant vendor would be for a longer duration of time however the cash backs will be offered only intermittently, and it would be completely unrelated to merchant vendor agreement. Further, the Commission is earned by the Company from all its merchants; however the cashback/supercash is given only to a handful of users. Hence, these are 2 distinct transactions with no relation to each other.

- Once the transaction is completed on which the user was eligible for cash back/super cash, it is pushed to his wallet and if later, the Company has disputes with merchant, the Company cannot claim back the cash back/super cash from the wallet user.
- Further, it has been noted that the increase in transactions per user and retention of user is highly correlated with cashback/supercash offers.
- *Accordingly, it should be considered that the intent of these incentives is purely promotional in nature and reaching out to multiple users at distinct points of time to increase or maintain transaction traffic via platform. Therefore, these should be considered as distinct from transactions with the merchant.*

Issue 3 - Whether the cashback/supercash offered to wallet user should be charged as promotional expense or netted from the commission earned from the merchant vendor.

- <u>In transactions where the Company does not receive any consideration from end user</u>, the user is not considered as a customer of the Company and thus any cashback/supercash offered to the user is treated as a marketing or promotional expense. Since supercash has restricted use (with respect to time and utilisation), the Company should reasonably estimate the amount expected to be utilised by users for recognition as marketing or promotional expense (i.e., determine breakage considering the past trend of user non-utilisation or expired super cash).
- <u>In transactions where the Company charges convenience fee from users</u>, the user is considered as a customer of the Company, any cashback/supercash offered to the user is recorded as reduction from revenue to the extent of convenience fee earned from end user. The supercash is netted of with revenue (as reduction) to the extent of revenue amount, i.e., only to the extent of convenience fee and any further amount of supercash on said

transaction will be recorded as an expense and will not be adjusted against commission earned from the merchant vendor.

View – II

Paragraph 70 of Ind AS 115 requires an entity to account for *consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue* (unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity).

As explained in View I above, only for those transactions where the Company charges service fee from the users, such users can be considered as the customer of the Company. Further, the incentives offered to the user and commission earned from the merchants are distinct transactions and are not linked. As supported by BC255 of Basis for Conclusions of International Financial Reporting Standard (IFRS) 15, *consideration payable to a customer includes amounts paid to a customer's customer.* Thus, the requirement of paragraph 70 of Ind AS 115 would apply not only to consideration payable to a customer but also to a customer's customer.

In this regard, apart from end users in a direct distribution chain, *it may be appropriate to apply the guidance more broadly - i.e., to amounts paid outside the direct distribution chain.* Judgement is required to evaluate a specific fact pattern to determine whether a payment to a party outside a direct distribution chain is treated as consideration payable to a customer.

Based on the above, both the merchant and the end users are the customers of Company following a broad assessment of who is the customer as both are part of the overall value chain (even though the end user is not within a direct distribution chain). The incentives do not provide the Company with any distinct good or service, but rather are offered to increase traffic and revenue of the Company from commissions.

In essence, the actual revenue to the Company from the commission is after the discount. This outcome is also consistent with the overall objective of determining the transaction price in Ind AS 115.47: *"The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer…"*.

Thus, the incentives offered by the Company on their platform to the users should be reduced from revenue.

Accounting for transactional incentives for cases where a convenience fee is charged but the incentive is in excess of the fee:

In cases, where a convenience fee is charged by the company to the end-user, the Company considers in view I above, the merchant as well as the end-user to be its customer. In such cases, if a transactional incentive (cashback or supercash) is given to the customer, the Company reduces the incentive from the revenue to the extent of convenience amount and any balance amount is considered as a marketing expense.

For example, assume the following amounts apply to a transaction:

- End user makes a payment of CU 50 to a mobile operator through the platform and is charged a convenience fee of CU 5
- Company charges a 15% commission to the mobile operator for arranging the payment (50 x 15% = CU 7.5)
- Company grants a credit of 10 to the end user off its total order – i.e., the end user pays CU 45 (55 – 10)
- Company passes on CU 42.5 (50 transaction value – 7.5 commission) of the 45 collected from the end user to the mobile operator
- Company retains CU 2.5 of cash related to the transaction (5 convenience fee + 7.5 commission – 10 credit)

In this case, the incentive of 10 exceeds X's revenue from the convenience fee of 5.

The end user incentive is related to the entire transaction, including the revenue earned from merchant commissions. The incentives are also offered to generate traffic on the platform and increase future revenues from both convenience fee and merchant commissions. In this case, the Company's revenues from the merchant commissions are the more significant portion of its revenues when a customer makes a payment using its platform.

This outcome is consistent with the overall objective of determining the transaction price in Ind AS 115.47: "The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer…" In the example scenario, the Company is entitled to 2.5 of consideration from providing the services to its customers – i.e., the end users and the merchant. Recognising revenue of 7.5 (and a marketing expense of 5) would overstate the amount of consideration that the Company is entitled to from the transaction.

(Emphasis supplied by the querist.)

5. Accounting treatment followed by Industry Peers:

Supporting View-I further, industry peers in India (e.g. ABC Limited) and abroad (e.g. U Inc.) have also followed a similar accounting treatment which can be seen from their financial statements available in the public domain. As an example, below is the presentation of this matter in the financial statements of one of the direct competitors of the Company. The relevant extracts from such XBRL financial statements for the financial year 2018-19 are:

a) Accounting policy on revenue recognition:

"The Company provides incentives to users in various forms including cashbacks. Prior to the adoption of Ind AS 115, cashbacks given to users where the Company recovers a convenience fees were classified in the statement of profit and loss as a marketing expense. Following the adoption of the Ind AS 115, cashbacks given to users **where the Company recovers a convenience fees** are classified as a reduction of revenue. However, such adjustment does not have an impact on the retained earnings of the Company at the date of transition."

b) The impact of adoption of Ind AS 115 on the financial statements:

i) Impact on financial statements

The following table show the adjustments recognised for each individual line item. Line items that were not affected by the changes have not been included.

	March 31, 2019		
	As presented under Ind AS 115	Adjustments on account of Ind AS 115	Amounts prior adoption of Ind AS 115
Revenue from operations	3,049.87	194.14	3,244.01
Other expenses	6,534.71	194.14	6,728.85
Profit/(loss) for the year for continuing operation	(3,954.33)	-	(3,954.33)
Profit/(loss) for the year for discontinuing operation	(5.31)	-	(5.31)
Basic and diluted Earnings per share for continuing operations	(705.02)	-	(705.02)
Basic and diluted Earnings per share for discontinuing operations	(0.95)	-	(0.95)
Contract liability	352.87	352.87	-
Other current liability- Advance from customer	-	352.87	352.87

c) Advertising promotional expenses presented under section [500100] Notes - Subclassification and notes on income and expenses:

[500100] Notes - Subclassification and notes on income and expenses

Unless otherwise specified, all monetary values are in Crores of INR

	01/04/2018 to 31/03/2019	01/04/2017 to 31/03/2018
Advertising promotional expenses	3,366.55	2,185.32

It can be seen from the above extracts that the cashbacks given to *users* ***where the Company recovers a convenience fees,*** have been classified as a reduction from the revenue while the rest has been classified as the advertising promotional expenses. (Emphasis supplied by the querist.)

The querist has emphasised that in case View II were to be adopted for this industry peer (whose extracts from financial statements have been provided above), then its revenue would be significantly impacted. Considering the prevalent industry practice, where most of the advertisement and promotional expenditure is incurred in relation to the end-user, its revenue under Ind AS 115 would be close to Nil, which would not be tenable for them or their shareholders.

6. Querist's Conclusion:

Based on the combined reading of View I, View II and the financial statements of reputed industry peers, the Company believes that View I should be applicable to the Company's business model.

Ind ASs are applicable to all the listed/to be listed companies without any exemption relating to the turnover or the size. The Company is in the process of filing Draft Red Herring Prospectus (DRHP) for Initial Public Offer and therefore, this matter is of the utmost significance to the Company.

The Company believes that Accounting Standards must be applied consistently across all the players in the industry so that retail investors can fairly compare their financial statements. Auditors (including the large auditing firms) must not be allowed to take differing positions on such an important standard such that it creates unfair advantages for a few companies, while prejudicing the revenue performance of all the other companies in the sector.

7. The querist has separately provided the following clarifications:

- The cashback/supercash incentives provided by the Company to users are not as per any contractual agreement with the merchants.
- The Company does not provide these cashback/supercash to users for payments towards all the merchants. It is at the Company's discretion to decide – a) which incentives it wants to provide, b) on which use, cases/merchants, and c) for what duration. Seasonality, religious holidays, and topical trends play a role in deciding what schemes should be run. As an example, if there is a cricket match on a Sunday, the Company may run a promotional campaign on top food delivery apps/merchants because many people will order food that day and transactions will spike. Therefore, if the Company wants to get a share of the merchant's peak volume (amongst all the competing payment options on the merchant's checkout screen), then it must run an incentive scheme to attract users so that they choose to pay via the Company's payment option. Not offering any incentive will reduce the Company's share of the merchant's total business on that day.

- The Company usually decides its schemes based on the expected transactions from specific merchants which in turn gives multiple tangible and intangible benefits to the Company, such as, stronger brand recall with users, higher new user acquisition from the merchant, higher retention of existing users and higher lifetime value per user.
- There is no differential commission charged from merchants whose users are incentivised versus whose users are not incentivised.
- These incentives are given by all the major players in the market, therefore, it is indeed a market compulsion. Without providing any incentives, it would be impossible to grow the business of the Company.
- The Company does not charge convenience fees to users in most instances. The Company charges convenience fees only when the merchant (usually a government entity) does not charge any fees to its customer (Company's user) nor pays any commission to the Company for the payment services rendered. In such cases, these merchants require the Company to charge its users a convenience fee in a transparent manner consistently across all payment options. For example, in relation to ticket booking for IRCTC (Indian Railways) through the Company's payment options, the Company charges convenience fees from its users for train tickets booked by them on IRCTC website.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether paragraphs 70 and 71 of Ind AS 115, (i.e., consideration payable to a customer) are applicable on the above-mentioned transaction.

C. Points considered by the Committee

9. The Committee, while expressing its opinion, has, restricted itself, to the issue raised in paragraph 8 above and has not examined any other issue that may arise from the Facts of the Case, such as, timing of the recognition of the incentives provided to the users under Ind AS 115, presentation of incentives paid in excess of commission received from merchant and/or convenience fee, accounting for commission received from the merchant, accounting for the convenience fee charged to the users, other aspects of revenue recognition including measurement of incentives, determination of principal vs. agent relationship between the Company and the merchant, accounting treatment in the financial statements of merchant, etc. The Committee has only examined the issue from Ind AS perspective and has not examined the regulatory or legal classification and implications, including those arising under Income tax Act and GST laws.

10. At the outset, the Committee notes that in the extant case, the arrangement is between the Company, the merchant, and the end users of the Company's payment platform (who have purchased goods and services from the merchant). The Company is rendering mobile phone-based payment services and digital wallet services to the end-users enabling them to make their payments to various merchants conveniently and in lieu of these services, the Company receives a percentage commission on the transaction value from merchants and in few cases (mostly, where the merchants so require), charges convenience fee from the end users.

11. With regard to the issue raised, the Committee notes paragraphs 70 and 71 of Ind AS 115 as follows:

> **"Consideration payable to a customer**
>
> 70 Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 26–30) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 50–58.
>
> 71 If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price."

The Committee further notes that paragraph BC255 of IFRS 15 which contains Basis for Conclusions for paragraphs 70 to 72 of IFRS 15 that contain similar requirements as in Ind AS 115, states as follows:

> "In some cases, an entity pays consideration to one of its customers or its customer's customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay a customer of that dealer or distributor). That consideration might be in the form of a payment in exchange for goods or services received from the customer, a discount or refund for goods or services provided to the customer, or a combination of both."

The Committee notes that when applying the above-reproduced requirements of consideration payable to a customer as per paragraphs 70 and 71 of Ind AS 115, it is important to determine who is an entity's customer. The Committee notes that Appendix A to Ind AS 115 defines 'customer' as follows:

> "A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."

The Committee notes that, the definition of customer under Ind AS 115, requires that a party should have contracted with the entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. The Committee is of the view that in the extant case, *except in cases where the convenience fee is charged,* there is no consideration in exchange of the payment wallet facility given by the Company to the end users. Further, there is no contractual obligation to provide incentives to the end users; rather incentives are offered to users from time to time based on different schemes launched by the Company. Therefore, the end users cannot be considered as customers of the Company.

The Committee further notes that paragraph 70 of Ind AS 115 states that the customer would not only include direct customers but "other parties that purchase the entities goods or services from the customer." Thus, as per the requirements of paragraph 70, the party who purchases the Company's goods or services from its customer (viz., merchant in the extant case) can also be considered as the customers of the entity. In the extant case, the end user is purchasing the merchant's goods or services and not availing the Company's services from the merchant. Therefore, in the extant case, end user cannot also be considered as 'other parties that purchase the entities goods or services from the customer' or 'customer's customer', as per the requirements of paragraphs 70 and 71 of Ind AS 115.

Further, the Committee notes that in the extant case, the Company does not have a contractual obligation under the arrangements with the merchants to provide consideration (viz., incentives) to the merchant's customers (i.e., the end users) and therefore, there is no link between the Company and end users in the contractual relationship with the merchant. The Committee is of the view that the transactions of the Company with merchants and the transactions of the Company with the end users are two separate and distinct transactions and there is no direct link between the two since the cashback to the wallet of the user is not dependent on the Company getting the payment from the merchants and there is no differential commission charged from merchants whose users are incentivised versus whose users are not incentivized. Therefore, the consideration received from the transaction with the merchant, viz., commission should not be linked with the incentive paid under the other transaction with the end users.

Accordingly, the consideration (viz., revenue of the Company) received from the merchant on account of commission cannot be reduced on account of the incentives provided to the end users under the requirements of paragraph 70 of Ind AS 115. The Committee is further of the view that the incentives provided by the Company in the extant case are in the nature of sales promotion activities and shall not be considered as 'consideration payable to customers' by the Company under paragraph 70 of Ind AS 115.

However, the Committee believes that in cases where the Company charges convenience fee from the end users, incentives (cashback or supercash) shall be considered as consideration payable to a customer and shall be reduced from the concerned revenue, viz., convenience fee (and not from the revenue/commission received from the merchants), as per the requirements of paragraph 70 of Ind AS 115.

D. Opinion

12. On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 8 above that, as mentioned in paragraph 11 above, except in cases where the Company charges convenience fee from the end users, incentives (cashback or supercash) shall not be considered as consideration payable to a customer and shall not be reduced from revenue, as per the requirements of paragraph 70 of Ind AS 115.

Query No. 11

Subject: Accounting treatment of construction of facilities for import of additional requirement of power.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company'), is a Government of India Undertaking, which is engaged in refining of crude oil and having a refining capacity of 3.0 MMTPA (Million Metric Tonne per Annum). The Company is jointly owned by A Ltd., B Ltd. and Government of Assam (GoA). A Ltd. holds 61.65% shares whereas B Ltd. and GoA own 26% and 12.35% respectively. The refinery is located in Golaghat district of Assam and is the fourth refinery in the state of Assam. The capacity of the refinery is being enhanced from 3.0 MMTPA to 9.0 MMTPA.

2. The Company is presently running the refinery from power generated from its own captive power plants. The power is generated from Gas Turbine Generator (GTG) and Steam Turbine Generator (STG) with natural gas. The present power requirement is 35 MW. However, with refinery expansion, requirement of power will be increased by around 80 MW from the present requirement. The said power requirement can be met either through grid power (220 KV grid connectivity) or through captive power.

3. The key drivers of the project to have 220 KV grid connectivity are as follows:

a) *Revenue maximisation*

Grid power is available at a cheaper rate in comparison to cost of captive power.

b) *Compliance to Ministry of Petroleum and Natural Gas (MoP&NG) Guidelines*

MoP&NG is emphasising on use of Grid power instead of captive power with the intent of avoiding burning of fossil fuel in the power plants and thereby minimising fuel and loss. This also bears a direct impact on environment in general and nation at large.

c) *Value addition to company's upcoming projects*

The company's upcoming Bio Refinery Project will produce surplus electricity which will have to be either consumed in the refinery or exported to Grid based on value proposition.

d) *Refinery expansion*

[1] Opinion finalised by the Committee on 22.7.2021.

The proposed expansion of refinery to 9.0 MMTPA, additional power demand is projected to be 74 MW. With the open access connectivity to Grid, the Company will be able to purchase stable power instead of setting up captive plants which is more capital cost intensive than developing the transmission infrastructure.

e) *Power Reliability and Risk Mitigation*

The national grid power is very stable and connectivity to national grid will enhance power security for the Company. Power failure in the Company has been identified as one of the major risks which requires mitigation strategy. The Grid connectivity will ensure un-interrupted power supply for reliable refinery operation.

In view of the above, the Company and State Electricity Grid Corporation (hereinafter referred to as 'C Ltd.') have entered into a memorandum of understanding (MoU) (a copy of which has been supplied separately by the querist for the perusal of the Committee), whereby the Company is required to set up infrastructure for import of Grid power to enhance reliability and availability of power to sustain operations of its refinery located at Numaligarh, Assam. The power is to be procured from electricity grid operated by C Ltd. C Ltd. has agreed to take up construction of infrastructure up to the boundary of the Company for facilitating it to procure power from C Ltd.'s Grid. The cost for the construction of infrastructure up to the boundary of the Company would be Rs. 185.32 crore which would be borne by the Company. This cost will benefit the Company in terms of continuous availability of cheap power to run its new 6 MMPTA new Refinery. Further, there will be two distinct future benefits to the Company due to grid connectivity.

i. Over time, with increased renewable capacity, the grid power will incrementally become green and the Company will get benefit in terms of augmenting its carbon footprint reduction.

ii. With this connectivity, the Company, in future, will be able to leverage on the group captive option of power generation and consumption beyond its refinery premises. Creation of the infrastructure will ensure adequate power supply to the Company for its new 6 MMTPA Refinery. Without this infrastructure, the Company will not be able to have the power to run the new 6 MMTPA Refinery. Power for the new 6 MMTPA new Refinery would then need to be met by setting up its own captive power plant which will mean incurring huge capex by the Company.

4. The querist has stated that the entire construction and commissioning activities are divided into three parts with detailed cost break-up as under:

(A) 220 KV Over Head (OH) Line :

Supply, installation, testing and commissioning of 220 KV double circuit, OH line to the Company from C Ltd. Grid point (approximate distance of 11 Km) including acquisition of required land for construction. The work will be carried out as deposit work basis whereby the Company will reimburse the cost against utilisation. The Company shall reimburse cost of land to C Ltd. and ownership of the land shall vest with C Ltd. The OH line will be owned, operated and maintained by C Ltd. after commissioning. Operation and maintenance charge will be payable by the Company to C Ltd. as per CERC/AERC regulation. The major break-up of cost for this 220 KV OH line is as under:

Head of Expenditure	Amount (Rs./crs)
ROU Compensation	3.08
Supply Erection	13.95
Total	17.03

(B) 220 KV Gas insulated Substation (GIS):

Supply, construction installation, testing and commissioning of 220 KV GIS in all respect in the location near refinery complex. The work will be carried out as deposit work basis whereby the Company will reimburse the cost against utilisation. The 220 KV GIS line will be owned, operated and maintained by C Ltd. after commissioning. Operation and maintenance charge will be payable by the company to C Ltd. as per CERC/AERC regulation. The major break-up of cost for this 220 KV GIA is as under:

Head of Expenditure	Amount (Rs./crs)
Land acquisition	10.28
Supply and Erection	146.01
Total	156.29

(C) 220/33 KV Switch Yard:

Supply, installation, testing and commissioning of 220/33 KV Switch yard inside refinery complex at the Company. The Switch yard will be owned, operated and maintained by the Company after commissioning. The job will be carried out by the Company and C Ltd. will provide Detail Design Consultancy, Tender Preparation and Tender Evaluation for the job. The cost of installation (both supply and erection) is around Rs. 12 crore.

5. The summarised cost break-up for this project is as under:

Particulars	Cost to be borne by the company (Rs. in Crs)
(A) 220 KV Over Head (OH) Line up to the Company's boundary – Line to be owned, operated by C Ltd.	**17.03**
(B) 220 KV Gas insulated Substation (GIS) - to be located near refinery complex and to be owned, operated by C Ltd.	**156.29**
(C) 220/33 KV Switchyard inside refinery complex of the Company and to be owned, operated by the Company	**12.00**
Total	**185.32**

6. The querist has also pointed out that although infrastructure is created to meet enhanced power requirement of the Company, C Ltd. also has the option to sell power to household/other industry in and around refinery area from this Grid. After meeting the Company's requirement from the transmission infrastructure in totality, C Ltd. can cater to the requirements of some small local consumers. The querist has also separately informed that at present, there is no agreement between the Company and C Ltd. for assured/minimum quantity of power. Further, at a later date, closer to completion of the project, a separate power purchase agreement will be entered into with the power supplier as grid power will be taken through open access mechanism. However, C Ltd. is responsible to make the quantity of power available to the Company as per the Agreement/MOU signed between the parties, through this infrastructure.

B. Query

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

(i) Whether above expenditure (A, B and C) would be capital or revenue expenditure for the Company. In case the same is a capital expenditure whether expenditure incurred to be recognised as an individual item of Property, Plant and Equipment or the same to be capitalised as a part of overall cost of the project.

(ii) In case capital, what shall be the useful life of the asset? It may be noted that life of the present refinery is expected to be over by 2025. However, present refining capacity of the Company shall be enhanced from existing 3 MMTPA to 9 MMTPA and project is expected to be completed by 2024. Accordingly, life of the enhanced 6 MMTPA will be taken as 25 years up to 2049.

(iii) In case the expenditure is of revenue nature, manner in which same shall be charged off, i.e., whether in one year and can spread over more than one year.

(iv) What will be the accounting treatment to be done by the company for the payment kept as Deposit with C Ltd. during the construction period and the accounting treatment to be done on completion of the Project?

(v) In case the expenditure to be treated as capital, how the same is to be presented in the financial statements of the Company?

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting treatment of expenditure incurred for construction of facilities to import power to the Refinery of the Company (hereinafter referred to as 'the transmission infrastructure'), which will be used for the power requirement of the present as well as proposed expansion Project, in the financial statements of the Company. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting for expenditure incurred for the proposed expansion of refinery etc., accounting for operation and maintenance expense/charge to be paid by the Company to C Ltd., accounting for any financing element in the above-mentioned transactions, impairment of the assets recognised (if any), etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from legal perspective, such as, legal interpretation of the Guidelines of Ministry of Petroleum and Natural Gas, Memorandum of Understanding between the Company and C Ltd. etc. Further, the Committee wishes to point out that the Indian Accounting Standards referred to in the Opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

9. At the outset, the Committee notes from the Facts of the Case that the Company is required to set up infrastructure for import of Grid power from C Ltd.'s Grid to the Company's boundary. Such infrastructure enhances reliability and availability of power to sustain operations of its existing refinery located at Numaligarh as well as proposed expansion of the refinery. With the open access connectivity to Grid, the Company will be able to purchase stable power instead of setting up captive plants which is more capital cost intensive than developing the transmission infrastructure. Thus, the infrastructure results in future economic benefits for the Company. For the said infrastructure, the Company is required to make payments to C Ltd. for three parts as follows:

(A) 220 KV Over Head (OH) Line, which will be owned, operated and maintained by C Ltd.

(B) 220 KV Gas insulated Substation (GIS), which will be owned, operated and maintained by C Ltd.

(C) 220/33 KV Switchyard inside refinery complex of the Company, which is to be owned, operated and maintained by the Company.

10. With regard to the accounting for the expenditure on construction of transmission infrastructure in the extant case, the Committee notes that the first issue to be examined is whether an individual asset (tangible or intangible) may be recognised in respect of such expenditure. In this regard, the Committee notes the definition of 'asset' from Ind AS 38, 'Intangible Assets' and paragraph 13 thereof with regard to 'control' as follows:

"An *asset* is a resource:

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

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

"Control

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."

The Committee further 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."

"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."

