

Query No. 17

Subject: *Accounting for interest earned on unutilized idle funds received as loan from the Governments/ Financial Institution for executing the capital projects.*¹

A. Facts of the Case

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

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

3. The Ministry of Power (MOP), Government of India (GoI) has introduced Restructured Accelerated Power Development and Reforms Programme (RAPDRP) Scheme during 11th Five Year Plan as Central Sector Scheme (relevant extracts from which have been separately supplied by the querist for the perusal of the Committee). A corporation, ABC, has been made a nodal agency to operationalise the programme under the guidance of the Ministry of Power. For implementation of the approved projects, funds are provided as a loan for the works within the scope of scheme from the Government of India on the terms decided by the Ministry of Finance. Accordingly, the company is receiving funds from ABC for executing above capital projects.

4. With regard to RAPDRP, the querist has also separately informed that as a part of distribution reforms, GOI had launched APDRP (Accelerated Power Development Programme) in 2001 which was later rechristened as APDRP (Accelerated Power Development and Reforms Programme) during the 10