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

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

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

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

From the above, the Committee notes that although the infrastructure constructed by C Ltd. in the extant case will result into future economic benefits, as mentioned in paragraph 9 above and the cost can also be measured reliably, the same, *other than switchyard in the Refinery complex of the Company,* will not result into any individual tangible asset controlled by the Company, as neither the Company owns the infrastructure nor it can restrict others from having access of benefits from the infrastructure. Therefore, infrastructure *other than Switchyard* cannot be recognised as an individual item of PPE as per the principles of Ind AS 16. However, the Switchyard, since results into a tangible asset controlled by the Company, may be recognised as an individual item of PPE if it meets the recognition conditions as per above-reproduced paragraph 7 of Ind AS 16.

11. The Committee also examines whether the above expenditure (other than switchyard) results into an intangible or right-of-use of asset for the Company. In this regard, the Committee notes the following requirements of Ind AS 38 and Ind AS 116:

Ind AS 38

"An *intangible asset* is an identifiable non-monetary asset without physical substance."

“Intangible assets

9 Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.

10 Not all the items described in paragraph 9 meet the definition of an intangible asset, ie identifiability, control over a resource and existence of future economic benefits. If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see paragraph 68).”

“Identifiability

…

12 An asset is identifiable if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Control

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."

Ind AS 116

"Lease A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset)** for a period of time in exchange for consideration."

"9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

10 A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce)."

"B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21– B23); and

(b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

B10 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term."

"B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Right to obtain economic benefits from use

B21 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party."

"**Right to direct the use**

B24 A customer has the right to direct the use of an identified asset throughout the period of use only if either:

(a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or

(b) the relevant decisions about how and for what purpose the asset is used are predetermined and:

(i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or

(ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use."

The Committee notes that paragraph B24 of Ind AS 116 specifically provides that where the relevant decisions about how and for what purpose the asset is used are predetermined (as in the case of transmission infrastructure in the extant case), an entity shall have the right to direct the use of an identified asset throughout the period of use only if it has the right to operate the asset or if it designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use. Since in the extant case, the Company neither has the right to operate the asset nor it appears to have designed the asset in the manner as discussed above (as, according to one of the clauses of MoU between the Company and C Ltd., detailed design consultancy for the infrastructure is being provided by the C Ltd.), the Company cannot be considered to have the right to direct the use of the transmission infrastructure. Accordingly, the Committee is of the view that the arrangement between C Ltd. and the Company, in respect of transmission infrastructure, does not contain a lease and is not within the scope of Ind AS 116.

The Committee further notes from the above-reproduced requirements of Ind AS 38 that in order to meet the definition of an intangible asset, three conditions should be fulfilled, viz., identifiability, control over a resource and existence of future economic benefits. With regard to these conditions, the Committee notes from the Facts of the Case that C Ltd. has the option to sell power to household/other industry in an around refinery area from the Power Grid. Further, after meeting the Company's requirement from the transmission infrastructure, C Ltd. can cater to the requirements of some small local consumers. Furthermore, although the querist has informed that C Ltd. is responsible to make the quantity of power available to the Company through the infrastructure as per the Agreement/MOU, at a later date, closer to completion of the project, a separate power purchase agreement will be entered into with the power supplier (which is not C Ltd.) and grid power will be taken through open access mechanism. Thus, C Ltd. is only a power transmission entity which facilitates transmission of power and does not provide power as such. By incurring expenditure on transmission infrastructure as aforementioned, the Company is only getting a right to use the infrastructure but that right is not exclusive; the infrastructure can be used to cater to the requirements of other customers as well. Thus, although the Company has the power to obtain the future economic benefits flowing from the underlying asset (viz., right to use the infrastructure), it cannot restrict the access of other to those benefits. Therefore, the Company cannot be considered to have 'control' over the asset. Accordingly, the same cannot be accounted for as an intangible asset in the financial statements of the Company.

12. Now, the Committee examines whether the cost incurred on transmission infrastructure by the Company (which is not already capitalised as an individual item of PPE as per the above discussion) can be included as a part of cost of expansion Project of the Refinery. In this regard, the Committee notes that paragraph 16 of Ind AS 16, inter alia, states that 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. The costs that are directly attributable to the construction/acquisition of an item of PPE/project for bringing it to its working condition are generally those directly related costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures

without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to the location and condition necessary for it to be capable of operating in the manner intended by management, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. In this context, the Committee notes that in the absence of the power, which is accessed through the infrastructure created, the expanded Refinery cannot be operated and therefore, the above-said expenditure can be considered as directly attributable to bringing the Refinery project to the location and condition necessary for it to be *capable of operating* in the manner intended by management. Accordingly, such expenditure should be included as a part of cost of expansion Project of the Refinery. However, the capitalised asset should be tested for impairment as per the requirements of Ind AS 36, 'Impairment of Assets'.

13. As far as useful life of the capitalised property, plant and equipment is concerned, the Committee notes the requirements of Ind AS 16, which are reproduced below:

> "**43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.**
>
> 44 An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.
>
> 45 A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.
>
> 46 To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that

faithfully represents the consumption pattern and/or useful life of its parts."

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

From the above, the Committee notes that the useful life of PPE should be determined as per the above-reproduced requirements of Ind AS 16. Further, as per the above requirements of Ind AS 16, the amount initially recognised in respect of an item of property, plant and equipment is allocated to its significant parts and each such part is depreciated separately if they have a useful life which is different from the useful life of the item of property, plant and equipment to which they relate. Accordingly, in the extant case, the amount initially recognised as cost of Refinery should be allocated to its various significant parts having a different useful life and should be depreciated separately as per the above-reproduced requirements of Ind AS 16.

14. As far as the accounting treatment of the payment kept as Deposit with C Ltd. during the construction period, the Committee notes from the MoU signed between the Company and C Ltd. that as per the detail estimate accompanied by demand notice to be given by C Ltd., the Company will deposit the amount to C Ltd. to execute the jobs. For project works mentioned at paragraph 9A above, C Ltd. has already submitted an estimate of Rs. XXX and the Company agreed to deposit the amount in one installment to C Ltd. to kick start the project post signing of MoU. Similarly, payment for project works mentioned at paragraph 9B above, will be milestone based and the Company will deposit the amount against each milestone, which is to be decided in mutual agreement by both the parties. From this, the Committee is of the view that the deposit made by the Company to C Ltd. are in the nature of advances for the execution of work and therefore, same should be treated/ shown as capital advance till the time the work is performed in respect of such advance, which thereafter should be recognised as capital work-in-progress or the PPE, as the case may be.

15. Further, with regard to presentation of capitalised PPE in the financial statements of the Company, the Committee is of the view that the Company should comply with the requirements of Ind AS 16 and Division II of Schedule III to the Companies Act, 2013.

D. Opinion

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

(i) Refer to paragraphs 10 to 12 above.

(ii) Refer to paragraph 14 above.

(iii) Answer to this Question does not arise.

(iv) As far as the accounting treatment of the payment kept as Deposit with C Ltd. during the construction period, the Committee is of the view that the same should be treated/shown as capital advance till the time the work is performed in respect of such advance, which thereafter should be recognised as capital work-in-progress or the PPE, as the case may be.

(v) Refer to paragraph 15 above.

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Query No. 12

Subject: Accounting treatment of interest free loan received from the State Government as a viability gap funding.[1]

A. Facts of the Case

1. A Company, which is a Public Limited Company (hereinafter referred to as 'the Company'), registered under the Companies Act is listed on stock exchanges and thereby governed under the relevant Regulations. It is a Maharatna Public Sector Undertaking under the administrative control of Ministry of Petroleum and Natural Gas, Government of India and is engaged in the business of refining and marketing of petroleum products. The Company conceived a project to set up a 9 Million Metric Tonne Per Annum (MMTPA) Grass-root Oil Refinery at Paradip and sought fiscal incentives for viability of the project from the State Government as, without incentives, the Project's Internal Rate of Return (IRR) was not sufficiently covering the cost of capital. The State Government decided to give a package of incentives to make it economically viable and the same was formalised in the form of a Memorandum of Understanding between the State Government and the Company in 2004. The incentives as per the MOU have been detailed in subsequent paragraphs.

[1] Opinion finalised by the Committee on 22.7.2021.

2. Pre-commissioning tax incentives:

   i) Exemption from the charge, levy and payment of royalty on sand and other materials under applicable mining law and/or license(s) from and in respect of entire land filling and construction and other activities related to Project.
   ii) Exemption from the charge, levy and payment of Octroi, Entry Tax, Terminal Tax or any other tax of similar nature on the entry of materials, machinery and equipment required for construction of Project.
   iii) Exemption from the charge, levy and payment of tax on Works Contract or sales tax on transfer of goods under Works Contract or other similar tax, howsoever designated on the construction of Project.

   Post-commissioning tax incentives:

   iv) Deferment of State sales tax for product sales in the State for 11 years from the date of commercial production.
   v) Exemption from the charge, levy and payment of Central sales tax on products of the Refinery for a period of 30 years from the commencement of commercial production.
   vi) Exemption from the charge, levy and payment of Octroi, Entry Tax, Terminal Tax or any other tax of similar nature on crude oil required by the Refinery.
   vii) Exemption from the charge, levy and payment of sales tax on materials, machinery and equipment or any other purchase required for the operation and maintenance of Project/Refinery for a period of 11 years from the commencement of commercial production.
   viii) Exemption from the charge, levy and payment of electricity duty for 5 years from the commencement of commercial production by the Refinery.

The combination of these incentives led to improvement in IRR through reduction in initial outlay during construction phase and improvement of subsequent inflows during payback period by way of exemption/deferment of statutory liabilities payable, facilitating repayment of capital expenditure borrowing. Out of all incentives, the deferment of State Sales Tax as per point 2(iv) above was significant and covered 78% of total incentives.

3. The querist has stated that even with these incentives, the Project IRR was not adequate, and the capacity was further enhanced from 9 MMTPA to 15 MMTPA. With the increased capacity, the commercial production commenced on 22nd November 2015 as against the targeted completion of the project was 2009-10.

4. State Government expressed inability to provide the interest free loan (Point 2(iv): Deferment of State Sales Tax on product sales in the State for 11 years from the date of commercial production) in view of several factors including delay in commencement of the Project and issued Notification dated 22nd February 2017 rescinding the relevant Gazette Notification but keeping other incentives intact.

5. A Working Group comprising of representatives from the Company, State Government and the Ministry of Petroleum and Natural Gas (MoPNG), was constituted in March'16 to resolve the issue but the issue could not be resolved. Thereafter, the demand notice was raised by authorities for the deferred VAT amount during the period December'15 to December'16, which was challenged by the Company in the Hon'ble High Court of the State. The Hon'ble High Court directed the Working Group, constituted earlier, to take up the matter for resolving the differences.

6. After several rounds of discussion and meetings of the Working Group, State Government and the Company agreed to the Viability Gap Funding (VGF) and an agreement was signed on 25th September 2017. The salient features of the VGF scheme were as follows:

i) Viability Gap Funding (VGF) for the Refinery was revised to ₹700 crore per annum, in four equal instalments of ₹175 crore in each quarter, in the form of interest free loan for 15 years starting from the financial year (F.Y.) 2016-17.

ii) The Company to deposit applicable VAT/GST as per law. The State Government shall pay the VGF in the form of interest free loan in each quarter. The repayment of amount will start in 16th year for each instalment.

iii) VAT collected by the Company during the financial years 2015-16, 2016-17 and 2017-18 was to be deposited immediately. State Government to provide interest free loan to the Company for financial year (F.Y.) 2016-17 onwards and waive interest and penalty.

iv) In line with the agreed VGF, instalments and its repayment are as follows:

   a) Seven instalments relating to period April'16 to December'17 was released by the State Government in 2nd week of January'18.

   b) Thereafter, one installment was scheduled for release on the last week of each quarter, till the last week of March'31.

   c) The quarterly repayment by the Company to start from last week of June'31 and to continue till last week of March'46.

7. Thus, under the new agreement, the State Government shall provide fiscal incentive to the Company as Viability Gap Funding in the form of interest free loan at quarterly installments of ₹175 Crores (₹700 Crores per annum) over the period of 15 years starting from F.Y. 2016-17, the total of which turns out to ₹10,500 Crores. The Company is to make repayment in quarterly installments of ₹175 Crores within next 15 years starting from F.Y. 2031-32.

Analysis of VGF from State Government:

8. Nature of Incentive:

The relevant paragraphs of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance' and Ind AS 109, 'Financial Instruments' are as follows:

i) As per paragraph 3 of Ind AS 20, Government grants are assistance by government in the form of transfer of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.
ii) As per paragraph 10A of Ind AS 20, the benefit of a government loan at a below- market rate of interest is treated as government grant. The loan is recognised in accordance with Ind AS 109, 'Financial Instruments'. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for in accordance with this Standard.
iii) Basis for Conclusions (BC) 4 of International Accounting Standard (IAS) 20, issued by the International Accounting Standards Board: "It believed that the imputation of interest provides more relevant information to a user of the financial statements. Accordingly, the Board amended IAS 20 to require that loans received from a government that have a below-market rate of interest should be recognised and measured in accordance with IAS 39. The benefit of the government loan is measured at the inception of the loan as the difference between the cash received and the amount at which the loan is initially recognised in the statement of financial position. This benefit is accounted for in accordance with IAS 20."
iv) As per paragraph 5.1.1 of Ind AS 109, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

As is evident from the above Ind AS paragraphs, the assistance to be received from the State Government in the form of interest free loan is a grant under Ind AS 20. Ind AS 20 requires that loan at below-market rate of interest shall be recognised and measured in accordance with Ind AS 109. As the Company has a contractual obligation to pay back each loan component after 15 years, it meets the definition of financial liability. Further, where the effect of time value of money is material, a loan should be discounted and should be shown at its present value at the time of its initial recognition. The difference between the transaction amount and fair value will form part of government grant.

Further, it was concluded that each tranche of interest free loan (i.e., instalment of ₹175 crores) from the State Government shall be treated separately and the booking of loan liability and government grant is carried out upon receipt of loan proceeds on quarterly basis. In other words, accounting is carried out converting ₹175 crores into fair value based on the Company's borrowing rate for next 15 years on the date of receipt (which may differ for each instalment) and the difference between fair value of loan and proceeds received are accounted as government grant. Separate accounting for each instalment is in line with paragraph 10A of Ind AS 20, which prescribes calculation of benefit as the difference between initial carrying value and proceeds received. Further, the treatment done by the Company is also supported by BC4 of IAS 20 which emphasises on accounting at the inception of the loan as the difference between the cash received and the amount at which the loan is initially recognised.

9. Type of Incentive:

As per paragraph 3 of Ind AS 20, grant related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Grants related to income are government grants other than those related to assets.

Initial MOU signed in 2004 was for the package of incentives to make the refinery economically viable; thus, there is this primary condition of construction of grass root refinery and since the new agreement is in substitution to one of the provisions of initial MOU entered with State Government, according to the querist, benefit on interest free loan (VGF) under the new agreement is 'grant related to asset' as per Ind AS 20.

Additionally, the amount of VGF is receivable upon compliance of setting-up a grass root refinery and without requiring any future compliance or condition. It is not a compensation for expenses or losses already incurred or for financial support with no future related cost (paragraph 20 of Ind AS 20), which further corroborates the grant being considered as related to asset.

10. Recognition of Incentive:

The relevant paragraphs of Ind AS 20, as per the querist, are as follows:

(i) As per paragraph 12 of Ind AS 20, "**Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate**."

(ii) As per paragraph 17 of Ind AS 20, grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

The installments under the VGF scheme have commenced (from April'16) after the commissioning of the Refinery (in November'15) and hence the same did not have any impact on the capitalisation value of refinery or the resultant depreciation. The related cost that is recognised in the Statement of Profit and Loss is interest resulting from unwinding of the financial liability and the benefit of the grant will be enjoyed by the Company for next 15 years till the loan is repaid.

Accordingly, the grant is being amortised on a systematic basis over the period of loan, i.e., 15 years over which the unwinding is being done.

11. To summarise, following transactions are being recorded towards interest free loan (VGF) from the State Government:

- Upon receipt of each new installment of ₹175 crores, loan is recognised in accordance with Ind AS 109 based on the Company's borrowing rate for next 15 years on the date of receipt. The difference between fair value of loan and proceeds received are accounted for as government grant. As the borrowing rate varies periodically and amount of grant can only be ascertained on the date of receipt, separate accounting of each installment is carried out.
- Unwinding of interest in each quarter on respective loan amounts received till date is provided (separately for each installment received) in the Statement of Profit and Loss based on its designated borrowing rate used during initial recognition.
- Grant received till date is amortised over the loan period, i.e., 15 years and recorded in the Statement of Profit and Loss. As the benefit of interest free loan commences upon receipt of the loan and concludes

upon repayment, the amortisation of grant over this period is considered most appropriate.

- However, looking into the nature and purpose of the grant by the State Government, the item was depicted/ disclosed under capital grant. Ind AS 20 states that grant related to depreciable assets are *usually* recognised in profit or loss over the periods in which depreciation expense on those assets is recognised. Unlike the usual case, the grant is neither forming part of the capitalised value of the asset nor the depreciation charge.
- Though the accounting practice was specifically deliberated with statutory auditors and reviewed by Comptroller and Auditor General (CAG) Auditors in the year of implementation, i.e. F.Y. 2016-17 but in view of the transaction gaining its significance on financial statements year by year, it was felt prudent to take the opinion of the Expert Advisory Committee of ICAI specifically on the issue of disclosure/ depiction under capital grant.

B. Query

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

(i) Whether the accounting treatment of Viability Gap Funding, considering each installment separately and recognising the loan amount and grant amount based on the Company's borrowing rate for next 15 years on the date of receipt of that installment, is in line with the requirements of Ind AS.

(ii) Whether the amortisation basis and amortisation period of grant based on the tenure of each installment, adopted for by the Company, is in order or whether the same should be linked to depreciation of the underlying asset.

(iii) Does the Standard require mandatory recognition of likely grant on the entire loan of ₹10,500 crore on notional basis before its actual receipt and include the same mandatorily as part of the asset capitalised at the inception itself?

(iv) Whether the depiction/ disclosure of Viability Gap Funding in the form interest free loan in the financial statement of the Company as grants related to assets (capital grants) in order.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to accounting treatment of interest free loan (Viability Gap Funding) received by the Company from the State Government for 15 years. The Committee has, therefore, considered only this issue and has not examined any other issue(s)

that may arise from the Facts of the Case, such as, accounting for any other incentive/exemption/benefit provided by the Government, adjustments/accounting on transition to Ind ASs, determination of fair value of interest free loan as per Ind AS 113, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the perspective of interpretation of any Act/Rules/Agreements, such as, Memorandum of Understanding and the Agreement entered between the Company and the State Government. The Committee wishes to point out that the Indian Accounting Standards referred to in the opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

14. With regard to accounting treatment of viability gap funding in the form of interest free loan, the Committee notes that since this is provided to the Company in the extant case in return for past or future compliances with certain conditions relating to operating activities of the entity, the same should be considered as government grant as per Ind AS 20. The Committee further notes that in respect of recognition of benefit of interest free loan received from Government, paragraph 10A of Ind AS 20 states as follows:

> "10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with Ind AS 109, *Financial Instruments*. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate."

In the extant case, the Company has received interest free loan from the Government in various tranches/quarterly instalments for fifteen years and therefore, gets economic benefit in the form of waiver of interest on receipt of the government loan. Further, the Committee notes that the interest free loan on its receipt from the State Government is in the nature of financial liability and should be accounted for as per the following requirements of Indian Accounting Standard (Ind AS) 109, 'Financial Instruments':

> **"5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly**

attributable to the acquisition or issue of the financial asset or financial liability."

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

15. From the above, the Committee is of the view that Ind AS 109 requires financial liabilities to be initially recognised at their fair value minus transaction costs (if not classified as subsequently measured at fair value through profit or loss). Therefore, each tranche of the interest free government loan, received at various intervals, at its initial recognition should be measured at its fair value, ascertained as per Ind AS 113, 'Fair Value Measurement', plus or minus transaction costs that are directly attributable to the acquisition of the government loan. The Committee is of the view that the initial fair value of each tranche of the loan would be the present value of the future payment of instalments of loan, discounted using the market rate of interest for a similar loan with similar term etc. for the term of loan, which is fifteen years in the extant case. Subsequently, interest will be imputed to the loan using the effective interest method, taking account of any transaction costs.

Further, the difference between the fair value of each tranche of the government loan on the transaction date and the proceeds received should be recognised as a government grant, and accounted for in accordance with Ind AS 20. The Standard stresses that the entity has to consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

16. With regard to classification of government grant, the Committee notes the following requirements of Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance':

"*Grants related to assets* are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary

conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

***Grants related to income* are government grants other than those related to assets."**

"16 It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see Ind AS 1, *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.

17 In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. Thus grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised."

From the above, the Committee notes that Grants related to assets are those grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire long-term asset and other grants are classified as grant related to income. Thus, in case of grants related to assets, primary condition is purchase, construction or acquisition of long-term assets. In this regard, the Committee notes the following from the Memorandum of Understanding between the Company and the State Government, made on 16th February, 2004:

"…with a view to improve the economic viability of the project, state government granted sales tax exemption/deferment for the project…The package of incentives provided inter alia for the issue of bonds of a 7 (seven) years…in payment of State Sales tax for a period of 11 years on petroleum products produced by the Refinery established pursuant to the project."

"ARTICLE III - COMPANY'S OBLIGATIONS

1. The Company will initiate all necessary steps to expedite implementation of the Project to complete the construction of the

Refinery in the year 2009-10. However if favourable market conditions in the country allowing higher level of domestic sale of products from the Refinery as compared to earlier estimate emerge, the Company will endeavour to complete the project in 2008-09. Milestones for implementation of the project are given in Schedule-1 annexed hereto.

2. ..."

Further, the State Gazette Notification dated 1st June, 2004 inter alia provides as follows:

> "In exercise of powers conferred by section 7 of the Orissa Sales Tax Act, 1947 … the State Government do hereby direct that the Paradeep Refinery at …of the company (hereinafter called the unit) shall be allowed to defer payment of sales tax collected and payable in the return prescribed under the said Act … on the sale of finished products manufactured or processed … subject to the following conditions and restrictions namely:
>
> (1) Deferment of sales tax shall be allowed from the date of the commercial production of the unit …
>
> (2) The deferment of sales tax shall be subject to the following conditions:
>
> (i)…
>
> …
>
> (v) In case of default or if the unit is closed either before or after the expiry of the period of deferment,… the Sales Tax Officer concerned shall … revoke the benefit of deferment from the date it was allowed and thereupon the entire amount of sales tax deferred, upto the date of such revocation, shall be payable by the unit forthwith in one instalment along with the interest …"

17. From the above, the Committee notes that the purpose of various fiscal incentives, including, deferment of sales tax in the extant case appears to be the successful implementation of Refinery Project and to make it commercially and economically viable for the Company. In case of sale tax deferment incentive, the Company is allowed to retain the sales tax collected from the customers for few initial years of operation of the Refinery after the date of commercial operation for improvement of subsequent inflows during payback period by way of deferment of statutory liabilities payable. Thus, although acquisition/construction of the Refinery is one of the qualifying conditions of the incentives, the main objective of the grant appears to be to improve the cash

inflows during the operations of the Refinery and the overall rate of return from the Project. The grant is thus a financial support for the operating activities of the Company and to make the Refinery project viable. However, later on, due to delay in the commencement of the Project and other factors, the State Government withdrew this incentive and instead, in lieu of this incentive, the Company and the State Government entered into an agreement on 25th September, 2017, whereby the State Government agreed to provide viability gap funding of Rs. 700 crore p.a. in four equal installments in the form of interest free loan for fifteen years starting from financial year 2016-17. Thus, the Committee is of the view that since the interest free loan is in lieu of deferment of sales tax incentive, its classification from the perspective of Ind AS 20 should be considered in the context of deferment of sales tax incentive. As discussed above, since the main objective of deferment of sales tax incentive is to improve the cash inflows during the operations of the Refinery and the overall rate of return from the Refinery Project, grant in terms of interest free loan cannot be considered as grant related to asset; rather it should be considered as grant related to income.

18. The Committee further notes that in the present case, it is not possible to infer from the Scheme, the costs intended to be compensated by the grant. The purpose of the grant seems to be improvement of inflows during the operation period of Refinery, subject to compliance with the conditions attached with the grant. The various conditions do not clearly indicate the costs intended to be compensated. The Committee notes that paragraph 7 of Ind AS 20 provides that grant should be recognised only when there is a reasonable assurance that the entity will comply with the conditions attached to the grant and that the grant will be received. The Committee is of the view that in the extant case, the conditions relating to recognition of grant would be fulfilled as and when the each installment of loans is received during the operations of the refinery (as the benefit of interest on interest free government loan would not arise/accrue unless the proceeds of loan are received), subject to the reasonable assurance that the other conditions as specified in the scheme are fulfilled. Accordingly, as and when loan installment is received, the element of interest free loan on such installment as per the requirements of paragraph 10A of Ind AS 20, as discussed in paragraphs 14 and 15 above should be recognised as government grant. Further, with regard to the period of amortisation of each tranche of such grant, as the benefit of interest free loan accrues and is available over the tenure of each tranche of loan (which is 15 years in the extant case), the grant should also be amortised over such tenure.

19. With regard to disclosures and presentation in the Statement of Profit and Loss, the Committee is of the view that since interest free loan is a grant related

to income as discussed above, it should be presented as per the requirements of paragraph 29 of Ind AS 20 as reproduced below:

> "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."

D. Opinion

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

(i) The accounting for Viability Gap Funding should be done as per the discussion in paragraphs 14 and 15 above.

(ii) The amortisation basis and amortisation period of grant is discussed in paragraph 18 above.

(iii) In view of (i) and (ii) above, answer to this question does not arise.

(iv) The disclosure of Viability Gap Funding in the form interest free loan in the financial statement of the Company should be made as per the discussion in paragraphs 17 and 19 above.

———

Query No. 13

Subject: Accounting treatment under Ind AS for Financial Year 2019-20 for research expenses in case of a new Company formed for setting up of new Urea Plant and 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 A Ltd., B Ltd. and C Ltd. The Company was incorporated on 17th February, 2015 in terms of Government of India's mandate of setting up of new Gas based Ammonia-Urea Complex at the closed Ramagundam unit of C Ltd. in terms of nomination by the Cabinet Committee of Economic Affairs (CCEA), Government of India decision dated 4th August, 2011 for revival of closed fertilizers units of C Ltd., which includes Ramagundam.

2. As per the process of revival of closed Ramagundam unit of C Ltd., the old plant was dismantled and sold off by C Ltd. and the Company is setting up a new State of Art Gas based Ammonia-Urea Complex with production capacity of

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[1] Opinion finalised by the Committee on 22.7.2021.

2200 MTPD of Ammonia and 3850 MTPD of Urea (1.27 Million MT Urea Per Annum) at Fertilizer City Karimnagar, Ramagundam, Telangana.

3. 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 constructions activities at Ramagundam, Site Office at Ramagundam was made operational.

4. Planned Shareholding of the Company is as under:

S.No.	Particulars	% of Shareholding
1.	A Ltd.	26
2.	B Ltd.	26
3.	C Ltd.(in lieu of land to the Company on leasehold basis and other usable assets)	11
4.	State Government of Telangana	11
5.	X Ltd.	14.30
6.	Y Consortium	11.70

5. Abridged Statement of Affairs as on 31st March' 20

Particulars	Amount (INR) in crs.
Equity Share Capital	1299.12
Outstanding Term Loan from Consortium of Bank	3399.20
Capital Work In Progress	4017.78
Reserve & Surplus	(67.87)

6. The querist has informed that the project is being executed on Engineering Procurement & Construction Management (EPCM) route. The Company after entering into contracts with technology suppliers & licensors for Ammonia & Urea and engaging B Ltd. as EPCM Consultant, declared zero date of the project on 25th September, 2015 and the project is commissioned in March' 21. The total project cost envisaged is Rs. 5900 crores. Total debt has been lined up and loan agreement has been entered into with Consortium of 6 banks led by the State Bank of India.

7. 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 issued by the Institute of Chartered Accountants of India (ICAI). All annual accounts for all the financial years (F.Y.) from F.Y. 2016-17 onwards were prepared in accordance with Indian Accounting Standards (Ind AS) in terms of Companies Act, 2013. Annual accounts for the F.Y. 2019-20 (duly audited by statutory auditor appointed by the Comptroller and

Auditor General (CAG)) have been prepared in terms of Ind ASs, which have been adopted and approved by the Board of Directors at its meeting held on 8th June 2020.

8. The querist has further informed that the audited accounts of the Company for the financial year 2019-20, were selected by Government audit for audit under section 143(6)(a) of the Companies Act, 2013 for supplementary audit. Government audit has raised comment -1 which is given below.

(a) Government Audit's Provisional Comment:

"Assets

Non Current Assets

Intangible Assets under development (Note 7): Rs. 2.83 lakh

The above does not include an amount of Rs. 18.90 lakh incurred on intangible assets under development (consultancy charges for project of ERP implementation). An amount of Rs. 20.31 lakh was incurred in 2018-19 out of which Rs. 18.90 lakh was charged to profit and loss account in the year of occurrence. Since this expenditure was incurred for an ERP implementation project which is an Intangible asset, consultancy charges should have been included in the Intangible assets under development instead of charging to Profit and Loss (P&L) Account.

This has resulted in understatement of Intangible assets under development by Rs. 18.90 lakh and overstatement of other expenses and loss for the year by the same amount."

The Company's Management Reply to Provisional comment:

In connection with Provisional Comment-1, it is submitted that:

(i) The subject amount of Rs 18.90 lakh was paid to a Consultant during F.Y. 2018-19 and accounted for during that year. The expenditure being in the nature of research, it was charged to P&L Account during F.Y. 2018-19. This accounting treatment was accepted by statutory as well as government auditors in that year.

(ii) The amount was paid to Consultant for "ERP Strategy & Roadmap for conducting of ERP study of 'As is process' including preparation of specifications, selections of module of ERP, estimated cost of hardware, recurring annual expenses, benefit analysis including road map and assessment of IT infrastructure required for Data Center".

(iii) It may be seen from (ii) above that fee was in respect of study, which is called as Research in Ind AS 38, 'Intangible Assets'. Relevant extracts from Ind AS 38 provide as follows:

"Recognition of an expense

68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18 to 67); or

…

69 In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised…In the case of supply of services, the entity recognises the expenditure as an expense when it receives the services. For example, expenditure on research is recognised as an expense when it is incurred (see paragraph 54)…"

(iv) The relevant paragraphs 54 and 56 of Ind AS 38 are reproduced below:

"**54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.**"

"56 Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for <u>alternatives</u> for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and <u>final selection of possible alternatives</u> for new or improved materials, devices, products, processes, systems or services."

(Emphasis supplied by the querist.)

(v) The payments made by the Company as mentioned in (ii) above, are squarely covered by definition of research as mentioned in paragraph 54 of Ind AS 38 i.e. for study (research), estimation and selection of available software/ alternatives etc. in form of evaluation.

(vi) Further to above, Appendix A, 'Intangible Assets—Web Site Costs' to Ind AS 38, refers to an issue at paragraph 2(a) as below:

> "...
>
> (a) Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences."

The accounting principle for above has been addressed at Appendix A to Ind AS 38 in paragraph 9(a) as given below:

> "the Planning stage is similar in nature to the research phase in paragraphs 54-56 of Ind AS 38. Expenditure incurred in this stage shall be recognised as an expense when it is incurred."

Since, expenditure of F.Y. 2018-19 was completely identical to research activity as defined in Ind AS, as mentioned above, it was correctly accounted for by charging to P&L Statement. In view of above, it was requested to drop provisional comment. Based on the reply of the Company and discussions held, government auditors did not agree with submissions and issued the same as a comment as stated below:

(b) Government Audit Final Comment:

"Govt. Audit observed that consultancy charges of Rs. 18.90 lakh for implementation of ERP accounted for during F.Y. 2018-19 should have been included in the 'Intangible Assets under development' instead of charging to Statement of Profit and Loss."

The Company's Management Reply to Provisional comment:

"The subject consultancy fee was incurred for feasibility study for implementation of ERP in the company particularly for benefit analysis, recurring annual expenses, assessment of IT infrastructure, estimated cost etc. As per Ind AS 38, these expenses are categorised as 'Expenditure on Research' and no intangible asset arising from expenditure on research can be recognised.

In view of difference arising in understanding and interpretation, the matter shall be reviewed in accounts of F.Y. 2020-21."

9. *Nature of transaction related to Government Audit Comment*

The Company has awarded a contract to consultant for giving consultancy for ERP implementation assistance on 22nd May 2018 at a fee of Rs. 36.34 lakh (Cloud Based Solution Option-2). (A copy of Contract awarded to Consultant has been supplied separately by the querist for the perusal of the Committee.) The salient features of the Contract are as follows:

Contract completion and eligible payment split into 3 milestones:

(1) Phase-I: ERP strategy and roadmap for implementation of ERP study of 'As is Process' including preparation of specifications, selection of modules of ERP, estimated cost of licensing, cost of hardware, recurring annual expenses benefit analysis including road map and assessment of IT infrastructure required for data center.

Milestone Payment of Rs. 17.80 Lakh + GST

(2) Phase-II: Preparation of RFP for selection of implementation partner, preparation of evaluation document based on offers & finalisation of purchase order on Implementation partner for both ERP & Data Centre.

Milestone Payment of Rs. 4.00 Lakh + GST

(3) Phase-III: Program management for implementation of ERP including compliance review of Data Centre.

Milestone Payment of Rs. 9.00 Lakh + GST

Contractual provision enables termination of Contract vide clause No. 10(iii), which provides:

"…in the event it is decided not to implement ERP solution after completion of phase-I of the scope of work, contract can be short closed… ".

Recognition of payments under the contract in financial statements is as follows:

(a) The Company has charged the expenses (inclusive of taxes) related to Phase I (considering as research phase) in the Statement of Profit and Loss Accounts totaling to Rs. 18.90 lakh in F.Y. 2018-19.

(b) The payment of Rs. 2.83 lakh, related to Phase II, paid in 2 equal instalments during F.Y. 2018-19 & 2019-20, recognised as 'Intangible Asset under development'. Payment under Phase II (considered as development phase) and were released as implementation of ERP in the Company was found to be feasible.

10. The Company's submission on accounting treatment:

    i. The amount of Rs. 18.90 lakh was paid to Consultant for "ERP Strategy & Roadmap for conducting of ERP study of 'As is process' including preparation of specifications, selections of module of ERP, estimated cost of hardware, recurring annual expenses, benefit analysis including road map and assessment of IT infrastructure required for Data Center".

    ii. It may be seen from (i) above that fee was in respect of study, which is called as Research in Ind AS 38 relating to 'Intangible Assets'.

    iii. Relevant extracts from Ind AS 38 provide as follows:

    "Recognition of an expense

    68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

    (a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18-67); or

    ..."

    "69 In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised….In the case of supply of services, the entity recognises the expenditure as an expense when it receives the services. For example, expenditure on research is recognised as an expense when it is incurred (see paragraph 54) ..."

    iv. The relevant paragraphs 54 and 56 of Ind AS 38 are reproduced below:

    "54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred."

    "56 Examples of research activities are:

    (a) activities aimed at obtaining new knowledge;

    (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services."

(Emphasis supplied by the querist.)

v. Further to above, Appendix A to Ind AS 38, refers to an issue in paragraph 2(a) as below:

"Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences."

The accounting principle for above issue in paragraph 2(a) has been addressed in paragraph 9(a) as given below:

"the Planning stage is similar in nature to the research phase in paragraphs 54-56 of Ind AS 38. Expenditure incurred in this stage shall be recognised as an expense when it is incurred."

vi. The payment made by Company as mentioned in paragraph 9(1) above, is squarely covered by definition of research, as mentioned in paragraph 54 of Ind AS 38, i.e., for study (research), estimation and selection of available software / alternatives etc. in form of evaluation and was completely identical to research activity as defined in Ind AS mentioned above; therefore, it was accounted for by charging to P&L Statement.

B. Query

11. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether expenses on account of Phase-I of Contract (considered as Research Phase) and expensed off by the Company during F.Y. 2018-19 are eligible for capitalisation by way of 'Intangible Asset under development'.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to accounting treatment under Ind AS 38 for expenses incurred by the Company during Phase I of the Consultancy Contract for ERP implementation assistance. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting for the revival of the closed unit including selling off the old plant,

accounting for any other expense incurred during any other phase of the contract (Phase II or Phase III), Accounting for debt and the loan taken from consortium of banks, accounting under the previous GAAP, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the legal perspective of interpretation of the consultancy contracts. The Committee wishes to point out that the Indian Accounting Standards referred to in the opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

13. At the outset, the Committee notes from the Facts of the Case that the Consultancy Contract terms the Phase I for which the issue has been raised as "ERP strategy and roadmap for implementation of ERP study of 'As is Process' including preparation of specifications, selection of modules of ERP, estimated cost of licensing, cost of hardware, recurring annual expenses benefit analysis including road map and assessment of IT infrastructure required for data center". With regard to accounting treatment of the above-mentioned expenditure, the Committee notes the following paragraphs of Ind AS 38, 'Intangible Assets':

"21 An intangible asset shall be recognised if, and only if:

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

"53 If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research phase

54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

55 In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

56 Examples of research activities are:

- (a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the *search for alternatives* for materials, devices, products, processes, systems or services; and

(d) the formulation, design, *evaluation and final selection of possible alternatives* for new or improved materials, devices, products, processes, systems or services.

Development phase

57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

58 In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.

59 Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) *the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services*."

(Emphasis supplied by the Committee.)

From the above, the Committee is of the view that the expenses incurred on research activities (or on the research phase of an internal project) should be recognised as an expense when it is incurred. However, the expenses incurred on development activities (or during development phase of an internal project) should be recognised as an intangible asset if, and only if, an enterprise can demonstrate that all the conditions mentioned in paragraph 57 of Ind AS 38 above are fulfilled.

14. With regard to the nature of activities being performed under Phase I of the Consultancy Contract in the extant case, the Committee notes that the contract, inter alia, states under the Broad Framework under the Scope of Work that the Consultant shall prepare an approach document for ERP & Data Center at the Company including selection of modules of ERP and other identified applications, *assessment of IT infrastructure required* for Data Center, *estimated cost of licensing, suggest on Premises hosting/cloud hosting*, *cost of hardware, recurring annual expenses on ERP/ data center maintenance & cost benefit analysis*. The Committee also notes that the Contract provides for the schedule of rates for two options/models for implementation the Project, viz., On-premise data Centre and Cloud based solution and states as follows:

"1. …

- The decision for the On-premise data Centre or Cloud based solution would be taken on the basis of cost benefit analysis to be submitted by 'the Consultant' during first phase of the project. In case it is decided to opt for cloud based solution, total fee shall be Rs. XX plus GST and in case it is decided to opt for On-premise Data Centre, total fee shall be Rs. YY plus GST."

Further, the Committee notes the following clauses from the Contract between the Company and the Consultant:

"**I. SCOPE OF PHASE-I:** ERP Strategy & Roadmap for implementation of ERP

(a) Consultant shall make an assessment of 'As is Processes', the current state of applications in various business domains, hardware infrastructure, risk and continuity, security and scalability.

(b) Consultant shall make a detailed functional requirement specification after studying the prevailing processes for various business domains viz. Finance, Human resource, Production, Planning, Marketing, Materials, logistics. Suggest, "to be process" with incorporation of mobile based front-ends. In this regard, consultant shall have to visit the Company's site at Ramagundam & Corporate Office at New Delhi.

(c) Consultant shall make a requirement study indicating expected business domains to be covered under ERP and highlight the potential benefits that the Company can derive on the implementation of ERP.

…

(f) Consultant shall also indicate various potential ERP systems which can be considered for implementation and identify options available to the Company which suit the prevailing business domains of the Company in particular and Fertilizer industry in general. A list of fertilizer manufacturers along with ERP system implemented by them may be provided.

(g) Consultant shall suggest various modules of ERP which are advisable to be implemented for the Company.

(h) Consultant shall prepare a cost breakup of implementation of an ERP system covering hardware, license, Annual technical support, implementation and support costs for a period of 3 years after warranty period.

(i) Consultant shall also work out the cost-benefit analysis on implementation of ERP.

(j) Consultant shall also suggest implementation of ERP at the Company with in-premises hosting model/ cloud based hosting model."

"10. GENERAL AND COMMERCIAL TERMS AND CONDITIONS

…

iii. **Activities of Phase-II** and subsequent activities shall be started on getting specific advice from the Company in writing. In the event it is decided not to implement ERP solution after completion of phase-I of the scope of work, contract can be

> short closed on mutual agreed terms and conditions for payment in r/o deliverables".

From the above, the Committee notes that during Phase I, the Consultant is required to make assessment of 'as is processes', make a detailed functional requirement specification after studying prevailing processes and make a requirement study indicating expected business domains to be covered under ERP. The scope of Contract also includes to indicate various potential ERP systems which can be considered for implementation and identify options available to the Company which suit its prevailing business domains. Consultant is also required to prepare a cost break-up, to work out the cost-benefit analysis on implementation of ERP and also suggest implementation of ERP at the Company with in-premises hosting model/ cloud based hosting model. Thus, during Phase I, even the ERP system to be implemented, various modules of ERP, hosting model, etc. are yet to be decided and only study is to be made to choose the best alternative for taking the decision about the implementation of the Project. Further, the activities performed during the Phase I are in the nature of analysis and study, which appear to be similar to the kind of activities undertaken in research phase as per the examples of research activities given in paragraph 56 of Ind AS 38, reproduced above. Moreover, as per the Contract with the Consultant, in the event it is decided not to implement ERP solution after completion of Phase I of the scope of work, Contract can be short closed, which further indicates that during Phase I, the usefulness of the output under the Contract is not established as the decision to continue with further stages of the Contract will be undertaken based on the result of the Phase I and therefore, how the intangible asset (if any) developed under the Contract will generate probable future economic benefits cannot be demonstrated as per paragraph 57 of Ind AS 38, reproduced above. Thus, the activities under Phase I do not give rise to any intangible asset that will generate probable future economic benefits.

Accordingly, the Committee is of the view that the expenses incurred during Phase I of the Contract in the extant case are for research activities and should be recognised as an expense, as and when incurred.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that expenses incurred during Phase I of the Consultancy Contract fall under the category of research phase as mentioned in Ind AS 38 and should be recognised as an expense as and when incurred, as discussed in paragraphs 13 and 14 above.

Query No. 14

Subject: Presentation of interest earned from deployment of surplus funds with banks.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a Public Sector Undertaking (PSU), incorporated as a project executing agency under section 617 of the Companies Act, 1956 on 12th July, 1999 by the Ministry of Railways (MoR) and the Government of Maharashtra (GoM) subscribing equity shares in the 51:49 ratio respectively. The main object of the Company is to plan, develop, and execute the ever-growing suburban railway transportation needs of Mumbai Metropolitan Region (MMR) by carrying out surveys, preparing survey/project reports and identifying feasible rail projects/corridors etc. The project to be executed by the Company is called Mumbai Urban Transport Project (MUTP). The other main object of the Company is to carry out the rehabilitation and resettlement of project affected persons.

2. The MUTP is planned for development over a period of time in various phases. The funds required for MUTP are provided to the Company in a 50:50 ratio by MoR and GoM as budgetary allocation in their respective annual budgets. Some of the projects are funded through a loan from the World Bank/Asian Infrastructure Investment Bank (AIIB), which are routed through GoI and GoM. The Company prepares feasibility reports and formulates estimates for MUTP which are sanctioned by MoR under MTP Plan Head in the Works, Machinery and Rolling Stock Programme of the Ministry of Railways. After sanction of projects by MoR, the funds are released/arranged for/by the Company for execution of the MUTP. (A copy of Memorandum of Understanding executed between the Company, MoR and GoM has been supplied separately by the querist for the perusal of the Committee.).

3. The Company has been incorporated as a project executing agency. As per terms of MoU/Agreements, the ownership of all the operating assets created by the Company under MUTP remains with the Indian Railways. These assets are not accounted for as assets in the books of the Company. The unique nature of accounting for funds received and utilisation in MUTP is explained in brief hereinafter. The funds received for executing the MUTP project from MoR and GoM are accounted for as 'Funds received for MUTP Works' and are presented under 'Other Long Term Liabilities' and funds utilised on the creation of MUTP assets are accounted for as 'Funds utilised on MUTP' and presented as a reduction from 'Funds received for MUTP' under 'Other Long Term Liabilities' in the financial statements. So, effectively the net balance, i.e., excess of funds

[1] Opinion finalised by the Committee on 1.9.2021.

received for MUTP over funds utilised on MUTP appears as 'Other Long Term Liability' in the financial statements of the Company.

4. Since the Company is formed without any profit motive and with the object of the advancement of the general public utility with the ultimate aim of improving transportation infrastructure for the Citizens of MMR, the Company is registered under section 12A of the Income-tax Act, 1961 with the Commissioner of Income Tax (Exemption) on 29th October, 2001 w.e.f. date of incorporation, i.e., 12th July, 1999. Since its registration under section 12A, the Company has been enjoying the benefit of exemption under section 11 of the Income-tax Act, 1961. To comply with the relevant provision and to continue to enjoy the exemption under section 11 of the Income-tax Act, 1961, the Company has deleted the declaration and distribution of dividend clause from its Article of Association. Thus, the Company does not have any profit motive as its object and cannot declare or distribute any dividend.

5. The querist has stated that for the purpose of execution, depending on the nature, expertise required, and quantum of work, MUTP component works are assigned by the MoR to the Central and Western Railways, and other agencies. However, a major part of MUTP is directly carried out by the Company for which the Company receives Direction and General (D&G) Charges. Direction and General Charges are charges fixed by MoR in % terms of the amount spent on MUTP and this % is based on the nature, type and complexities of the relevant project involved and past experiences of the execution of the project of the same size and nature. While fixing Direction and General Charges of the Company, MoR also takes into account the similar projects executed by other zonal railways of Indian Railways and Indian Railway's PSU.

6. The Company incurs an establishment cost to execute the projects allotted under MUTP. The amount of Direction and General Charges fixed by the MoR for carrying out a particular project by the Company is actually nothing but an estimated cost, based on previous experience of execution of projects of similar size and nature, which the Company would be incurring for the execution of the project. So, the Direction and General Charges are nothing but reimbursement of cost, which the Company incurs as an establishment cost to execute a particular project.

7. In addition to revenues received by way of Direction and General Charges, the Company also earns interest on funds temporarily deployed with Scheduled Banks, pending the funds' utilisation in MUTP.

8. Financial statements of the Company are audited every year by Chartered Accountants appointed by the Comptroller and Auditor General of India (CAG). In addition to the statutory audit conducted by Chartered

Accountants, annual supplementary audit of the Company is also conducted by the Principal Director of CAG.

9. As stated in earlier paragraphs, in addition to the Direction and General Charges, the Company earns interest from deployment of surplus funds with the banks as stated at paragraph 7 above. The details of Direction and General Charges, establishment cost and interest earned over a period of last 9 financial years are as under:

Financial Year	D & G Charges	Establishment Cost	Deficit	Interest Income	Surplus/ deficiency
2019-2020	39.98	50.03	-10.05	29.65	19.60
2018-2019	40.39	46.88	-6.49	42.36	35.87
2017-2018	22.98	44.32	-21.34	22.96	1.62
2016-2017	31.51	36.95	-5.44	34.42	23.38
2015-2016	28.42	25.72	2.70	37.51	40.21
2014-2015	26.63	27.74	-0.61	37.18	36.57
2013-2014	17.37	25.02	-7.65	30.66	23.01
2012-2013	11.66	22.66	-11.00	23.24	12.24
2011-2012	11.79	20.22	-8.43	31.14	22.71

10. The querist has stated that from the above details, it may be observed that every year except for financial year (F.Y.) 2017-18 and F.Y. 2019-20, the quantum of interest earned is higher than the Direction and General Charges. As explained in paragraphs 5 and 6 above that Direction and General Charges are nothing but reimbursement of cost which the Company incurs on executing the project; it is very important to note here that while deciding such % of Direction and General Charges payable to the Company, the MoR also considers the approximate amount of interest, which the Company may earn on the deployment of surplus funds during the execution of the concerned project. Thus, Direction and General Charges and interest, both, form part of the total estimated revenue required by the Company to incur the estimated establishment cost to execute a particular MUTP Project. Hence, interest, just like Direction and General Charges invariably becomes part of the revenue from operating activities of the Company. Considering the above facts and unique circumstances, the Company is of the view that such interest earned shall be classified as 'other operating revenue', if not 'operating revenue' of the Company. The querist has also referred to the minutes of meeting held in November 2000 at the juncture of foundation of the Company (a copy of the minutes has been supplied separately by the querist for the perusal of the Committee), wherein interest is considered along with Direction and General Charges as part of the total estimated cost required by the Company for executing a project and not just as an income from incidental or ancillary investment activity. According to the

querist, this is an important document, tantamounting to an MoU between the Ministry of Railways and the Company at the time of the Company's inception.

11. To support the above stated contention, the querist has referred to paragraphs 9.1.7, 9.1.8 and 9.1.9 of the Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013, (Revised July, 2019 Edition)[2], issued by the Institute of Chartered Accountants of India, which read as under:

> "**9.1.7** For non-finance companies, revenue from operations needs to be disclosed separately as revenue from
>
> (a) sale of products,
>
> (b) sale of services and
>
> (c) other operating revenues.
>
> It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".
>
> **9.1.8** 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 the sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based *on the facts of each case and detailed understanding of the company's activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held.* For instance, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is *continuously engaged in leasing of real estate properties*, the rent arising from leasing of real estate is likely to be "other operating revenue". On the other hand, consider a consumer products company which owns a 10 storied building. The company currently does not need one floor for its own use and has given the same temporarily on rent. In that case, lease rent is not an "other operating revenue"; rather, it should be treated as "other income".
>
> **9.1.9** To take other examples, sale of Property, Plant and Equipment is not an operating activity of a company, and hence, profit on sale of Property, Plant and Equipment should be classified as other income and not as 'other operating revenue'. On the other hand, sale of manufacturing scrap arising from operations for a manufacturing company

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[2] The Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013 (July 2019 Edition) has been subsequently revised in January 2022.

should be treated as other operating revenue since the same arises on account of the company's main operating activity."

(Emphasis supplied by the querist.)

The querist has stated that from the close observations of the above stated paragraphs of the Guidance Note, it is established that the deciding criteria for a particular item of income to be classified either as 'other operating revenue' or 'other income' are as under:

i. whether it's a principle or ancillary revenue-generating activity and not the activity of the sale of products or rendering of services;
ii. the purpose for which the particular asset is acquired or held;
iii. the frequency or continuity of the revenue-generating activity; and
iv. on the facts of each case and detailed understanding of the Company's activities.

12. The querist has stated that the Company fulfils all of the above-stated tests in the following manner:

i. The Company deposits the funds received for executing MUTP with the banks pending the funds' utilisation in the MUTP. This activity of deposit of funds with banks is carried out on a regular basis throughout the period of execution of MUTP. The interest earned on the deployment of funds with banks, pending the funds' utilisation in MUTP, is inextricably connected to the core activity of the execution of MUTP as the size and nature of the Company and project are such that it requires funds in advance for project planning and execution. Activities of deposit of funds with the banks are made in a well thought-out, planned and prudent manner wherein the expected amount and date of receipt of funds, physical progress of the MUTP and expected amount and time of requirement/utilisation of funds in MUTP are projected, considered, reviewed and monitored in a systematic manner so as to keep uninterrupted funds' flow towards discharging project liabilities and at the same time, interest, being part of total planned revenue of the Company , on such deposits can be maximized.

   Further, how crucial and important is the activity of deposit of funds for the survival of the Company can be observed from the table given in paragraph 9 above that in the last 9 years, except for in the F.Y. 2015-16, Direction and General Charges were not able to meet the establishment cost of the Company and in the absence of interest income, the Company would have incurred losses in every such year. So, as per the querist, the above establishes the fact beyond any doubt that along with Direction and General Charges, interest is considered as part of the total operating revenue required by the Company for meeting its establishment cost.

It may also be noted that except in the F.Y. 2019-20 and 2017-18, the quantum of interest earned is more than Direction and General Charges and on close observation, it can be seen that in a couple of years, the interest income is even more than double of the Direction and General Charges.

From the above facts, it can be derived that the activity of deposit of funds with banks, in 7 out of last 9 years, generates more income than from the activity of Direction and General Charges. It is also because of the interest income that, in 8 out of 9 years, the Company was able to generate the surplus of income over expenditure otherwise it would have made losses. So, based on the above facts, the Company is of the view that revenue generated from the activity of deposit of funds with banks is crucial, integral and inextricable part of the core revenue generating activities of the Company.

ii. The purpose for which such assets (in the case of the Company its 'Funds received for MUTP'), are held or acquired is their utilisation in the development of MUTP, the main objective of the Company. The funds given by the MoR and GoM to the Company are deployed in banks pending their utilisation in the core operational activity of the Company, i.e., development of MUTP.

iii. The activity of deposit of funds is carried out on a regular basis, reviewed and monitored at least on a weekly basis. While deploying the funds in banks some of the important points which are kept in mind are as under:

    a. The amount of funds estimated for a particular project of MUTP;
    b. The expected period of the execution of the project and its important milestones;
    c. The dates, schedule and amount of funds expected to be required for a project;
    d. The actual progress of the project;
    e. Actual funds available with the Company for the project; and
    f. Special terms and conditions related to the payment for the project.

Thus, the foundation of activity of deployment of funds is inextricably connected to the execution of MUTP and it is carried out, reviewed and monitored regularly on the same basis, frequency and manner in which the physical progress of the particular project of MUTP is carried out, reviewed and monitored.

iv. Based on above stated unique facts and circumstances of the Company, the activity of planning and executing of deposit of funds, the inextricable nature of activity with the funding and execution of MUTP, the frequency of the activity itself, and the quantum of the interest earned year after year over the Direction and General Charges give sufficient strength and reason to treat and consider the activity of deposit of funds as an integral and inextricable part of the revenue generating activities of the Company. Hence, interest earned in the case of the Company, because of its unique facts and circumstances, is considered as 'other operating revenue'.

13. However, there is another view in respect to the classification and presentation of such interest. Note No. 4 of General Instructions for Preparation of the Statement of Profit and Loss in Part II of the Schedule III of the Companies Act, 2013 reads as under:

> "4. Other income
>
> Other income shall be classified as:
>
> (a) Interest Income (in case of a company other than a finance company);
> (b) Dividend Income;
> (c) Net gain/loss on sale of investments;
> (d) Other non-operating income (net of expenses directly attributable to such income)."

The other view is based on Note No. 4, as reproduced above. It is claimed that since the Company is also a company other than a finance company, interest shall be classified and presented as part of "Other Income".

The querist further wishes to bring to the notice of the Expert Advisory Committee (EAC) of Query No.11 of Volume XXXVII of Compendium of Opinions, wherein it was opined that interest should be classified as 'Other Income' and not as 'Other Operating Revenue'.

14. However, on the basis of reasons and grounds as enumerated in paragraphs 9 to 12 above and unique facts and circumstances of the Company being different from the facts and ratio of the Opinion of EAC to Query No.11, as mentioned in paragraph 13 above, the Company is of the view that the present treatment of accounting, classification and presentation of interest earned on

funds deployed with banks as 'Other Operating Income' is reasonable and correct.

15. The querist has separately informed that the word 'establishment cost' in Railway parlance means the cost incurred to run an establishment. It includes all the costs of an establishment. In the case of the Company, 'establishment cost' means all the expenses incurred/debited in the Income and Expenditure Account by the Company to run its operations. The following items of expenses are establishment costs of the Company:

i. Salary and Wages/Employee Cost
ii. Administrative Expenses
iii. Depreciation/Amortisation Expenses
iv. Any other Expenses.

B. Query

16. On the basis of above, considering the unique facts and circumstances of the Company as submitted above, the Company has sought the opinion of the Expert Advisory Committee as to whether the present practice of accounting and presentation of interest earned from the activity of deployment of funds with banks, pending their utilisation in MUTP, as 'other operating revenue' in the financial statements is correct. If not, then what should be the correct treatment and presentation of interest earned on deployment of funds with banks in the financial statements of the Company?

C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to the presentation of interest earned on the surplus/idle funds deployed with banks, viz., whether the same should be presented as 'other operating revenue' or 'other income' in the Income and Expenditure Account of the Company. The Committee has, therefore, considered only this issue and has not examined any other issues that may arise from the Facts of the Case, such as, accounting for receipt of funds provided by the MoR and GoM as budgetary allocation and utilisation thereof for MUTP, accounting for loan from the World Bank/AIIB routed through the GoI and GoM, accounting for MUTP component works assigned to other agencies, accounting for Direction and General Charges and establishment cost, application of the provisions of Accounting Standard (AS) 5, 'Profit or Losses for the Period, Prior Period Items and Changes in Accounting Policies' (if any), etc. The Committee notes from the annual report for the financial year 2019-20 that the Company is following Accounting Standards, notified under the

Companies (Accounting Standards) Rules, 2006[3]; therefore, the Committee has examined the issue considering these standards only. Further, the Committee has examined the issue only from accounting perspective and has not looked into the regulatory or legal aspects and implications, including those arising under Income-tax Act.

18. The Committee notes the following paragraphs of the Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013 (revised July, 2019 Edition), issued by the Institute of Chartered Accountants of India (hereinafter referred to as the 'Guidance Note'):

> "**9.1.7** For non-finance companies, revenue from operations needs to be disclosed separately as revenue from
>
> (a) sale of products,
>
> (b) sale of services and
>
> (c) other operating revenues.
>
> It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".
>
> **9.1.8** 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 the sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held. For instance, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is continuously engaged in leasing of real estate properties, the rent arising from leasing of real estate is likely to be "other operating revenue". On the other hand, consider a consumer products company which owns a 10 storied building. The company currently does not need one floor for its own use and has given the same temporarily on rent. In that case, lease rent is not an "other operating revenue"; rather, it should be treated as "other income".

[3] In respect of accounting period(s) commencing on or after April 1, 2021, Companies (Accounting Standards) Rules, 2006 (as amended from time to time) have been superseded by Companies (Accounting Standards) Rules, 2021.

> **9.1.9** To take other examples, sale of Property, Plant and Equipment is not an operating activity of a company, and hence, profit on sale of Property, Plant and Equipment should be classified as other income and not as 'other operating revenue'. On the other hand, sale of manufacturing scrap arising from operations for a manufacturing company should be treated as other operating revenue since the same arises on account of the company's main operating activity."
>
> "**9.2 Other income:**
>
> …
>
> **9.2.2** All kinds of interest income for a company other than a finance company should be disclosed under this head such as interest on fixed deposits, interest from customers on amounts overdue, etc."

From the above-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. Thus, whether a particular income constitutes 'other operating revenue' or 'other income' is a matter of judgement considering the specific facts and circumstances of each case, and considering the nature of activity the Company is engaged into, etc. The Committee also notes that the Guidance Note requires all types of interest income in case of a Company other than finance company to be disclosed under the head 'other income'.

Accordingly, the Committee is of the view that as per the requirements of the Guidance Note, interest income in case of a company other than finance company needs to be disclosed under the head 'other income' unless it is arising from the company's operating activities (as in case of a finance company).

In this context, the Committee notes that in the extant case, the main object of the Company is to plan, develop, and execute the ever-growing suburban railway transportation needs of Mumbai Metropolitan Region (MMR) by carrying out surveys, preparing survey/project reports and identifying feasible rail projects/corridors etc. The project to be executed by the Company is called Mumbai Urban Transport Project (MUTP) and the Company is an executing/implementing agency of the GoM and MoR for carrying out MUTP. Thus, essentially the Company's operating activities comprise activities relating to execution of MUTP. The Committee further notes that during project execution, excess funds are deployed with banks leading to earning of interest income.

19. The Committee now examines whether the interest earned in the extant case can be considered to be arising from the Company's operating activities and in this regard, the Committee notes that the querist has stated that while deciding the percentage of Direction and General charges payable to the Company, the MoR also considers the approximate amount of interest which the Company may earn on the deployment of surplus funds during execution of the concerned project. In this regard, the querist has also referred to the following clause from Railway Board decision (minutes) taken on 11.11.2000 which states as follows:

> "Staffing Pattern
>
> 3.1 The organisation should be kept lean but this shall be left to the Board of Directors of the Company. It should, however, be ensured that the size remains small enough for *the establishment costs to be contained within the D&G charges/Interest available to the Company*." (Emphasis supplied by the querist.)

Without getting into the interpretation of the Board decision, the Committee is of the view that the above paragraph or any other paragraph in the Railway Board decision does not clearly indicate that the percentage of Direction and General charges payable to the Company has been decided after considering the approximate amount of interest which the Company may earn. Further, the above also does not indicate that interest is the compensation/consideration of operating activities of the Company, which is execution of MUTP, as discussed above. Further, the various communications between the Company and the Railway Board (MoR) while making a request to the Board to allow the Company to retain the interest (separately provided by the querist for the perusal of the Committee), also do not clearly demonstrate that the MoR allowed the Company to temporarily retain such interest as a compensation/consideration of the operating activities of the Company.

Accordingly, the Committee is of the view that in the extant case, considering the requirements of the Guidance Note and the information and facts available with the Committee, interest income in the case of the Company (being an 'other than finance company') should be disclosed under the head 'other income'.

With regard to various contentions provided by the querist, the Committee also wishes to point out that accounting treatment depends on the nature of income and mere allowing to retain or use interest income for meeting the expenditure does not change the nature of income. The Committee is also of the view that regularity or quantum of an item of income may not necessarily determine the nature of an income as operating or non-operating.

D. Opinion

20. On the basis of the above, the Committee is of the view that in the extant case, interest income should be disclosed under the head 'other income', as discussed in paragraph 19 above.

Query No. 15

Subject: **Accounting treatment in the Company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being Parent Company to banks/suppliers/service providers on behalf of its Step-down subsidiary company.**[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. 4,440.39 crore is paid-up share capital. The Government of India holds 51.45% equity of the Company at present. The Company is India's leading natural gas company with presence along the entire natural gas value chain comprising of exploration & production (E&P), LNG imports, gas transmission & marketing, gas processing, petrochemicals, LPG transmission, city gas distribution and power. The Company is having its global presence in various countries, such as, USA, Singapore, Myanmar, Egypt, China through subsidiaries/joint ventures (JVs)/associates etc. The securities of the Company are listed on the National Stock Exchange of India, the Bombay Stock Exchange and the London Stock Exchange (in the form of GDRs) with market capitalisation of over Rs. 61,000 crores (as of 31st March 2021). The Company's consolidated turnover for the year ended 31st March 2020 was approximately Rs. 72,400 crores with a profit after tax of Rs. 9,422 crores.

2. 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 has prepared its financial statements for the financial year (F.Y.) 2016-17 with comparative figures for F.Y. 2015-16. The Company has adjusted the impact of transition from Indian Generally Acceptable Accounting Principles (I GAAP) to Ind AS in the opening

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[1] Opinion finalised by the Committee on 1.9.2021.

reserve of 1st April 2015 and in the Statement of Profit and Loss for F.Y. 2015-16.

3. The Company has the following wholly owned subsidiary companies in USA:

a) Subsidiary 1, which is a wholly owned subsidiary of the Company and is engaged in the E&P business.

b) Step-down subsidiary, which is a wholly owned subsidiary of Subsidiary 1 and a Step-down subsidiary of the Company, and is engaged in LNG trading business.

At present, the Company has issued corporate guarantees on behalf of its US subsidiary, Subsidiary 1 and Step-down subsidiary to the tune of USD 1057.57 million (Rs. 7,810.15 crore). The Guarantee of USD 72.5 million (Rs. 535.41 crore) issued on behalf of Subsidiary 1 is towards meeting obligation of Subsidiary 1 and therefore, guarantee fee is being charged by the Company from Subsidiary 1 and as per the Company's assessment, presently there is no possibility of default by Subsidiary 1. Further, guarantees issued on behalf of Step-down subsidiary of USD 985.07 million (Rs. 7,274.73 crore), have been issued for furtherance of business of the company wherein ultimate beneficiary of these guarantees is the Company itself. As per the Company's assessment, there is no possibility of default by the Step-down subsidiary for meeting its obligation. Accordingly, the Company of the view that fair value of the guarantees is 'Nil' as the entire transaction is for the furtherance of business of the Company.

4. Facts of Step-down subsidiary and corporate guarantees provided on behalf of Step-down subsidiary are given hereunder:

Step-down subsidiary, a wholly owned subsidiary of Subsidiary 1, was established on March 28, 2013. On April 01, 2013, Step-down subsidiary executed a terminal service agreement (TSA) with M/s ABC, LP to book capacity rights of approximately 330,000 dekatherm per day (Dth/day) at the Dominion Cove Point LNG liquefaction terminal.

On December 12, 2014, Step-down subsidiary executed a pipeline service agreement (PSA) with M/s ABC, LP to secure pipeline transportation capacity rights of 430,000 Dth/day, in accordance with the broad terms and conditions of the pipeline precedent agreement (PPA) that Step-down subsidiary executed with M/s ABC, LP on April 1, 2013.

On November 30, 2014, Step-down subsidiary signed a gas sale and purchase agreement (GSPA) with M/s XYZ, Inc for sourcing of natural gas on a delivered basis at the inlet of the pipeline at the Dominion Cove Point LNG liquefaction terminal for a term of 20 years. The natural gas purchased from M/s XYZ Inc will be liquefied at the Dominion Cove Point LNG liquefaction Terminal.

During September 2017, the Company and Step-down subsidiary have entered into a LNG Sale & Purchase Agreement (SPA), wherein Step-down subsidiary is to sell the *entire quantity of LNG* to the Company *on back-to-back basis* on FOB US Coast basis *for the entire contract period of 20 years. The entire risks and obligations of* Step-down subsidiary *under the upstream contracts entered by* Step-down subsidiary *with its suppliers have been passed to the Company through the SPA.* The Company will take delivery of and pay for specified quantities of LNG procured by Step-down subsidiary, or compensate Step-down subsidiary for its costs incurred in the event that the Company fails to take delivery of the specified quantities (i.e., take or pay). Step-down subsidiary *bears limited risk and is acting as a low margin distributor and managing the operations of the contracts only*. Further, under Transfer Pricing Regulation, the Company has also filed Advance Pricing Agreement, and presently, Step-down subsidiary is charging 10% of value-added expenses as margin in overall value chain from the Company.

Under the LNG SPA, the Company is purchasing entire quantity of LNG from Step-down subsidiary and Step-down subsidiary is being reimbursed for (i) the cost of natural gas plus liquefaction expenses and other third-party costs; and (ii) all other expenses plus a mark-up.

(Emphasis supplied by the querist.)

5. In order to carry out the operations smoothly, as per contract terms, the Company has given the following corporate guarantees on behalf of Step-down subsidiary:

Date of Issue	**Valid Up to**	**Company (To whom Guarantee Given)**	**Fund Based (FB) Amount In USD**	**Non-Fund based (NFB) Amount In USD**	**Fund Based (FB) Amount In Rs. -Crs.**	**Non-Fund based (NFB) Amount In Rs. -Crs.**	**Purpose of Guarantee**
01.04.2013	31.12.2039	M/s ABC LP	0	$ 700 Mn	0	5169.50	Payment Security under TSA
01.04.2013	31.12.2039	M/s ABC LP	0	$ 90Mn	0	664.65	Payment Security under PPA

29.12.2014	28.12.2044	M/s XYZ Inc	0	$ 25Mn	0	184.63	Performance Guarantee for GSPA
24.04.2020	23.04.2021	State Bank of India, New York Branch	$70 Mn	0	516.95	0	*Working Capital Facility
28.09.2020	27.09.2021	Credit Agricole Corporate and Investment Bank	0	$100.06 Mn	0	739.01	*SBLC Facility

* *These Working Capital Facility and Stand-by Letter of Credit Facility (SBLC) are being renewed from same bank or another bank (based on the competitive rates) on yearly basis for next one year (12 months)*

The querist has stated that the performance of Step-down subsidiary under the contracts signed by it with its supplies are solely dependent upon the performance of the Company and the failure of payment to third parties (i.e. suppliers of Step-down subsidiary) is solely within the control of the Company. Therefore, the expected credit loss due to this guarantee is 'Nil'. Further due to the same reason, the Company is not charging any guarantee fee from the Step-down subsidiary for providing these guarantees. Charge for provision of guarantee would be appropriate where the issue of guarantee is considered to be a service performed by the issuer for the benefit of the entity availing the guarantee. However, in cases where the guarantee is for the benefit of the guarantor only, i.e., for promoting/ protecting its interest, no charge/ compensation for issue of guarantee is warranted.

Further, the Company is accounting for the amount payable for gas purchase from Step-down subsidiary in its books of account and if the Company provides loss allowance for guarantee given on behalf of Step-down subsidiary for the same transaction, it amounts to duplication and overstating the Company's liabilities.

It may also be noted that the parent companies of the counter parties of TSA & PPA *have also provided reciprocal Corporate Guarantee to Step-down subsidiary* for the performance of M/s ABC LP (Operator) and M/s XYZ Inc as follows:

Date of Issue	Valid Up to	Company (To whom Guarantee Given)	Guarantee Amount In USD	Non-Fund based (NFB) Amount In Rs. Crs.	Purpose of Guarantee
01.04 .2013	31.12. 2039	Step-down Subsidiary	$ 1750 Mn	12,923.75	Payment Security under TSA
01.04 .2013	31.12. 2039	Step-down Subsidiary	$ 150 Mn	1,107.75	Payment Security under PPA
29.12 .2014	31.12. 2039	Step-down Subsidiary	$ 25 Mn	184.63	Performance Guarantee for GSPA

It is quite clear that the parent company is required to provide corporate guarantee on behalf of its subsidiaries as newly formed subsidiaries do not have the requisite financial standing, credit worthiness and credit rating. However, these corporate guarantees could have been avoided, if the contracts would have been entered by the Parent Companies.

6. The querist has also stated that all the guarantees provided by the Company on behalf of Step-down subsidiary are in furtherance of the Company's business, wherein the Company is the ultimate beneficiary for these guarantees provided by the Company. Further, entire performance of Step-down subsidiary is also dependent upon the performance of the Company. *So, it can be construed that the Company has provided these guarantees for its own performance only.* (Emphasis supplied by the querist.)

Step-down subsidiary started its commercial operations in the year 2018. Since starting, Step-down subsidiary is having a back to back arrangement with the Company and the Company has lifted all its LNG cargos from the Step-down subsidiary on FOB US Coast basis. Some of these cargos are directly imported to India and some are sold in the international market by the Company. Further, if the Company charges guarantee fees to Step-down subsidiary, the same will be loaded in the gas cost along with the margin by Step-down subsidiary to the Company.

Till date, in this contract, there is no default on the part of Step-down subsidiary and the Company with respect to their contractual obligations, and hence, the corporate guarantees given by the company on behalf of Step-down subsidiary carry no risk. Further, in India, gas market is growing and the Government of India is also promoting use of LNG / R-LNG. The Company has laid additional pipeline network with approx. pipeline length of 2655 Km. Along the pipeline, approximately four fertilizer plants will get revived, and as a result, the LNG requirement in India will increase. Presently, natural gas share in the India energy basket is around 6% and the Government of India has set a target to increase the same to 15%. Therefore, it is expected that usage of natural gas in India will rise and due to limited domestic production of the gas, the same shall be met through imported LNG.

Currently, the Company is disclosing the above guarantees in Notes to Accounts under details of Loans, Investment, Guarantees and security given by the Company under the Companies Act, 2013 and under Financial Risk Management (Liquidity Risk), as per the requirements of Ind AS 107, 'Financial Instruments: Disclosures'.

Documents separately provided by the querist for the perusal of the Committee:

1	Guarantee dated 01.04.2013 provided by the Company to M/s ABC LP for USD 700 million on behalf of the Step-down subsidiary for payment/ performance security under TSA
2	Guarantee dated 01.04.2013 provided by the Company to M/s ABC LP for USD 90 million on behalf of Step-down subsidiary for payment/ performance security under PPA
3	Guarantee Agreement dated 29.12.2014 provided by the Company to M/s XYZ Inc for USD 25 million on behalf of Step-down subsidiary for payment/performance security under GSPA
4	Letter of Guarantee dated 24.04.2020 provided by the Company to State Bank of India, New York Branch for USD 70 million on behalf of Step-down subsidiary for Working Capital Facility
5	Letter of Guarantee dated 19.08.2020 provided by the Company to Credit Agricole Corporate & Investment Bank Newyork for USD 100.06 million on behalf of Step-down subsidiary for SBLC Facility
6	Guarantee dated 01.04.2013 received from Parent of M/s ABC LP to Step-down subsidiary for USD 1750 million on behalf of M/s ABC LP for performance security under TSA
7	Guarantee dated 01.04.2013 received from Parent of M/s ABC LP to Step-down subsidiary for USD 150 million on behalf of M/s ABC LP for performance security under PPA
8	Guarantee dated 29.12.2014 received from Parent of M/s XYZ Inc to Step-down subsidiary for USD 25 million on behalf of M/s XYZ Inc for performance security under GSPA
9	LNG sale and Purchase Agreement between Step-down subsidiary and the Company

B. Query

7. In view of the above, the querist is hereby seeking opinion from the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India on the following issues:

(i) As per Ind AS, whether any accounting treatment is required for the corporate guarantees provided on behalf of Step-down subsidiary for satisfaction of its obligations under the contract (i.e., TSA, PPA and GSPA), towards the suppliers (i.e., M/s ABC LP and M/s XYZ Inc) considering back to back contract with the Company for procuring 100% LNG from Step-down subsidiary and that there is no credit risk involved for Step-down subsidiary as 100% risk is transferred to the Company through SPA.

(ii) As per Ind ASs, whether any accounting treatment is required for the corporate guarantees provided on behalf of Step-down subsidiary, for obtaining working capital loan and SBLC facility from bankers, as the same have been availed by Step-down subsidiary to meet the temporary obligations to the suppliers, due to time lag between payment made by the Company to Step-down subsidiary and payment made by Step-down subsidiary to its suppliers.

(iii) Whether any expected credit loss is to be provided for any of the above guarantees as per Ind AS 109, 'Financial Instruments'.

(iv) Whether any other disclosure is required for any of the above guarantees in the Company's books of account, as presently, the Company is disclosing these guarantees under Notes to Accounts.

(v) Any other advice in the context, which EAC may deem fit.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the bank guarantees provided by the Company on behalf of its Step-down subsidiary in the separate financial statements of the Company. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of the purchase and sale agreement with the Step-down subsidiary, determining the fair valuation of the financial guarantee contracts, accounting in the financial statements of Subsidiary 1 and Step-down subsidiary company, accounting on transition to Ind ASs, accounting treatment of corporate guarantees on behalf of Subsidiary 1, accounting treatment in the consolidated financial statements of the Group, accounting treatment of performance guarantee received from suppliers, determination of fair value, etc. The

Committee has only examined the issue from Ind AS perspective and has not examined the regulatory or legal classification and implications, including those arising under Income-tax Act and Foreign Exchange Management Act (FEMA). The Committee presumes that the Step-down subsidiary is not acting as an agent of the Company. The Committee also observes from the Company's financial statements that the Company has neither previously nor on transition to Ind ASs in the financial year 2016-17, asserted explicitly that it regards financial guarantee contracts as insurance contracts and uses accounting that it is applicable to insurance contracts. Consequently, the irrevocable option to treat the corporate guarantee as an insurance contract available under paragraph 2.1(e) of Ind AS 109 is not applicable. The Committee also wishes to point out that the accounting standards referred hereinafter are Indian Accounting Standards (Ind ASs), notified under the Indian (Accounting Standards) Rules, 2015.

9. The Committee notes that Appendix A to Ind AS 109 defines a financial guarantee contract as follows:

"**financial guarantee contract**	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument."

Further, paragraphs B2.5 of Appendix B to Ind AS 109 and AG 8 of Appendix A to Ind AS 32, 'Financial Instruments: Presentation' provide as follows:

Ind AS 109

"B2.5 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2.1(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in Ind AS 104 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts. If this Standard applies, paragraph 5.1.1 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15–3.2.23 and B3.2.12–B3.2.17 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance with Section 5.5; and

(ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115 [see paragraph 4.2.1(c)].

(b) …"

Ind AS 32

"AG8 The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be insurance contracts within the scope of Ind AS 104."

The Committee notes that a financial guarantee contract is defined under Ind AS 109 as a contract that requires the issuer to make *specified payments to reimburse* the holder for a loss it incurs because *a specified debtor* fails to make payment when due in accordance with the original or modified terms of a *debt* *instrument*. For a financial guarantee under Ind AS 109 to exist, amongst others, there shall be a reimbursement for loss incurred by a specified debtor.

In the extant case, the Committee notes the following:

- In Documents 1 and 2 (as mentioned in the Table in paragraph 6 above) supplied alongwith the query, the Company has undertaken to irrevocably and unconditionally guarantee M/s ABC LP, prompt payment by the Step-down subsidiary of all the amounts that become due and payable by the Step-down subsidiary under the Terminal Service Agreement, up to amount stated in the respective agreements. In case of default in payment of guaranteed obligation by the Step-down subsidiary, the Company shall promptly pay M/s ABC LP.
- In Document 3 supplied alongwith the query, the Company has undertaken to irrevocably and unconditionally guarantee M/s XYZ Inc, prompt payment by the Step-down subsidiary of all the amounts that become due and payable by the Step-down subsidiary, up to $ 25 million. In case of default in payment of guaranteed obligation by the Step-down subsidiary, the Company shall promptly pay M/s XYZ Inc.
- In Document 4 supplied alongwith the query, the Company has undertaken to irrevocably and unconditionally guarantee State Bank of India, New York branch, due repayment of all amounts outstanding under credit facilities due and payable by the Step-down subsidiary to the extent of $ 70 million in the event of failure on the part of the Step-down subsidiary to repay the amount drawn under credit facilities.
- In Document 5 supplied alongwith the query, the Company has undertaken to irrevocably and unconditionally guarantee Credit Agricole, due repayment of all amounts outstanding under credit facilities due and payable by the Step-down subsidiary to the extent of $ 100 million in the event of failure on the part of the Step-down subsidiary to repay the amount drawn under credit facilities.

The Committee notes that the term 'debt instrument' is neither defined in Ind AS 109 nor in Ind AS 32. The Committee is of the view that the term implies a contractual right to receive cash arising on account of a debtor-creditor or lender-borrower relationship. The Committee is of the view that apparently there is debtor-creditor or lender-borrower relationship between the Step-down subsidiary and the holder/beneficiary of the guarantee contract (viz., M/s ABC LP, M/s XYZ Inc, SBI etc.) under the terms of TSA/PPA/GSPA/credit facilities etc. In case the Step-down subsidiary does not make payment to the holder/beneficiary of the guarantee (viz., M/s ABC LP, M/s XYZ Inc, SBI etc.) under TSA/PPA/GSPA or credit facilities, the holder has a right to recoup the loss suffered by it from the Company. The Committee is, therefore, of the view that the corporate guarantee issued by the Company to the various parties mentioned above meets the definition of financial guarantee contract given in Ind AS 109. The Committee is also of the view that there exists a contractual right of the holder of the guarantee contract, to receive cash from the guarantor (viz., the Company) and a corresponding contractual obligation of the guarantor to pay the holder, if the Step-down subsidiary defaults. This is so even if the holder's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on future act of default on future payments becoming due and payable by the Step-down subsidiary. Therefore, the contingent right and obligation meet the definition of financial guarantee contract, in accordance with the requirements of paragraph AG 8 of Ind AS 32.

The Committee further notes that the querist has argued that the performance of Step-down subsidiary under the contracts signed by it with its suppliers are solely dependent upon the performance of the Company and the failure of payment to third parties (i.e. suppliers of Step-down subsidiary) are solely within the control of the Company. Therefore, the expected credit loss due to this guarantee is 'Nil'. Further due to the same reason, the Company is not charging any guarantee fee from Step-down subsidiary for providing these guarantees. Charge for provision of guarantee would be appropriate where the issue of guarantee is considered to be a service performed by the issuer for the benefit of the entity availing the guarantee. However, in cases where the guarantee is for the benefit of the guarantor only, i.e., for promoting/protecting its interest, no charge/compensation for issue of guarantee is warranted.

The Committee also notes that the querist has also put forth an argument that the Company is accounting for amount payable for gas purchase from Step-down subsidiary in its books of account and if the Company provides loss allowance for guarantee given on behalf of Step-down subsidiary for the same transaction, it amounts to duplication and overstating the Company's liabilities.

The Committee notes that the trade payable for the gas purchased from the Step-down subsidiary and the financial guarantee issued by the Company to third party on behalf of the Step-down subsidiary are separate financial liabilities emanating from separate transactions. The Company has obligations towards different parties in the two transactions. Therefore, the Committee is of the view that recogising the two financial liabilities and providing for loss allowance on the financial guarantee contract shall not result in duplication or overstating of liabilities. Further, as also pointed out by the querist, since there could be time lag in the payment made by the Company to Step-down subsidiary and payment made by the Step-down subsidiary to its suppliers, it may result in expected credit losses at the reporting date for some time till the payment becomes due from the Parent company from the perspective of the Step-down subsidiary (refer paragraph B 5.5.28 of Ind AS 109).

10. The Committee further notes that another argument put forth by the querist is that these guarantees could have been avoided, if the contracts would have been entered by the Company itself. All the guarantees provided by the Company on behalf of Step-down subsidiary are in furtherance of the Company's business, wherein the Company is the ultimate beneficiary for these guarantees provided by the Company. Further, entire performance of Step-down subsidiary is also dependent upon the performance of the Company. So, it can be construed that the Company has provided these guarantees for its own performance only.

The Committee believes that the financial guarantee provided to an external party on behalf of a subsidiary is required to be accounted for in the separate financial statements of the parent company as per Ind AS 109. This is notwithstanding the fact that the Step-down subsidiary's financial performance and position may be dependent on the business that is generated with the Company and that the Company being the ultimate parent of the subsidiary, is ultimately the beneficiary of the subsidiary's operation. From the perspective of the separate financial statements, the reporting entity is the parent company only and not the group, i.e., parent company together with the subsidiaries. Therefore, it does not matter if the financial performance of the Step-down subsidiary is dependent on its business operations with the Company.

Further, the querist has also argued that till date there is no default on the part of Step-down subsidiary and the Company w.r.t. their contractual obligations, hence the corporate guarantees carry no risk. The Committee is of the view that the extent of credit risk shall not affect the initial recognition of the financial guarantee liabilities. However, this may be one of the factors that the Company may consider for the purpose of fair valuation at the time of initial measurement and for measuring the expected credit loss at the time of subsequent measurement.

11. Further, with regard to accounting treatment of such financial guarantee, the Committee is of the view that the guarantee obligations, as mentioned above, should be recognised and measured as per the requirements of Ind AS 109 by the Company in its separate financial statements. In this regard, the Committee notes from paragraph B 2.5(a) of Ind AS 109 reproduced above and other requirements of Ind AS 109 (paragraphs 5.1.1, 5.1.1A and B5.1.1) that the issuer of a financial guarantee should recognise it initially at its fair value. The Committee is of the view that this requirement is also applicable in respect of a guarantee issued by a parent on behalf of its subsidiary and where no fee or commission is charged by the parent for issuance of such guarantee.

Accordingly, in the extant case, the Company, in its separate financial statements, should initially recognise a liability (a deferred income such as 'unearned financial guarantee commission') at fair value which will be equivalent to an amount that the Step-down subsidiary would have paid to obtain a similar guarantee in a standalone arm's length transaction.

The Committee further notes that in the extant case, the guarantee obligation has been undertaken by the Company in its capacity as the ultimate parent of the Step-down subsidiary company. The Company has a right to future economic benefits arising from its overall investments in the Step-down subsidiary through its control over Subsidiary 1. In case the Company is not charging any guarantee commission or other consideration to the Step-down subsidiary company, upon initial recognition of the financial guarantee liability, the Company should recognise deemed investment in the Subsidiary 1 and the same should be accounted for as per the requirements of Ind AS 27.

12. The Committee also notes the requirements of Ind AS 109 in respect of subsequent measurement of financial guarantee as follows:

> **"4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:**
>
> **(a) *financial liabilities at fair value through profit or loss*. Such liabilities, including *derivatives* that are liabilities, shall be subsequently measured at fair value.**
>
> **(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities.**
>
> **(c) *financial guarantee contracts*. After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:**
>
> **(i) the amount of the *loss allowance* determined in accordance with Section 5.5 and**
>
> **(ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115.**
>
> **…"**
>
> **"5.5.1 An entity shall recognise a loss allowance for *expected credit losses* on a financial asset that is measured in accordance**

with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a *contract asset* or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d).”

“B5.5.32 For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.”

“5.7.9 Despite the requirements in paragraphs 5.7.7 and 5.7.8, an entity shall present in profit or loss all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through profit or loss.”

From the above, the Committee notes that as per the requirements of Ind AS 109, expected credit loss should be considered on financial guarantee contracts at the time of subsequent measurement.

13. The Committee notes that Ind AS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’ states as follows:

“2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments*.”

Therefore, financial guarantees, in the extant case, being governed by Ind AS 109, are not within the scope of Ind AS 37 and therefore, cannot be classified as contingent liabilities. Instead, the Company should comply with the relevant presentation and disclosure requirements of Ind AS 107 and related disclosures of Division II of Schedule III to the Companies Act, 2013 for financial liability.

D. Opinion

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

(i) and (ii) The Company should account for the financial guarantee contracts as per the requirements of Ind AS 109, as discussed in paragraphs 9-12 above.

(iii) The Company should account for expected credit loss provision, if any, as per the requirements of Ind AS 109, as discussed in paragraph 12 above.

(iv) The disclosures in the Company's financial statements should be provided based on the classification as financial liabilities, as discussed in paragraph 13 above. The Company should comply with the relevant presentation and disclosure requirements of Ind AS 107 and Division II of Schedule III to the Companies Act, 2013.

(v) Refer above.

Query No. 16

Subject: Accounting treatment of assets funded by customers for its use in specific project.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is an Indian State owned aerospace and defence company, headquartered in Bangalore and is the largest public sector undertaking (PSU) under the Ministry of Defence in terms of value of production. The Company is engaged in the design, development, manufacture, repair, overhaul, upgrade and servicing of a wide range of products including aircrafts, helicopters, aero engines, avionics, accessories and aerospace structures.

2. The Company's operations are managed by 5 (five) complexes, namely:

(i) Bangalore complex

(ii) MIG complex

(iii) Helicopter complex

(iv) Accessories complex and

(v) Design complex,

The Company has 29 accounting units located across the country. The Company relies on indigenous research as well as enters into technology transfer and license agreement to manufacture various products.

3. The Company is under the administrative control of Ministry of Defence, Department of Defence Production. Manufacture of the Company's products

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[1] Opinion finalised by the Committee on 6.10.2021.

involves a substantial period of time and is subject to high precision and stringent quality control measures and inspection procedures.

4. The querist has stated that in terms of value of business, majority comes from the Indian Defence Services, i.e., Indian Air force, Indian Army, Indian Navy and Indian Coast Guard. Defence services place orders on the Company in the form of contracts for manufacture and supply of aircrafts, helicopters, aero engines, spares and LRUs for helicopter, aircraft and aero engines; and repair, service and overhaul of aircraft, helicopters, aero engines and LRUs.

Accounting Treatment in the books of account:

Accounting treatment on Transition to Ind AS

5. As per the querist, apart from payment for supplies as per unit rate agreed in the contract, contract provides for funding for establishing infrastructure facilities inside the Company for effective management of production activities in line with customers requirement.

Accordingly, the Company has procured items of property, plant and equipment with funds given by the customer.

The Company has adopted Indian Accounting Standards (Ind AS) from the financial year (F.Y.) 2016-17 with April 1, 2015 as the transition date. On transition to Ind AS, the Company capitalised all assets created after 01.04.2016, with customer funding, by applying Appendix C 'Transfer of Assets from Customers' of the erstwhile Indian Accounting Standard (Ind AS) 18, 'Revenue'[2].

Paragraph 20 of Appendix C of Ind AS 18, provided as follows:

> "If an ongoing service is identified as part of the agreement, the period over which revenue shall be recognised for that service is generally determined by the terms of the agreement with the customer. If the agreement does not specify a period, the revenue shall be recognised over a period no longer than the useful life of the transferred asset used to provide the ongoing service."

Based on the above conclusion, the items of property, plant and equipment were shown as 'Property, Plant and Equipment-Customer Funded' in the books of account of the Company. Depreciation was provided in the books as per Schedule II to the Companies Act, 2013, based on useful life of the assets. Revenue was recognised to the extent of depreciation provided on such assets.

[2] Ind AS 18 has been substituted by Ind AS 115 vide Notification G.S.R. 310(E) dated 28th March, 2018.

<u>Accounting treatment on implementation of Ind AS 115 which is presently being followed</u>

6. Ind AS 115, 'Revenue from Contracts with Customers', became applicable to the Company from 01.04.2018. Subsequent to implementation of Ind AS 115 from 01.04.18, Ind AS 18 is withdrawn. Paragraphs 66-69 of Ind AS 115 deal with 'Non-Cash consideration'. Paragraph 69 of Ind AS 115 states as follows:

> "If a customer contributes goods or services (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer."

In the present case, as the contract was entered into between the Company and the customer, the assets bought by the Company with the funds provided by the customer are to be used for fulfillment of the specific project for which the funds have been provided. Also, as per the querist, the Company has obtained control over the asset. Hence, the Company determines that the assets purchased will be considered as non-cash consideration and the accounting treatment as prescribed under non-cash consideration of Ind AS 115 will be applicable. The accounting treatment will vary based on the control aspect of the asset.

<u>Accounting treatment where the Company has obtained control over the assets funded by customer</u>

7. The assets funded by customers are capitalised and shown under property, plant and equipment along with the Company-funded assets. Depreciation is calculated for all these assets. Further, revenue is recognised during the reporting period, to the extent of depreciation provided on such customer-funded assets. The advance received from customer towards purchase of the asset and outstanding in the books is adjusted to the trade receivable to the extent of depreciation recognised as revenue.

Thus, the funds given by the customer for purchase of assets for specific use for their project are recognised as revenue over the useful life of the assets.

<u>Accounting treatment where the Company has not obtained control over the assets funded by customer</u>

8. The expenditure incurred in respect of assets funded by the customer is not capitalised. Instead, the expenditure incurred on purchase of customer-funded assets is initially recognised in 'Capital Work in Progress' and on the completion of installation and commissioning of the asset, it is adjusted against advance received from customer for the purchase of the asset. Necessary

disclosure is also made in notes to financial statements indicating that the property, plant and equipment of the Company does not include assets given by the customers for use of their jobs by the Company.

Issue raised by the auditors:

9. During the audit of the financial statements for the year ended 31st March 2020, the statutory auditor appointed by the Comptroller and Auditor General (C&AG) has raised an issue over the accounting treatment followed by the Company in the case of customer-funded assets where the Company obtains control over the assets as under:

> In the contract with the Government Space Agency, Article VII reads as under.
>
> > "The Augmented facility for Cryogenic Engines and Semi-cryogenic Engines at the Company shall be the property of the DEPARTMENT located at the Company for long term utilization for the above program and other allied future programs of the DEPARTMENT."
>
> The Article is specific that the assets acquired out of the advance from the Government Space Agency, shall be the property of the Department and for long term utilisation of the programme mentioned in the agreement and other allied future programmes of the Department.
>
> *Thus, the control expressly vests with the Government Space Agency.*
>
> Therefore, reducing the amount received from the cost of the assets acquired and disclosure by a note in the financial statements that assets belonging to the customer are in the custody of the Company, is in order.
>
> *However, the arrangement with the Ministry of Defence, Department of Defence Production is different.*
>
> In the communication from the Ministry of Defence, Department of Defence Production, the Government approves setting up of facilities by the Company for specific projects/work at a pre–determined cost for which the funding is made available by the Government of India.
>
> The communication granting the funds is for specific projects or orders and therefore, the assets acquired out of the funds given by the Ministry of Defence partakes the character of non-cash consideration.
>
> It may be a fact that the facilities may be utilised by the company for further orders from the Department of Defence Production. The communication is not specific as to who controls the assets, but the advance is made for a specific project. As there is no specific mention

that assets would be in the control of the Company, the Company cannot treat the assets as its own or having control by an assumption.

Assuming but not admitting, the Ministry of Defence does not exercise control over the assets, as the facilities are created for a specific order leads to a conclusion that the facilities created are for the purpose of executing the order and had the Company spent this amount on their own, the price charged would have been higher to the customer.

Since, the price is not loaded with the cost of the facilities created, the same amounts to a non-cash consideration which will have to be recognised as revenue over the number of articles to be manufactured under the Contract, even though the money is received from the Government.

a. Ind AS 115 applies to all entities and all contracts with customers to provide goods or services in the ordinary course of business except for the specific exclusions as mentioned under Paragraph 5 (a) to (d) of Ind AS 115. Thus Ind AS 115 applies to a contract (other than a contract listed in the exceptions) only if the counter party to the contract is a customer.
b. A customer is defined as a party that has contracted with an entity to obtain goods or services that are output of the entity's ordinary activities in exchange for consideration.
c. As per Paragraph 69 of Ind AS 115, in such cases, where the contract is with a customer and a customer contributes goods or services to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of these contributed goods or services. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer.
d. Further, as per Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance', Government grants are assistance by the government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.
e. The amount received from the Government (customer) is not a transfer of resources in return for past or future compliance with the conditions relating to operating activities of the entity, and therefore not a government grant.

f. The contribution made by the Government (customer) to the Company in the form of funding for plant and machinery, etc. towards supply of products will be covered under Ind AS 115 and to be treated as non-cash consideration and not as government grant under Ind AS 20.

In the auditor's opinion, the accounting should be as under:

a. The assets acquired out of funds should be treated as property, plant and equipment (PPE) and depreciation to be recognised based on the useful life and the residual value of the assets.
b. The amount of funding receipt should be recognised as income over the number of production units specified in the agreement for extending the funding, even though the facilities may be available for use for any other purpose/order from the Government.
c. Recognition of revenue equal to the amount of depreciation charged and adjustment of the advance against the trade receivable towards the revenue, so recognised, may not be the correct accounting, as the entire revenue will be recognised over the useful life of the assets, when the advance/funding is given for a specific order.

(Emphasis supplied by the querist.)

The auditor is of the opinion that since the assets purchased out of funds given by the customer are to be used only for the specific project of the customer, revenue should be recognised towards the value of non-cash consideration over the fulfilment of the project as and when the performance obligation is fulfilled for each unit of goods given to the customer and the present method of recognising revenue over period of the useful life of the assets at an amount equal to deprecation charged is not correct.

Comments of the Company:

10. The Company is of the view that although the assets purchased out of funds given by customer are to be used only for the specific project of the customer, these assets remain with and within the control of the entity even after the end of the project and the entity is at liberty to use these assets for other projects of the same defence customers till the end of the useful life of these assets. In view of the above, the entity recognises the revenue towards the customer-funded assets over the useful life of the assets equivalent to yearly depreciation for such asset.

B. Query

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

(i) Whether the view taken by the Company that it has control over the assets since the Company is at liberty to use these assets for other projects of the same Defence customers till the end of the useful life of these assets is correct.

(ii) Whether the present accounting treatment followed by the Company of recognising revenue towards non-cash consideration received in the form of assets, over the useful life of the asset, to the extent of depreciation provided on such assets is in line with Ind AS 115.

(iii) If the answer to (i) above is in the negative, whether the Company should recognise the revenue towards non-cash consideration in the form of assets over the total duration of the project as and when performance obligation is fulfilled.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to accounting for funds received from the customers (viz., Department of Space and Department of Defence Production, Ministry of Defence) for creation of manufacturing/infrastructure facilities which will be used for manufacturing/providing goods or services to the customer. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, depreciation accounting on property, plant and equipment (if any) recognised by the Company, recognition of revenue arising from goods/services other than that towards funds received from the Department of Space and Department of Defence Production, Ministry of Defence, accounting impact on transition to Ind AS by the Company, presentation of the funds received and spent on manufacturing/infrastructure facility in the financial statements of the Company, appropriateness of journal entries passed by the Company in respect of the above-mentioned transactions as separately supplied the querist, evaluation of the contracts with clauses for use of premises of the Company for facility or storage from Ind AS 116 perspective and accounting thereof, timing of transfer of control over facilities, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of agreement with the customers of the Company or the Government/Ministry orders. Furthermore, the Committee has not examined (apart from those supplied by the querist) any other contract or agreement or communication as mentioned in the Contracts with the customers (for example, Article XII of the Contract with Department of

Space states that "On signing of this MoU, a separate contract shall be entered into, between the Department and the Company for carrying out the Developmental, Learning and Series production of Engine Hardware to meet the Department's requirements."). The Committee presumes in the extant case that the Company is acting in the capacity of principal and not as an agent of the Department of Space or the Department of Defence Production, Ministry of Defence.

13. At the outset, the Committee notes the following relevant information from the Memorandum of Understanding between the Department of Space/ISRO (the 'Department') and the Company for setting up of Integrated Cryogenic Engines Manufacturing Facility (the 'manufacturing facility') at the Company dated 31st December 2013 (hereinafter referred to as the 'Contract A') and Communication from the Ministry of Defence, Department of Defence Production to the Company dated 13th August 2009 (hereinafter referred to as the 'Contract B') for establishment of facilities ('infrastructure facility') by the Company under license from the Country X Government for Repair & Overhaul of specific Aircraft and its Aggregates (together referred hereinafter as the 'Contracts'):

a. Apart from payment for supplies and other services as agreed in the contracts, the contracts provide for funding for establishing manufacturing/infrastructure facilities inside the Company for effective management of production activities in line with customers requirement.

   Contract A is in respect of an integrated cryogenic engines manufacturing facility for producing cryogenic and semi-cryogenic engines. Article I of the contract states that necessary facilities would be set up/augmented at the Company which shall be funded by the Department on the *land belonging to the Company as per financial arrangements to be worked out and mutually agreed to*, provided these are essential for processing the Engine realisation work at the Company. It also states that the Company shall be eligible for a specified % of facility cost as handling charges and a specified % profit on handling charges. As per Article IV of the Contract, the Company will be responsible for the procurement and commissioning of the machineries and setting up of facilities. Article V of Contract A further states that the Company agrees to make available in its premises adequate space for the establishment of necessary buildings and facilities. Whereas the Company will endeavor to meet the requirements of ISRO, ISRO on its part recognises that the Company is deploying its prime land for this project and will ensure enough Turnover."

b. Article VII of Contract A states that the augmented facility for Cryogenic Engines and Semi cryogenic Engines at the Company shall be the property of the Department located at the Company for long term utilisation for the above programme and other allied future programmes of the Department. Further, Article VIII states that the production of each type of engine would be spread over three phases – Development, Learning and Series Production.

c. Contract B with the Ministry of Defence, Government of India, provides for reimbursement of total cost of project of establishment of facilities for repair and overhaul of specific aircrafts alongwith its aggregates, including cost of foreign supplies/support on DRE, cost of indigenous DRE, profit, cost of facilities creation, i.e., civil works, plant and machinery etc., storage space, etc. Further, it specifies that the freight and insurance will be reimbursed based on FPQ of respective Division of the Company and would be reimbursed separately. It also states that the non-recurring costs would be funded by the Government of India and that these costs will be reimbursed on incurrence by the Company alongwith a specified% profit thereon on submission of proof of payment. Further, all the recurring costs of material, labour and overheads and profits thereon will be paid. Moreover, all capital expenditure for civil works including storage space for liaison establishment and plant and machinery and services is also being reimbursed in two instalments at the beginning of each year by the Government/Ministry.

From the above, the Committee notes that the Company procured/created items of property, plant and equipment for establishing the facilities with the funds given by the Customer (viz., the Department of Space and Ministry of Defence). Since these facilities are funded by the customers as per the Contracts, The Committee notes the following requirements of Ind AS 115, 'Revenue from Contracts with Customers':

"66 To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of non-cash consideration) at fair value."

"69 If a customer contributes goods or services (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer."

The Committee notes that the above requirements are in respect of goods or services (non-cash items) received from the customer whereas in the extant case, fund/cash has been received for creation of above-mentioned facilities; however, the Committee is of the view that these requirements can still be applied in respect of funds/cash received from customer for creation/acquisition of a specific asset (property, plant and equipment), which is to be used for providing goods or services to customers. The Committee further notes that in order to apply the above-reproduced requirements in respect of non-cash consideration, it needs to be assessed whether the Company obtains 'control' of the assets acquired out of customer's funds. Further, with respect to the meaning of the term 'control', the Committee notes paragraphs 33 and 38 of Ind AS 115, 'Revenue from Contracts with Customers' and paragraph BC 120 of Basis for Conclusions to IFRS 15 (which lays down requirements similar to Ind AS 115), issued by the International Accounting Standards Board (IASB) as follows:

"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."

"38 If a performance obligation is not satisfied over time in accordance with paragraphs 35–37, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31–34. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

(a) The entity has a present right to payment for the asset—if a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

(b) The customer has legal title to the asset—legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

(c) The entity has transferred physical possession of the asset—the customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs B64–B76, B77–B78 and B79–B82 provide guidance on accounting for repurchase agreements, consignment arrangements and bill-and-hold arrangements, respectively.

(d) The customer has the significant risks and rewards of ownership of the asset—the transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

(e) The customer has accepted the asset—the customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs B83–B86."

"**Developing the notion of control**

BC120 The boards' description of control is based on the meaning of control in the definitions of an asset in the boards' respective conceptual frameworks. Thus, the boards determined that control of a promised good or service (ie an asset) is the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The components that make up the description of control are explained as follows:

(a) ability—a customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognise revenue. For example, in a contract that requires a manufacturer to produce an asset for a particular customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, the entity should not recognise revenue until the customer has actually obtained that right (which, depending on the contract, might occur during production or afterwards).

(b) direct the use of—a customer's ability to direct the use of an asset refers to the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset.

(c) obtain the benefits from—the customer must have the ability to obtain substantially all of the remaining benefits from an asset for the customer to obtain control of it. Conceptually, the benefits from a good or service are potential cash flows (either an increase in cash inflows or a decrease in cash outflows). A customer can obtain the benefits directly or

> indirectly in many ways, such as by using, consuming, disposing of, selling, exchanging, pledging or holding an asset."

From the above, the Committee notes that paragraph 33 of Ind AS 115 states that 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.

In this context, the Committee notes that the Article VII of Contract A is specific that the assets acquired out of the advance from the Government Space Agency, shall be the property of the Department and for long term utilisation of the programme mentioned in the agreement and other allied future programmes of the Department.

The funding for the facilities as per Contract B is for the specific project. Thus, use of the facilities is apparently strictly as per the Contract. The querist has also mentioned that the Company is at liberty to use these assets for other projects of the *same* defence customers till the end of the useful life of these assets. Therefore, manufacturing/infrastructure facilities, apparently, cannot be utilised by the Company for further orders other than from the Customer as per the Contract. In other words, the facilities can be used for specific purpose for specific customer only. The Company cannot deploy the assets (facilities) in its activities or use/deal with the asset as it pleases e.g. cannot sell/exchange, pledge etc. and accordingly, does not have the right to direct the use of the asset. Further, the Committee notes that the Company is not only reimbursed the entire cost but also a profit margin for creation of such asset, which also indicates that the asset is being constructed for the Customer only.

Further, the Committee notes that as per paragraph 38 of Ind AS 115, to determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

(a) **The entity has a present right to payment for the asset** – The facilities are funded by the customers as per the contracts and hence, the Company has the right to payment for establishment of the facilities as per the contracts.

(b) **The customer has legal title to the asset** – As per Contract A, the property of the facility is with the Department. However, Contract B is silent on this aspect.

(c) **The entity has transferred physical possession of the asset** – Although, the facilities are established/set up on the land/premises of the Company as per the specifications and terms of the contracts, the facilities are specifically used only for the orders placed by the customers as per the contracts. Further, although both the contracts explicitly require the facilities to be in the physical possession of the Company, they take into consideration storage/custodial services provided by the Company. In Contract B, one of the price components relates to storage. From this, it appears that these facilities are held by the Company on behalf of its customers and the Company is providing custodial services for these facilities.

(d) **The customer has the significant risks and rewards of ownership of the asset** – In this regard, the Committee notes that Contract A states that, "Whereas the company shall be responsible to maintain the facilities in operational condition, the Department recognises that the Company needs to be compensated suitably for maintaining these exclusive facilities, which will be mutually discussed and agreed to". It implies that the asset is being maintained by the Company on behalf of the Department of space, viz., customer. Further, the Contract B specifically mentions about reimbursement of insurance costs as per the terms agreed, which indicates that the risk under insurance cover is being borne by the customer.

(e) **The customer has accepted the asset** – The facilities are established or set up as per the specifications and terms of the Department /customer under the contracts.

From the above, the Committee is of the view that the Company in the extant case has transferred 'control' over the manufacturing/infrastructure facilities created out of the customer's funds to the customer and the Company does not possess control over such facilities. Therefore, the facilities cannot be considered and accounted for as non-cash consideration received from the customer and should also not be recognised as property, plant and equipment by the Company.

14. As regards the recognition of revenue from the funds received in the extant case, the Committee notes the following requirements of Ind AS 115:

"**22 At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:**

(a) a good or service (or a bundle of goods or services) that is distinct; or

(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 23).”

“27 A good or service that is promised to a customer is distinct if both of the following criteria are met:

(a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (ie the good or service is capable of being distinct); and

(b) the entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ie the promise to transfer the good or service is distinct within the context of the contract).

28 A customer can benefit from a good or service in accordance with paragraph 27(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

29 In assessing whether an entity’s promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 27(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more

promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

(a) the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element or unit.

(b) one or more of the goods or services significantly modifies or customises, or are significantly modified or customised by, one or more of the other goods or services promised in the contract.

(c) the goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfil its promise by transferring each of the goods or services independently."

"Satisfaction of 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."

"46 When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 56–58) that is allocated to that performance obligation."

The Committee notes from the above that in the extant case, the Company should assess the goods or services promised in the contract with customer and should identify as its performance obligations each promise to transfer a distinct good or service. Accordingly, in the extant case, the Company should evaluate whether the manufacturing/infrastructure facility created out of the funds received from the customer in the extant case is a distinct good or service considering whether the Company's promise to create facilities for the customer is separately identifiable from other promises in the contract, for example, providing goods or services to the customer using the manufacturing facility. Further, after identifying the performance obligations, the Company should determine whether it satisfies the performance obligation over time or satisfies the performance obligation at a point in time, and accordingly, recognise revenue in accordance with the above-reproduced requirements of Ind AS 115.

In the extant case, the Committee is of the view that manufacturing/infrastructure facility is a distinct good as it is not dependent on other goods or services to be provided and has an economic value separate from other goods or services in the contract with the customers. Therefore, in accordance with the requirements of Ind AS 115, reproduced above, revenue in respect of such performance obligation (viz., promise to transfer the manufacturing/infrastructure facility) should be recognised when (or as) the Company satisfies a performance obligation by transferring the promised good (ie an asset) to the customer. Further, in this regard, the Committee wishes to point out that the expenditure incurred by the Company on creation of facilities should not be recognised as 'Capital work-in-progress (CWIP)'.

D. Opinion

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

(i) The view taken by the Company that it has control over the assets is not correct, as discussed in paragraphs 13 and 14 above.

(ii) The present accounting treatment followed by the Company of recognising revenue towards the consideration received in the form of assets, over the useful life of the asset, to the extent of depreciation provided on such assets is not correct.

(iii) The revenue in respect of funds received from the customer for the manufacturing facility should be recognised as or when the control over manufacturing facility is transferred to the customer as per the requirements of Ind AS 115, as discussed in paragraph 14 above.

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Query No. 17

Subject: Accounting treatment of grant under AS 12.[1]

A. Facts of the Case

1. Government of India (GoI) has launched Smart City Mission in June 2015 with an objective to promote sustainable and inclusive cities that provide core infrastructure and give a decent quality of life to its citizens, a clean and sustainable environment and application of 'Smart' solutions.

2. The implementation of the Mission at the city level will be done by a Special Purpose Vehicle (SPV) created for the purpose. The SPV will plan, appraise, approve, release funds, implement, manage, operate, monitor and evaluate the Smart City development projects. Each smart city will have a SPV which will be headed by a full time CEO and have nominees of Central Government, State Government and Urban Local Body (ULB) on its Board. The States/ULBs shall ensure that, (a) a dedicated and substantial revenue stream is made available to the SPV so as to make it self-sustainable and could evolve its own credit worthiness for raising additional resources from the market and (b) Government contribution for Smart City is used only to create infrastructure that has public benefit outcomes. The execution of projects may be done through joint ventures, subsidiaries, public-private partnership (PPP), turnkey contracts, etc. suitably dovetailed with revenue streams.

3. The SPV Company (hereinafter referred to as 'the Company') is a limited company incorporated under the Companies Act, 2013 at the city-level, in which the State/Union Territory (UT) and the ULB will be the promoters having 50:50 equity share holding. The private sector or financial institutions could be considered for taking equity stake in the SPV, provided the shareholding pattern of 50:50 of the State/UT and the ULB is maintained and the State/UT and the ULB together have majority shareholding and control of the SPV.

4. The querist has stated that the funds provided by the Government of India in the Smart Cities Mission to the SPV will be in the form of tied grant and kept in a separate Grant Fund. These funds will be utilised only for the purposes for which the grants have been given and subject to the conditions laid down by the Ministry of Housing and Urban Affairs.

5. The State Government and the ULB will determine the paid-up capital requirements of the SPV commensurate with the size of the project, commercial financing required and the financing modalities. To enable the building up of the equity base of the SPV and to enable ULBs to contribute their share of the equity capital, the GoI grants will be permitted to be utilised as ULBs share of equity

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[1] Opinion finalised by the Committee on 27.10.2021.

capital in the SPV, subject to the conditions given in Smart City Guidelines. Initially, to ensure a minimum capital base for the SPV, the paid up capital of the SPV should be such that the ULB's share is at least equal to Rs. 100 crore with an option to increase it to the full amount of the first instalment of funds provided by the GoI (Rs. 194 crore). With a matching equity contribution by State/ULB, the initial paid-up capital of the SPV will thus be Rs. 200 crore (Rs. 100 crore of the GoI contribution and Rs. 100 crore of State/UT share). Since the initial GoI contribution is Rs. 194 crore, along with the matching contribution of the State Government, the initial paid up capital can go up to Rs. 384 crore at the option of the SPV. The paid up capital may be enhanced in the subsequent years as per project requirements, with the provision mentioned above ensuring that ULB is enabled to match its shareholding in the SPV with that of the State/UT.

6. The Smart City Mission will be operated as a Centrally Sponsored Scheme (CSS) and the Central Government proposes to give financial support to the Mission to the extent of Rs. 48,000 crore over five years, i.e., on an average Rs. 100 crore per city per year. An equal amount, on a matching basis, will have to be contributed by the State/ULB; therefore, nearly Rupees one lakh crore of Government/ULB funds will be available for Smart Cities' development.

7. The distribution of funds under the Scheme will be as follows:

   i. 93% project funds.

   ii. 5% Administrative and Office Expenses (A&OE) funds for the State/ULB (towards preparation of Smart City Proposals (SCPs) and for Project Management Consultants (PMCs), pilot studies connected to area-based developments and deployment and generation of smart solutions, capacity building as approved in the challenge and online services).

   iii. 2% A&OE funds for Ministry of Urban Development (MoUD) (Mission Directorate and connected activities/structures, research, pilot studies, capacity building, and concurrent evaluation).

8. K City has been successfully selected as a city to be developed as Smart City in Round-1 of Smart City Challenge. It is proposed to implement various initiatives for Area Based Development (ABD) and Pan City Solutions worth about INR 1993 crore in K City under Smart City Mission.

9. The Company is an SPV incorporated on 07.03.2016 under the Companies Act, 2013 for implementation of Smart City projects in K City. The SPV will plan, appraise, approve, release funds, implement, manage, operate, monitor and evaluate the Smart City development projects.

10. Total grant received so far from the Government of India and the State Government together is Rs. 577 (384+193) crore out of which Rs. 200 crore have been considered as authorised and paid up share capital as per the instructions of the Ministry of Urban Development and the Smart City Guidelines (A copy of guidelines applicable to the Smart City Mission as applicable for projects execution and related compliances have been supplied separately by the querist for the perusal of the Committee) issued by it. The balance amount of Rs. 367 crore shown under Grant (Capital Reserve) for projects execution and transferred to Profit and Loss Account as and when the project expenditure is incurred and balance Rs. 10 crore has been marked as Grant (Capital Reserve) for Administrative & Office Expenses (A&OE). The querist has separately informed that till August, 2021, the Company has received an amount of Rs. 488 crore from the State Government and Rs. 490 crore from the Central Government. The Company has utilised an amount of Rs. 239.14 crore from the State Government fund and an amount of Rs. 444.51 crore from the Central fund till August, 2021.

11. The Company is executing several projects in K City on the lands owned by State Municipal Corporation (ULB) like laying of roads, development of existing parks, construction of buildings etc., within the limits of ULB. The querist has further informed that the grant can be used for core infrastructure elements in a Smart City, which include, adequate water supply, assured electricity supply, sanitation, including solid waste management, efficient urban mobility and public transport, affordable housing, especially for the poor, robust IT connectivity and digitalisation, good governance, especially e-Governance and citizen participation, sustainable environment, safety and security of citizens, particularly women, children and the elderly, and health and education. However, no agreements or MOUs are entered into with ULBs either regarding ownership rights or for any lease arrangements for the expenditure incurred/capital assets created. This project expenditure is not capitalised since the ownership of the lands is not with the Company. The expenditure incurred towards execution of the projects is debited to Profit and Loss Account. At the year-end, Grant (Capital Reserve) Account, to the extent of expenditure incurred towards execution of projects, is transferred to Profit and Loss Account as other income.

12. Similar accounting treatment is followed in respect of revenue grant and revenue expenditure, i.e., transfer from revenue grant account to Profit and Loss Account as other income to the extent of administrative expenditure incurred. The project expenditure in financial year 2019-20 exceeded the available balance in Grant (Capital Reserve) Account since it was met out of the funds accounted for as share capital of Rs. 200 crore, resulting in loss of about Rs. 145 crore in the Profit and Loss Account. This is because the share capital created

cannot be transferred to the Profit and Loss Account to the extent of the project expenditure met out of it.

13. It can be observed that at the end of all projects, following this practice, the loss in the Profit and Loss Account would rise up to Rs. 200 crore (i.e. the share capital amount spent but cannot be transferred to Profit and Loss Account.)

B. Query

14. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed for accounting project expenditure and the grants received is in line with Accounting Standard (AS) 12, 'Accounting for Government Grants'. In case it is felt otherwise, accounting of project expenditure and the grants received may be advised.

C. Points Considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to accounting treatment for project expenditure and grants received in relation to smart city mission. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, calculation of total funds received so far towards execution of projects and towards A&OE, accounting for funds received from the GoI/State Government as share capital and issue of shares against those funds, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the legal perspective, such as, interpretation of Smart City Guidelines etc. The Committee notes that the issue has been raised in the context of AS 12, notified under the Companies (Accounting Standards) Rules, 2006[2] and accordingly, the opinion expressed hereinafter is from the perspective of the Accounting Standards, and not from the perspective of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

The Committee presumes from the Facts of the Case that the State Government/GoI/ULB, while providing funds to the Company is not acting in the capacity of owner; rather acting as 'Government' as per Accounting Standard (AS) 12, 'Accounting for Government Grants'. The Committee further presumes from the Facts of the Case that the Company is not working as an agent of Government of India/State Government/ULB; rather it is working in the capacity of principal.

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[2]Companies (Accounting Standards) Rules, 2021 supersedes the Companies (Accounting Standards) Rules, 2006 with effect from accounting periods commencing on or after 1.4.2021.

16. The Committee notes from the Facts of the Case that the Company is executing several projects in the City on the lands owned by the State Municipal Corporation (ULB). However, no agreements or MoUs are entered into with ULBs either regarding ownership rights or for any lease arrangements for the expenditure incurred/capital assets created. It is further stated in the Facts of the Case that the project expenditure is not capitalised since the ownership of the lands is not with the Company and the expenditure incurred towards execution of the projects is debited to Profit and Loss Account. From the above, the Committee is of the view that in the extant case, as the ownership of the land is not with the Company and there is no agreement/MoU entered into with ULBs either regarding ownership rights or for right-of-use of any asset created out of the expenditure incurred as a part of smart city development project, in the absence of anything contrary, at present, the Company neither has the power to obtain the future economic benefits out of the expenditure incurred nor can restrict the access of others to those benefits.

17. In this context, the Committee notes the definition of 'asset' and paragraph 14 from Accounting Standard (AS) 26, 'Intangible Assets' as follows:

> "***6.2 An asset is a resource:***
>
> ***(a) controlled by an enterprise as a result of past events; and***
>
> ***(b) from which future economic benefits are expected to flow to the enterprise."***
>
> "14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way."
>
> "56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. …"

From the above, the Committee notes that an asset is a resource *controlled* by the enterprise and an enterprise *controls* an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

Accordingly, the Committee is of the view that it is only where the asset is controlled by the Company in the manner envisaged by paragraph 14 of AS 26, the Company should recognise asset in its financial statements in respect of the expenditure incurred. The Committee is of the view that in the extant case since at present, the Company neither has the power to obtain the future economic benefits out of the expenditure incurred nor can restrict the access of others to those benefits, as discussed in paragraph 16 above, the Company does not *control* the assets created/modified under smart city development project in the manner envisaged in the above-mentioned paragraphs of AS 26. Therefore, the expenditure incurred for the smart city development should not be capitalised as an asset in the financial statements of the Company. Further, the Committee notes the following requirements of AS 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies':

> ***"5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."***

From the above and considering the requirements of paragraph 56 of AS 26, as reproduced above, the Committee is of the view that the expenditure incurred by the Company for the smart city development should be recognised as an expense in the Statement of Profit and Loss of the Company.

18. With regard to the accounting for the funds received from the GoI/State Government/ULB against which shares have not been issued, the Committee notes the following requirements of Accounting Standard (AS) 12, 'Accounting for Government Grants':

> ***"3.2 Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise."***
>
> "8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held."
>
> "10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay

> (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income."

The Committee notes that in the extant case, part of the funds provided by the Government of India/ULB and State Government against which shares have not been issued have been granted to the Company for project execution and administrative and office expenses (A&OE) as per Smart City Guidelines. Accordingly, these are government grants under AS 12. As far as the nature of such grants, the Committee notes that these funds are being provided by the GoI/State Government/ULB from time to time for various projects and administrative and office expenditure under the Guidelines and cannot be considered as a one-time initial support or with reference to total investment in the Company or by way of contribution towards capital outlay only. Therefore, grant in the extant case cannot be considered as grant of the nature of promoters' contribution. Further, as discussed above, no fixed asset comes into existence for the Company out of the expenditure incurred on various projects under the Guidelines and therefore, grant in the extant case cannot also be considered as grant related to specific fixed asset. Accordingly, the Committee is of the view that the grant in the extant case should be considered as grant related to revenue.

19. With regard to disclosure and presentation of the grant related to revenue, the Committee notes the following requirements of AS 12:

> "9.1 Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense."
>
> ***"15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense."***

From the above, the Committee is of the view that the grant received from the GoI/State Government/ULB for meeting the project expenditure and A&OE should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. In this context, the Committee also wishes to point out that the grant received but unspent should be considered as unamortised deferred credit (and not as capital reserve) and should be suitably disclosed in the balance sheet with appropriate nomenclature, such as 'deferred revenue grant'.

With regard to loss in the Statement of Profit and Loss due to project expenditure exceeding the available balance in Grant and being met out of the funds accounted for as share capital, the Committee wishes to mention that the facts and circumstances underlying such loss should be appropriately explained in the notes to accounts for a better understanding of the users of financial statements.

D. Opinion

20. On the basis of the above, the Committee is of the opinion that the expenditure incurred by the Company for the smart city development should be recognised as an expense in the Statement of Profit and Loss of the Company as discussed in paragraph 17 above and the funds received as grant for project execution and A&OE should be recognised on a systematic basis in the Profit and Loss Statement over the periods necessary to match them with the related costs which they are intended to compensate, as discussed in paragraphs 18 and 19 above.

Query No. 18

Subject: Accounting treatment in the Company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being parent company to banks on behalf of its wholly owned subsidiary company.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') was incorporated in the year 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. 4,440.39 crore is paid-up share capital. The Government of India holds 51.45% equity of the Company at present. The Company is India's leading natural gas company with presence along the entire natural gas value chain comprising of exploration and production (E&P), LNG imports, gas transmission & marketing, gas processing, petrochemicals, LPG transmission, city gas distribution and power. The Company is having its global presence in various countries such as USA, Singapore, Myanmar, Egypt, China through subsidiaries/joints ventures (JVs)/associates etc. The securities of the Company are listed on the National Stock Exchange of India, the Bombay Stock Exchange

[1] Opinion finalised by the Committee on 27.10.2021.

and the London Stock Exchange (in the form of GDRs) with market capitalisation of over Rs. 61,000 crore (as of 31st March 2021). The Company's consolidated turnover for the year ended 31st March 2020 was approximately Rs. 72,400 crore with a profit after tax of Rs. 9,422 crore.

2. 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 has prepared its financial statements for the financial year (F.Y.) 2016-17 with comparative figures for F.Y. 2015-16. The Company has adjusted the impact of transition from Accounting Standards (generally referred to as 'IGAAP') to Ind AS in the opening reserve of 1st April 2015 and in the Statement of Profit and Loss for the F.Y. 2015-16.

3. The querist has informed that the Company has the following wholly owned subsidiary companies in USA:

(a) A Inc. – wholly owned subsidiary of the Company, which is engaged in the E&P business.

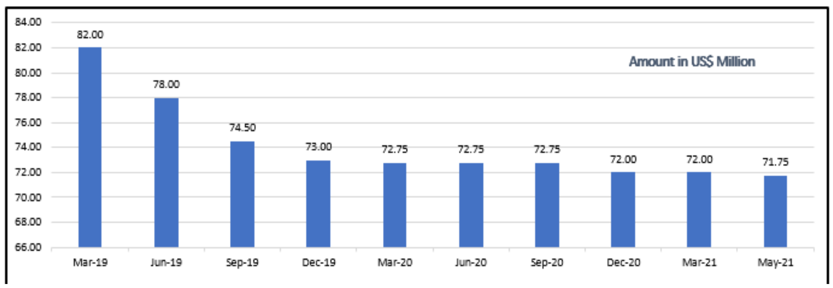
(b) B LLC. – wholly owned subsidiary of A Inc. and step down subsidiary of the Company, which is engaged in LNG trading business.

4. At present, the Company has issued corporate guarantees on behalf of its US subsidiary, A Inc. and step down subsidiary, B LLC. to the tune of USD 1057.57 million (Rs. 7,810.15 crore). The guarantee of USD 72.5 million (Rs. 535.41 crore) issued on behalf of A Inc. is towards meeting obligations of A Inc. and therefore, guarantee fee is being charged by the Company from A Inc. As per the Company's assessment, presently there is no possibility of default by A Inc. Further, guarantees issued on behalf of step down subsidiary of USD 985.07 million (Rs. 7,274.73 crore), have been issued for in-furtherance of business of the Company wherein ultimate beneficiary of these guarantees is the Company itself.

5. The querist has further informed that during September 2011, the Company has formed its wholly owned subsidiary in USA, namely A Inc., for acquiring 20% participation interest (PI) in XYZ Inc. in Texas, USA. Accordingly, the Company has made investment of USD 36 Mn (Rs. 179.17 crore) in A Inc. and corporate guarantee of USD 84 million was issued in December, 2011 in favor of C Bank N.A. for a period of 1 year for obtaining loan by A Inc. for acquiring the assets. Further, the Company had also issued another corporate guarantee of USD 16 Mn to C Bank USA in August 2012 for obtaining short-term loan by A Inc.

6. The querist has also submitted that generally cost of obtaining for long-term facility is higher than for obtaining short-term facility, therefore as a

commercial prudence from its inception, A Inc. has been obtaining short-term loan facility from banks based on corporate guarantee provided by the Company. This is a normal and well accepted practice for loan cost optimisation. Therefore, from inception, the Company has been providing corporate guarantee (CG) on behalf of A Inc. for obtaining short-term loan facility (each time for a period of one year). Presently A Inc. has taken a short-term loan facility of USD 72.5 Mn from the B Bank, New York based on the Company's corporate guarantee. Against this loan facility, A Inc. had withdrawn loan of only USD 72 Mn in Dec. 2020. The below chart shows the trend of loan repayment by A Inc. and reducing loan value:



It may be noted till date, A Inc. has not defaulted in its loan servicing including principal repayment and interest payment to respective banks.

7. The querist has mentioned that since inception, the Company has been charging guarantee fee from A Inc. for providing corporate guarantee at fair value (presently 0.44% p.a.) and the same is being recognised as income in the Company's books and expenses in the books of A Inc. A Inc. is paying fair value guarantee fee to the Company for issuance of corporate guarantee and there has been no default by it in loan servicing in past and no such default is expected in future too. Therefore, in the Company's view, there is no further requirement of accounting by the Company apart from present disclosure in the notes to accounts.

8. The querist has further mentioned that as per the requirements of Ind AS 36, 'Impairment of Assets', the Company is carrying out impairment testing of the above investment in A Inc. on every reporting period, which is based on the crude reserves and crude price. During F.Y. 2018-19, due to reduction in crude oil prices, based on impairment study on the Company's investment in A Inc., the Company had provided for impairment provision of Rs. 173.62 crore as against total equity investment of Rs. 179.17 crore in A Inc. Further, during F.Y. 2019-20, based on impairment study on the Company's investment in A Inc., the Company has made a reversal of impairment of Rs. 5.06 crore. Furthermore, based on impairment study, the Company's investment in A Inc. as on

31.03.2021 has been worked out as negative USD 1.17 Mn. Therefore, impairment provision has been made for balance amount of the Company's equity investment of Rs. 10.61 crore. With this impairment provision, carrying amount of the Company's investment in A Inc. stands at 'Nil' as on 31.03.2021 as against Rs. 10.61 crore as on 31.03.2020.

9. As mentioned in the above paragraphs, the Company has provided parent corporate guarantee of USD 72.50 Million to B Bank, New York on behalf of A Inc. against which as on 31.03.2021, A Inc. is having outstanding loan of USD 72 million (as on 31.03.2021), which has been considered as payable while working out the impairment valuation on investment in A Inc. Therefore, A Inc.'s estimated equity value of USD (1.17) Mn already considers outstanding loan as payable.

As per present valuation, equity fair value is only negative by USD 1.17 Mn, which is based on crude price as on 31.03.2021, and present trend of crude price is on increasing side (A Inc.'s reserves value based on prevailing crude price of June 2021 has increased to USD 75.48 Mn from USD 65.13 Mn, which was based on the crude price of 31.03.2021) and based on these reserve value, fair value of equity investment also turns out to be positive. Therefore, considering the following points, as per the Company's assessment, there is no requirement of creating any provision against the Company's guarantee given on behalf of A Inc.:

a. Till date, A Inc. has not defaulted in its loan repayment, so there is no requirement of creating provision of guarantee, as the Company's guarantee will be invoked only when A Inc. defaults in loan servicing. Further, in future also, any default by A Inc. is not expected in loan servicing.

b. Outstanding loan amount of USD 72 Mn (as on 31.03.2021) has already been considered as payable while working out the equity valuation.

c. As per present valuation, equity fair value is negative only by USD 1.17 Mn and considering materiality concept, making provision of guarantee may not be required.

d. Present trend of crude price is on increasing side (A Inc. reserve value based on prevailing crude price of June 2021 has increased to USD 75.48 Mn from USD 65.13 Mn, which was based on the crude price of 31.03.2021) and based on these reserve, fair value of equity investment also turns out to be positive.

Currently, the Company is disclosing the above guarantees in notes to accounts under details of 'Loans, Investment, Guarantees and Security' given by the

Company under Companies Act, 2013 and under 'Financial Risk Management (Liquidity Risk)' as per the requirements of Ind AS 107.

10. The querist has also mentioned that there is no security provided by the Company. As per the provisions of Ind AS 109, 'Financial Instruments', the Company has disclosed the issued guarantees in its notes to accounts and is of the view that no provision is required towards expected credit loss (ECL) on guarantees. However, the Company is evaluating applicability of provisions of Ind AS 109 with respect to the provisioning under ECL model for guarantees issued to third parties on behalf of subsidiaries in furtherance of business of the Company and is in process of obtaining opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI). On receipt of the opinion/ clarification from the EAC, the Company will take necessary action in the matter.

B. Query

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

(i) As per Ind AS, whether further accounting treatment is required for the corporate guarantee provided on behalf of A Inc. for obtaining loan from bankers, as the Company is already charging guarantee fees for the said guarantee and recognising income in the books.

(ii) Whether any expected credit loss to be provided for any of the above guarantees as per Ind AS 109.

(iii) Whether any other disclosure is required for any of the above guarantees in Company's books of account, as presently, the Company is disclosing these guarantees under notes to accounts.

(iv) Any other advice in the context, which EAC may deem fit.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the corporate guarantee provided by the Company on behalf of its subsidiary for obtaining loan from the bank in the separate financial statements of the Company. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment for transition to Indian Accounting Standards (Ind ASs), accounting treatment of corporate/bank guarantee issued on behalf of the Company's step-down subsidiary, accounting and measurement of investment made in subsidiary (including impairment thereof), accounting treatment in the separate financial statements of the subsidiary and the consolidated financial statements of the Group,

determination/measurement of ECL, considerations of materiality, measurement of fair value, etc. The Committee has only examined the issue from Ind AS perspective and has not examined the regulatory or legal classification and implications. The Committee also observes from the Company's financial statements that the Company has neither previously nor on transition to Ind ASs in the financial year 2016-17, asserted explicitly that it regards financial guarantee contracts as insurance contracts and uses accounting that is applicable to insurance contracts. Consequently, the irrevocable option to treat the corporate guarantee as an insurance contract available under paragraph 2.1(e) of Ind AS 109 is not applicable. The Committee also wishes to point out that the Standards referred hereinafter are Indian Accounting Standards (Ind ASs) notified under Indian (Accounting Standards) Rules, 2015.

13. The Committee notes that Appendix A to Ind AS 109 defines a financial guarantee contract as follows:

"**financial guarantee contract**	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument."

Further, paragraph B2.5 of Appendix B to Ind AS 109 and AG 8 of Appendix A to Ind AS 32, 'Financial Instruments: Presentation' provide as follows:

Ind AS 109

"B2.5 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2.1(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in Ind AS 104 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts. If this Standard applies, paragraph 5.1.1 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15– 3.2.23 and B3.2.12–B3.2.17 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance with Section 5.5; and

(ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115 [see paragraph 4.2.1(c)].

(b) …"

Ind AS 32

"AG8 The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be insurance contracts within the scope of Ind AS 104."

The Committee notes that a financial guarantee contract is defined under Ind AS 109 as a contract that requires the issuer to make *specified payments to reimburse* the holder for a loss it incurs because *a specified debtor* fails to make payment when due in accordance with the original or modified terms of a *debt instrument*. For a financial guarantee under Ind AS 109 to exist, amongst others, there shall be a reimbursement for loss incurred by a specified debtor. Further, the contract may not necessarily be called as financial guarantee contract and it may take any name or legal form, however the treatment will be same as that of a financial guarantee contract. In this context, the Committee notes the following clauses from the deed of guarantee entered between the Company and the bank (supplied separately by the querist for the perusal of the Committee):

> "(1) The Guarantor doth hereby irrevocably and unconditionally guarantees the due repayment to the Lender … on its first demand without demur, protest, delay and/or contestation, and notwithstanding any dispute between the Lender and the Borrower, of all the amounts outstanding under the Credit Facilities and all other indebtedness due and payable by the Borrower to the Lender thereunder including all interest, commission, costs, charges and expenses and all other monies whatsoever due and payable by the Borrower to the Lender thereunder to the extent of US Dollar 72,500,000 (US Dollar Seventy Two Million Five Hundred Thousand only) (**'Borrower's Indebtedness'**) in the event of failure on the part of Borrower in repaying the same to the Lender in accordance with terms of the Facility Agreement and various loan and security documents executed between the Borrower and the Lender (collectively, the **"Facility Documents"**) …
>
> (2) The obligations hereunder are joint and several and independent of the obligations of the Borrower and a separate action/ actions may be brought and pursued against the Guarantor alone or jointly with the Borrower."
>
> "(9) This Guarantee shall remain in full force and effect until the Borrower is fully discharged by the Lender of all the liabilities under the Credit Facilities and until the Borrower has got the discharge confirmed in writing from the Lender and all the dues and claims of the Lender hereunder or relating to the said Credit Facilities have been paid or satisfied.
>
> (10) Further, this guarantee shall be applicable to the ultimate balance to the extent of Borrower's indebtedness that may become due to the Lender from the Borrower under the Credit Facilities.
>
> (11) Notwithstanding the Lender receiving payments from the Borrower/ the Guarantor or any person or persons as aforesaid, or from any security held by the Lender of the whole or any part of the amount hereby guaranteed, if the Borrower shall become Bankrupt or insolvent or shall be ordered to be wound-up by an order of the court, the Lender shall be at liberty without discharging the Guarantor's liability to make or assent to any compromises, compositions or arrangements and to rank as creditors and to prove

against the estate of the Borrower for the full amount of the Lender's claim."

"(13) In case of any event of default on the part of the Borrower any indebtedness of the Borrower now or hereafter held by the Guarantor is hereby subordinated to the indebtedness of the Borrower to the Lender and such indebtedness of the Borrower to the Guarantor, if the Lender so requests, shall be collected, enforced and received by the Guarantor as trustee for the Lender and be paid over to the Lender on account of the indebtedness of the Borrower to the Lender but without reducing or affecting in any manner the liability of the Guarantor under the other provisions of this guarantee.

(14) The Lender may proceed against and recover from any of the Guarantor's property including any credit balance or security held/to be held in future, by the Lender on the Guarantor's account by sale and/or otherwise and allocate and apply the net proceeds of sale and realisation thereof and any other monies in the Lender's hands standing to the Guarantor's credit or belonging to the Guarantor …towards the payment of any monies to the extent of Borrower's Indebtedness payable by the Borrower/Guarantor to the Lender hereunder. … "

"(20) In order to give effect to this guarantee, the Lender shall be entitled to act as if the Guarantor is the principal debtor to the Lender for all payments and covenants hereby guaranteed."

The Committee notes that the term 'debt instrument' is neither defined in Ind AS 109 nor in Ind AS 32, 'Financial Instruments: Presentation'. The Committee is of the view that the term implies a contractual right to receive cash arising on account of a debtor-creditor or lender-borrower relationship. The Committee is of the view that apparently there is lender-borrower relationship between the subsidiary, A Inc. and the holder/beneficiary of the guarantee contract (viz., the bank). In case the subsidiary does not make payment to the holder/ beneficiary of the guarantee (viz., the bank) in accordance with terms of the Credit Facility Agreement and various loan and security documents executed between the subsidiary and the bank, the holder (bank) has a right to recoup the loss suffered by it from the Company. The Committee is, therefore, of the view that the corporate guarantee issued by the Company to the bank meets the definition of financial guarantee contract given in Ind AS 109. The Committee is also of the view that there exists a contractual right of the holder of the guarantee contract, to receive cash from the guarantor (viz., the Company) and a corresponding contractual obligation of the guarantor to pay the holder, if the subsidiary defaults. This is so even if the holder's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on future act of default by the subsidiary. Therefore, the contingent right and obligation meet the definition of financial guarantee contract, in accordance with the requirements of AG 8 of Ind AS 32.

14. The Committee further notes that the querist has argued that since the liability towards the loan has already been considered while working out the impairment valuation of investment in subsidiary, there is no requirement of creating any provision against the Company's guarantee given on behalf of A Inc. In other words, a financial guarantee in respect of such liability should not be recognised in the Company's financial statements. Further, it has been mentioned that considering the following points, there is no requirement of creating any provision against the Company's guarantee given on behalf of A Inc.:

a. Till date, A Inc. has not defaulted in its loan repayment, so there is no requirement of creating provision of guarantee, as the Company's guarantee will be invoked only when A Inc. defaults in loan servicing. Further, in future also, any default by A Inc. is not expected in loan servicing.

b. Outstanding loan amount of USD 72 Mn (as on 31.03.2021) has already been considered as payable while working out the equity valuation.

c. As per present valuation, equity fair value is negative only by USD 1.17 Mn and considering materiality concept, making provision of guarantee may not be required.

d. Present trend of crude price is on increasing side (A Inc. reserve value based on prevailing crude price of June 2021 has increased to USD 75.48 Mn from USD 65.13 Mn, which was based on the crude price of 31.03.2021) and based on these reserve, fair value of equity investment also turns out to be positive.

The Committee notes that the investment in the subsidiary and the financial guarantee issued by the Company to third party (bank) on behalf of the subsidiary are separate financial liabilities emanating from separate items with different parties in the two transactions and should be accounted for as per the relevant requirements of the applicable Standards. In case of financial guarantee, the Company has obligations towards the bank in terms of Deed of Guarantee which should be recognised as per the relevant applicable requirements of Ind AS 109. Therefore, the Committee is of the view that recognising the investment in subsidiary and impairment thereon that considers liabilities of the subsidiary towards the guarantee holder (viz., the bank) and providing for loss allowance on the financial guarantee contract shall not result in duplication or overstating of liabilities.

From the perspective of the separate financial statements, the reporting entity is the parent company only and not the group, i.e., parent company together with the subsidiaries. Therefore, while determining the expected credit loss on financial guarantee, it does not matter if the liabilities of the subsidiary have been considered while determining the impairment of investment in subsidiary.

Further, with respect to the querist's argument that till date, there is no default on the part of subsidiary on its loan repayment, and hence the corporate guarantees carry no risk, the Committee is of the view that the extent of credit risk shall not affect the initial recognition of the financial guarantee liabilities. However, this may be one of the factors that the Company may consider for the purpose of fair valuation at the time of initial measurement and for measuring the expected credit loss at the time of subsequent measurement. The Committee also wishes to point out that although the subsidiary has not defaulted in loan servicing payment in past, this fact does not guarantee that there cannot be defaults in payments in future as even though there may not be any intention of default on the part of subsidiary, the same depends on its future performance. Further, any expectation that there will not be any default in future considering the future performance of the subsidiary should be considered while measuring the expected credit loss on the financial guarantee liability rather than at the time of recognition of the same.

With regard to querist's contention that since as per present valuation, equity fair value is negative only by USD 1.17 Mn and considering materiality concept, making provision of guarantee may not be required, the Committee wishes to mention that the measurement of a guarantee obligation will not only consider crude reserve prices but also many other factors determining the ability of the subsidiary to honour its liabilities or payables on time.

In the above context, the Committee notes that as per the principles of Ind AS 38, the purpose of providing impairment of assets is to ensure that these are carried at no more than their recoverable amount, i.e., the amount to be recovered through use or sale of the asset. Similarly, the requirements to provide for expected credit loss under Ind AS 109 are also of the nature of impairment requirements, the purpose of which is to recognise expected credit losses for all financial instruments for which there are credit risk from initial recognition till the period over which the entity is exposed to credit risk considering all reasonable and supportable information, including that which is forward-looking.

15. Further, with regard to accounting treatment of such financial guarantee, the Committee is of the view that the guarantee obligations should be recognised

and measured as per the requirements of Ind AS 109 by the Company in its separate financial statements. In this regard, the Committee notes from paragraph B 2.5(a) of Ind AS 109 reproduced above and other requirements of Ind AS 109 (paragraphs 5.1.1, 5.1.1A, B5.1.2A) that the issuer of a financial guarantee should recognise it initially at its fair value. The Committee is of the view that this requirement is also applicable in respect of a guarantee issued by a parent on behalf of its subsidiary. Accordingly, in the extant case, the Company should initially recognise a liability (a deferred income such as 'unearned financial guarantee commission') at fair value in its separate financial statements.

The Committee also notes the requirements of Ind AS 109 in respect of subsequent measurement of financial guarantee as follows:

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

(a) …

(b) …

(c) *financial guarantee contracts*. After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:

(i) the amount of the *loss allowance* determined in accordance with Section 5.5 and

(ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115.

…"

"5.5.1 An entity shall recognise a loss allowance for *expected credit losses* on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a *contract asset* or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d)."

"5.5.6 For loan commitments and financial guarantee contracts, the date that the entity becomes a party to the irrevocable commitment shall be considered to be the date of initial recognition for the purposes of applying the impairment requirements."

"B5.5.8 For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract."

"B5.5.32 For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee."

From the above, the Committee notes that Ind AS 109 requires that at the time of subsequent measurement, financial guarantee should be measured at the higher of the amount initially recognised less cumulative amortisation, and the expected credit loss (ECL). Thus, ECL is to be considered on financial guarantee contracts at the time of subsequent measurement.

16. With regard to the disclosure requirements, the Committee notes that Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' states that:

"2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments*."

Therefore, financial guarantees, in the extant case, being governed by Ind AS 109, are not within the scope of Ind AS 37 and therefore, cannot be classified as contingent liabilities. Instead, the Company should comply with the relevant presentation and disclosure requirements of Ind AS 107, 'Financial Instruments: Disclosures' and related disclosures of Division II of Schedule III to the Companies Act, 2013 for financial liability. In this regard, the Committee notes that paragraph 8.2.14.2 of the Guidance Note on Division II-Ind AS - Schedule III to the Companies Act, 2013, issued by the ICAI, inter alia provides as follows:

"8.2.14.2. Ind AS Schedule III requires guarantees other than financial guarantees to be disclosed as a part of contingent liabilities, since financial guarantees are recognized on the balance sheet in accordance with Ind AS 109. Ind AS 107 specifies certain disclosure in respect of the exposure to credit risk on financial guarantee contracts as a part of the disclosures on 'credit risk exposures', which an entity should provide in its Notes to Accounts."

From the above, the Committee is of the view that the requirements of Ind AS 109 and Ind AS 107, 'Financial Instruments: Disclosures', notified under the Rules, to the extent relevant, should be considered while providing disclosures for the corporate guarantee issued by the Company. In particular, paragraph B10 of Ind AS 107 requires disclosure of maximum exposure of the financial guarantee to credit risk, which is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.

D. Opinion

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

(i) The Company should account for the financial guarantee contracts as per the requirements of Ind AS 109, as discussed in paragraphs 13-16 above.

(ii) The Company should consider expected credit loss on financial guarantee contracts at the time of subsequent measurement as per the requirements of Ind AS 109, as discussed in paragraph 15 above.

(iii) The Company should comply with the relevant presentation and disclosure requirements of Ind AS 107 and Division II of Schedule III to the Companies Act, 2013, as discussed in paragraph 16 above.

(iv) Refer above.

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Query No. 19

Subject: Accounting treatment of expenditure incurred on the assets not owned by the Company.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a company registered under the provisions of the Companies Act, 2013 in 2016. The Company is a Special Purpose Vehicle (SPV) for implementing Smart City

[1] Opinion finalised by the Committee on 27.10.2021.

Project of the Ministry of Urban Development (MoUD). The capital of the Company is contributed, subscribed and paid-up by the State Municipal Council.

2. The Company is responsible for monitoring and evaluation of completion and progress of the work/activities carried out by the State Municipal Council according to the time frame with regard to the project.

3. The querist has informed that the State Municipal Council has been appointed and engaged as the implementing agency to execute the Smart City Projects on the deposit work basis. Accordingly, a Memorandum of Agreement has been entered between the Company and State Municipal Council on July 18, 2018 for smooth working of both the entities. The Company has been given the limited time frame for the execution of the project by the Government of India (GoI).

4. The querist has further informed that the works to be executed by the Company in the project are development of new drainage system, facilities for general public, utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement etc.; and redevelopment of State Municipal Council area.

5. As per the querist, the funds of the Company are given as a grant and cost of execution of the project has to be met out from those funds and part of these funds received has been capitalised as equity capital of the Company.

6. The Company received the fund from Government of India and State Municipal Council as under:

At the start - Government of India - Rs. 196 crore and State Municipal Council – Rs. 200 crore aggregating to Rs. 396 crore. Out of Rs. 396 crore, the Company issued the share capital of Rs. 250 crore, out of which Rs. 194 crore was from Government of India and Rs. 56 crore was from the State Municipal Council.

7. All the works so executed under the project neither shall yield any revenue nor shall form part of assets of the Company. The works so completed and executed in part shall form the assets of the other entity, i.e., State Municipal Council. All development works shall not yield any revenue in future and none of the assets developed or created are controlled or owned by the Company.

8. The querist has stated that in the financial year (F.Y.) 2017-18, the Company has executed part of the main project as sub-projects worth Rs. 27.27 crore through two executing agencies (Rs. 21.29 crore for smart city development expenses and Rs. 5.98 crore for A Ltd. project). The expenses so incurred were charged as operating and other expenses by the management of the Company since the expenses were incurred towards the main object of

development works in the area of State Municipal Council. Further, any asset so generated or to be generated as part of the project shall not belong to, or be owned or controlled by the Company or booked under the Company's assets. (A copy of Guidelines applicable to the Smart City Mission as applicable for projects execution and related compliances and Memorandum of Agreement between the Company and the State Municipal Council have been supplied separately by the querist for the perusal of the Committee.)

9. The querist has also made specific reference to the following extracts from the Smart City Mission Guidelines, wherein the structure of such SPV is defined:

"**Annexure 5: Structure and Functions of SPV**

1. Structure of the SPV

The City level SPV will be established as a Limited Company under the Companies Act, 2013 and will be promoted by the State /UT and the ULB jointly, both having 50:50 equity shareholding. This shareholding pattern has to be maintained at all times. The private sector or financial institutions could be considered for taking equity stake in the SPV, provided the State/UT and ULB share are equal to each other, and the State/UT and ULB together have majority shareholding and control of the SPV (e.g. State/UT:ULB:Private sector shareholding can be in the ratio 40:40:20 or 30:30:40. Ratios such as 35:45:20 or 40:30:30 are not permitted since State/UT and ULB shares are not equal. Ratios such as 20:20:60 are also not permitted since the State/UT and ULB together do not have majority shareholding). In addition to equity, the State/UT can provide its contribution to the Smart Cities Mission as grant to fulfil the State Government responsibility for ensuring availability of funds for the mission and for ensuring the financial sustainability of the SPV.

2. Raising and utilization of funds by the Company (SPV)

The funds given by the Central Government to the SPV will be in the shape of tied grants and kept in a separate Grant Fund. These funds will be utilized only for the purposes given in the Mission Statement and Guidelines and subject to the conditions laid down by the Central Government. The ULBs may, through the State Government, request MoUD to permit utilization of GoI grants as ULB's equity contribution to the SPV, subject to the following conditions:

i. The State Government has made adequate contribution to the SPV out of their own funds.

ii. The approval will be limited to the GoI grants that have already been released. Since future instalments of Smart City funds are subject to performance and are not guaranteed, the ULB will not be permitted to earmark future instalments to meet its equity contribution.

iii. The utilization of the GoI grants as equity contributions will not alter the relative shareholding of the State Government and the ULB, which will remain equal as per Mission guidelines.

iv. It is clarified that the Government of India contribution to Smart Cities is strictly in the form of grant and the ULB is exercising its own discretion in utilizing these funds as its equity contribution to the SPV.

The SPV will also access funds from other sources such as debt, user charges, taxes, surcharges, etc.”

10. The Comptroller and Auditor General (CAG) conducted the supplementary audit of the Company for F.Y. 2017-18 and issued a half margin stating that as the expenditure incurred by the Company is out of capital contribution shown under the liability side of the balance sheet, the incurring of expenditure for the projects under the expenditure side of Profit and Loss Account is against the matching concept of accounting principles.

11. The querist has stated that it could be gathered from the CAG half margin that in the opinion of CAG, the expenses need to be capitalised and amortised over the period of its utility based on matching concept since they are paid out of the capital of the Company.

B. Query

12. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the expenses incurred are the operating expenses of the Company or whether these should be charged to the capital of the Company without going through the Profit and Loss Account for the financial year or whether the treatment of expenses as suggested by the CAG is correct.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to recognition of expenses incurred for smart city development and A Ltd. Project. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, classification and accounting for fund/grant/contribution received from the GoI/ULBs, accounting for share capital issued by the Company, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the legal perspective, such as, interpretation of Smart City Mission

Guidelines, MoA between the State Municipal Council and the Company etc. The Committee has also not examined whether the State Municipal Council, while providing funds to the Company is acting in the capacity of owner or as 'Government' as per Accounting Standard (AS) 12, 'Accounting for Government Grants', as this issue has not been specifically raised by the querist.

The Committee notes from the annual reports of the Company for the financial years 2017-18 and 2018-19 that the Company is following Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006[2] and accordingly, the opinion expressed hereinafter is from the perspective of the Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not from the perspective of Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee presumes from the Facts of the Case that the Company is not acting as an agent of the Government of India/State Municipal Council; rather it is acting in the capacity of principal.

At the outset, the Committee notes from the Facts of the Case that the querist has specifically stated that the expenses mentioned above (including expenditure in respect of A Ltd. Project) were charged as operating and other expenses by the management of the Company since the expenses were incurred towards the main object of development works in the area of State Municipal Council. Further, any asset so generated or to be generated as part of the Project shall not belong to or be owned or controlled by the Company or booked under the Company's assets. Accordingly, in the absence of any other specific information/details about A Ltd. project to the contrary, the Committee presumes that from accounting perspective, A Ltd. project is similar to or part of project of smart city development and, therefore, the Committee has not examined the expenses incurred in relation to A Ltd. project separately. In case, the nature, purpose and/or other modalities of A Ltd. project is/are different, the opinion expressed hereinafter will not be relevant for the A Ltd. project.

14. With regard to recognition of the expenses incurred on smart city development and A Ltd. project, the Committee notes that Clause 6 of Memorandum of Agreement (MoA) entered between the Company and State Municipal Council states as follows:

> "… the main objective of this agreement is to implement, manage and monitor arrangements made for the Smart City Development Projects for the area under "State Municipal Council" in accordance with the Smart City Mission Guidelines issued by Government of India.

[2]Companies (Accounting Standards) Rules, 2021 supersedes the Companies (Accounting Standards) Rules, 2006 with effect from accounting periods commencing on or after 1.4.2021.

…

6) Any construction/upliftment/re-modification on any asset of State Municipal Council under the Smart City Mission shall not dilute the right of State Municipal Council and it shall be the exclusive owner of that asset."

"II. SCOPE OF SERVICES TO BE PERFORMED BY STATE MUNICIPAL COUNCIL

…

1) State Municipal Council will maintain assets created for the purpose of this Project under this Agreement. The cost for maintenance of these assets including AMCs etc. are to be borne by State Municipal Council."

From the above, it is evident that the Company will neither get ownership rights of any assets created/modified as part of smart city development project nor maintain the same.

In this context, the Committee notes the definition of 'asset' from Accounting Standard (AS) 26, 'Intangible Assets' and paragraphs 14 and 56 thereof as follows:

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

> ***(a) controlled by an enterprise as a result of past events; and***
>
> ***(b) from which future economic benefits are expected to flow to the enterprise."***

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

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

From the above, the Committee notes that an asset is a resource *controlled* by the enterprise and an enterprise *controls* an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. Accordingly, the Committee is of the view that it is only where the asset is controlled by the Company in the manner envisaged by paragraph 14 of AS 26, the Company should recognise asset in its financial statements in respect of the expenditure incurred. However, in the extant case, the MoA clearly states that the State Municipal Council shall be exclusive owner of and shall maintain the assets created/modified as part of smart city development project. Further, the Committee notes from the Facts of the Case that the querist has specifically stated that "all development works shall not yield any revenue in future and none of the assets developed or created are controlled or owned by the Company".

Therefore, the Committee is of the view that in the extant case, the Company does not *control* the assets created/modified under smart city development project in the manner envisaged in the above-mentioned paragraphs of AS 26. Thus, the expenditure incurred for the smart city development and A Ltd. project should not be capitalised as an asset in the financial statements of the Company. Further, the Committee notes the following requirements of AS 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies':

> ***"5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."***

From the above and considering the requirements of paragraph 56 of AS 26, as reproduced above, the Committee is of the view that the expenditure incurred by the Company for the smart city development and A Ltd. project should be recognised as an expense in the Statement of Profit and Loss of the Company.

D. Opinion

15. The Committee is of the opinion that the expenses incurred for the smart city development and A Ltd. project should be recognised as an expense in the Statement of Profit and Loss of the Company, as discussed in paragraph 14 above.

Query No. 20

Subject: Classification of business activity as operating activity or investing activity.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a wholly-owned Government of India company, engaged in providing long-term finance to viable infrastructure projects through the Scheme for Financing Viable Infrastructure Projects through a Special Purpose Vehicle called 'the Company', referred to as SIFTI. The Company enjoys the status of public financial institution and is also registered as a Non-Banking Financial Company - Infrastructure Finance Company (NBFC-IFC) with the Reserve Bank of India. The Company is categorised as Systemically Important Non-Deposit taking company. The Company complies with various elements of RBI Regulations applicable to NBFC-IFC. As per SIFTI (a copy of which has been provided by the querist for the perusal of the Committee), "The Company would raise funds as and when required. The funds so raised may be utilised for on-lending and *surplus funds may be invested in marketable government securities* (G-Sec and T-Bills) and/or Certificates of Deposit, Fixed Deposits and, for Treasury Management purposes, in AAA rated PSU Corporate Bonds." (Emphasis supplied by the querist.)

2. The querist has stated that the Comptroller and Auditor General of India (C&AG) conducts supplementary audit of accounts of the Company under section 143(6)(b) of the Companies Act, 2013. The office of C&AG after completing the supplementary audit of the Company for financial year (F.Y.) ended 31st March 2020 has issued a letter dated 5th January 2021 and informed, inter-alia, the following:

"Cash Flow Statement is deficient as detailed below:

- Investment of Rs. 5297.60 crore in Government Securities has been shown under Operating Activities instead of Investing Activities which is in contravention to Ind AS 7.

- Similarly, receipt of Rs. 97.87 crore on account of sale of Government Securities has been shown under Operating Activities instead of Investing Activities.

- Equity Infusion of Rs. 188.45 crore in ABC (UK) Ltd., (a wholly owned subsidiary of the Company) has been shown under operating activities instead of Investing Activities."

[1] Opinion finalised by the Committee on 27.10.2021.

3. In this regard, the querist has submitted as follows:

A. <u>Investment of Rs. 5297.60 crore in Government Securities:</u>

a) The Company is operated under the Scheme for Financing Viable Infrastructure Projects (SIFTI) and as per this scheme; *the Company doesn't undertake any investment activities*. Interest/ income on surplus funds is considered as income from operations.

b) The surplus funds are invested in marketable government securities (G-Sec and T-Bills) and/or certificates of deposit, fixed deposits and, for treasury management purposes, in AAA rated PSU corporate bonds.

c) Government of India, on 30th March 2020 infused equity share capital, by way of Right Issue (Recapitalisation bonds) of Rs. 5,297.60 crore.

d) Consequently, the Government of India issued, vide Notification dated 26th March 2020, Special GoI securities (non-transferable) aggregating Rs. 5,297.60 crore. The special securities shall not be transferable and conversion in any other form of security is not permitted.

As per point 8 of the aforesaid Notification, "The investment in the special securities by the Company would not be considered as an eligible investment which the Company is required to make in Government securities in pursuance of any statutory provisions or directions applicable to the investing bank/company, i.e., the Company."

Considering the fact that the Company cannot undertake the investing activities and parked the surplus funds in Government Securities, which is the part of primary operations of the Company, the *subscription of Special GoI Securities is considered as operating activity* by the Company.

B. <u>Receipt of Rs. 97.87 crore on account of sale of Government Securities:</u>

a) *The Company doesn't undertake any investment activities.* The surplus funds are invested in marketable government securities (G-Sec and T-Bills) and/or Certificates of Deposit, Fixed Deposits and, for Treasury Management purposes, in AAA rated PSU Corporate Bonds.

b) The investment in government securities by the Company is considered as an operating activity. *Accordingly, the proceeds from* *maturity of any government security are treated as operating activity of the Company.*

Further, the querist has clarified that the receipt of Rs. 97.87 crore was on account of redemption of marketable Government Securities, other than special Government Securities.

C. **Equity Infusion of Rs. 188.45 crore in ABC (UK) Ltd.:**

a) ABC (UK) Limited, a 100% owned subsidiary of the Company, was incorporated in February 2008 to lend to Indian companies implementing infrastructure projects in India, or to co-finance their external commercial borrowings for such projects, solely for the capital expenditure outside India. The Company infused capital of Rs. 188.45 crore (USD 25 million) during the financial year 2019-20.

b) In accordance with the Company's plan for business continuance to further supplement financial resources for infrastructure development in India, ABC (UK) Ltd. was set up with the objective of lending in foreign currency to Indian companies implementing infrastructure projects in the Country specifically for import of capital equipment. The Reserve Bank of India (RBI) has extended line of credit of USD 5 billion from foreign exchange reserves for the same.

c) The Company's equity investment is a part of operating activity in the Cash Flow Statement considering it as an integral part of its operation to fund infrastructure loan.

It is also submitted by the querist that the Company had received a similar comment on classification of interest on fixed deposits as operating activity from the office of C&AG during the supplementary audit for the financial year ended 31st March 2010 and 31st March 2011. The matter was referred to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI). The *EAC opined (published as Query No. 16 of Volume XL (Part-II) of the Compendium of Opinions) that "it is appropriate for the company to treat interest on bank deposits as income from operations in its books of account and, accordingly, to consider and disclose interest on bank deposits as income from operations in preparation of financial statements including cash flow statement"*.

(Emphasis supplied by the querist.)

B. Query

4. On the basis of the above, the querist has sought the opinion of the EAC regarding classification of investment/redemption of government securities and equity investment in the cash flow statement.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to classification of investment/redemption of government securities and equity investment in the statement of cash flows, presented in accordance with Indian Accounting Standard (Ind AS) 7, 'Statement of Cash Flows'. The Committee has, therefore, examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of investment in foreign subsidiary in the financial statements of the Company, accounting for equity contribution received from the Government, classification of cash flows arising from investments other than the above-mentioned investments, if any, valuation of investments, etc. Further, the Committee presumes from the Facts of the Case that investments in marketable government securities do not meet the definition of 'cash equivalent' as per Ind AS 7.

6. The Committee notes that the Company in the extant case is a Non-Banking Financial Company - Infrastructure Finance Company and therefore, can be considered as a financial institution under Ind AS 7.

The Committee notes that the following three types of transactions/investments have been referred to in the extant case:

(i) Investment in Special government securities: These special securities shall not be transferable and conversion in any other form of security is not permitted.

(ii) Sale of marketable government securities other than special government securities as referred above.

(iii) Equity infusion in the wholly-owned subsidiary, ABC (UK) Ltd.

7. In the context of the issue raised, the Committee notes the following paragraphs of Ind AS 7, 'Statement of Cash Flows':

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

"14 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments from contracts held for dealing or trading purposes.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities. However, cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68A of Ind AS 16, *Property, Plant and Equipment,* are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

15 An entity may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities

since they relate to the main revenue-producing activity of that entity.

Investing Activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(a) *cash payments to acquire* property, plant and equipment, intangibles and other *long-term assets*. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) cash receipts from sale of property, plant and equipment, intangibles and other long-term assets;

(c) *cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes)*;

(d) *cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);*

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged."

"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 cost of obtaining financial resources or returns on investments."

"39 The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities."

(Emphasis supplied by the Committee.)

8. The Committee notes that in the definition of 'operating activity', reproduced in paragraph 7 above, the term 'principal' qualifies the term 'revenue-producing activity' and not just 'revenue'. Revenue may flow from activities undertaken by an entity or from a resource created or acquired by an entity. For example, in the case of manufacturing enterprises, plant and machinery (which are long-term assets) are resources and, hence, construction/acquisition of the same are investing activities, while purchase of raw materials, manufacturing and sale of finished goods are principal revenue-producing activities. Cash flows arising from such revenue-producing activities are, therefore, cash flows from operating activities. Similarly, investments are resources and, hence, normally, acquisition and disposal of investments (whether or not long-term - see the definition of investing activities, reproduced in paragraph 7 above) are investing activities even for a financial institution (unless held for trading or dealing purposes or which are considered to be cash equivalents), while earning of income, such as interest and dividend, may be the principal revenue-producing activity. Receipts of interest and dividend (for a financial institution) are, therefore, cash flows from operating activities.

Further, the examples cited in Ind AS 7 indicate that irrespective of the nature of an entity, purchase and sale of securities, such as debt and equity instruments, held for trading or dealing purposes or which are considered to be cash equivalents are operating activities, while purchase and sale of securities in other cases are investing activities (see paragraphs 15, 16(c) and 16(d) of Ind AS 7, reproduced in paragraph 7 above). The reason is that in the case of purchase and sale of securities held for trading or dealing purposes, earning of interest and dividend is an incidental activity only, while revenue is principally generated by the trading or dealing activities of the entity, and, consequently, purchase and sale of the securities themselves are principal revenue-producing activities. In fact, shares, debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are not long-term assets; rather considered similar to inventories. Hence, purchase and sale of securities held for trading or dealing purposes are not investing activities.

In the case of purchase and sale of securities held not for trading or dealing purposes, earning of interest and dividend is generally considered as the principal revenue-producing activity for a financial institution. In such cases, purchase of the securities is considered as acquisition of a resource for generating future revenue and not as a principal revenue-producing activity. Hence, sale of securities in such cases is also not a principal revenue-producing activity. Thus, it is possible that even for a financial institution, acquisition and disposal of some investments may qualify as investing activities.

This is evident from Illustrative Example B, titled 'Statement of cash flows for a financial institution', contained in International Accounting Standard (IAS) 7, 'Statement of Cash Flows', issued by the International Accounting Standards Board, wherein proceeds from sales of non-dealing securities and purchase of non-dealing securities are exhibited as cash flows from investing activities.

In the extant case, the Committee notes that investments in non-transferrable and non-convertible special government securities are apparently long-term in nature, having a tenure of 10-15 years and therefore, cannot be considered as held for trading or dealing purposes. Accordingly, considering the above discussion, the Committee is of the view that acquisition and disposal of the special government securities are investing activities and therefore cash flows from acquisition and disposal/maturity of such investments are cash flows from investing activities.

With reference to the above discussion, the Committee also notes from the annual report of the Company for F.Y. 2019-20 that in the extant case, the special government securities are carried at amortised cost and not fair value. Therefore, considering the facts of the extant case, the Committee has not examined the situation where investments are managed on a fair value basis and fair value changes are recognised in the Statement of Profit and Loss.

9. With regard to cash flows from redemption of government securities other than special government securities, the Committee is of the view that as discussed above, in the case of purchase and sale of securities, distinction between operating activities and investing activities is not made on the basis of whether an entity is a financial institution or not. Rather cash flows from

investments are classified as operating activities when these are held for trading or dealing purposes or are considered to be cash equivalents. Accordingly, in the extant case, the proceeds from redemption of government securities other than special government securities would depend upon whether these can be considered as held for trading or dealing purposes or are long-term resources. If investments in marketable government securities can be considered as held for trading or dealing purposes, cash flows from redemption of these securities should be considered as operating activities, otherwise these should be considered as investing activities.

10. With regard to cash flows from equity infusion in wholly-owned subsidiary, the Committee notes that the requirements of Ind AS 7 relating to investments in subsidiaries do not make distinction in classification due to an entity being a financial institution. Accordingly, considering the requirements of paragraph 39 of Ind AS 7 and the above discussion on investing activities, the Committee is of the view that the cash flows from obtaining control of a subsidiary cannot be considered as cash flows from operating activity and should be classified as cash flows from investing activity.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that in the Cash Flow Statement of the Company, presented in accordance with Ind AS 7, cash flows from purchase of special government securities should be classified as cash flows from investing activities, as explained in paragraph 8 above. With regard to cash flows from redemption of government securities other than special government securities, these can be considered as operating activities only if investments in marketable government securities can be considered as held for trading or dealing purposes; otherwise these should be considered as investing activities, as explained in paragraph 9 above. The cash flows to acquire investment in subsidiary cannot be considered as cash flows from operating activity and should be classified as cash flows from investing activity, as explained in paragraph 10 above.

ADVISORY SERVICE RULES OF THE EXPERT ADVISORY COMMITTEE
(***Applicable w.e.f. 1st July, 2017***)

1. Queries should be stated in clear and unambiguous language. Each query should be self-contained. The querist should provide complete facts and in particular give the nature and the background of the industry or the business to which the query relates. The querist may also list the alternative solutions or viewpoints though the Committee will not be restricted by the alternatives so stated.

2. The Committee would deal with queries relating to accounting and/or auditing principles and allied matters and as a general rule, it will not answer queries which involve only legal interpretation of various enactments and matters involving professional misconduct.

3. Hypothetical cases will not be considered by the Committee. It is not necessary to reveal the identity of the client to whom the query relates.

4. Only queries received from the members of the Institute of Chartered Accountants of India will be answered by the Expert Advisory Committee. The membership number should be mentioned while sending the query.

5. The fee charged for each query is as follows:

   (i) Where the queries relate to enterprises whose equity or debt securities are **listed** on a recognised stock exchange:

      (a) enterprises having an annual turnover exceeding Rs. 500 crores based on the annual accounts of the year immediately preceding the date of sending of the query

      Rs. 200,000/- plus taxes (as applicable) per query

      (b) enterprises having an annual turnover of Rs.500 crores or less based on the annual accounts of the year immediately preceding the date of sending of the query

      Rs. 100,000/- plus taxes (as applicable) per query

   (ii) Where the queries relate to enterprises whose equity or debt securities are **not listed** on a recognised stock exchange:

      (a) enterprises having an annual turnover exceeding Rs. 500 crores based on the annual accounts of the year immediately preceding the date of sending of the query

      Rs. 200,000/- plus taxes (as applicable) per query

(b) enterprises having an annual turnover of Rs.500 crores or less but more than Rs. 100 crores based on the annual accounts of the year immediately preceding the date of sending of the query

Rs. 100,000/- plus taxes (as applicable) per query

(c) enterprises having an annual turnover of Rs.100 crores or less based on the annual accounts of the year immediately preceding the date of sending of the query

Rs. 50,000/- plus taxes (as applicable) per query

The fee is payable in advance to cover the incidental expenses. Payments should be made by crossed Demand Draft or cheque payable at Delhi or New Delhi drawn in favour of the Secretary, The Institute of Chartered Accountants of India or may be made online using the link given below:

https://easypay.axisbank.co.in/easyPay/makePayment?mid=NDIzNjY%3D

6. Where a query concerns a matter which is before the Board of Discipline or the Disciplinary Committee of the Institute, it shall not be answered by the Committee. Matters before an appropriate department of the government or the Income-tax authorities may not be answered by the Committee on appropriate consideration of the facts.

7. The querist should give a declaration to the best of his knowledge in respect of the following:

   (i) whether the equity or debt securities of the enterprise to which the query relates are listed on a recognised stock exchange;

   (ii) the annual turnover of the enterprise to which the query relates, based on the annual accounts of the accounting year immediately preceding the date of sending the query;

   (iii) whether the issues involved in the query are pending before the Board of Discipline or the Disciplinary Committee of the Institute, any court of law, the Income-tax authorities or any other appropriate department of the government.

8. Each query should be on a separate sheet and one copy thereof, duly signed should be sent. The Committee reserves the right to call for more copies of the query. A soft copy of the query should also be sent through E-mail at eac@icai.in

9. The Committee reserves its right to decline to answer any query on an appropriate consideration of facts. If the Committee feels that it would

not be in a position to, or should not reply to a query, the amount will be refunded to the querist.

10. The right of reproduction of the query and the opinion of the Committee thereon will rest with the Committee. The Committee reserves the right to publish the query together with its opinion thereon in such form as it may deem proper. The identity of the querist and/or the client will, however, not be disclosed, as far as possible.
11. It should be understood clearly that although the Committee has been appointed by the Council, an opinion given or a view expressed by the Committee would represent nothing more than the opinion or view of the members of the Committee and not the official opinion of the Council.
12. It must be appreciated that sufficient time is necessary for the Committee to formulate its opinion.
13. The queries conforming to above Rules should be addressed to the Secretary, Expert Advisory Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi-110 002.

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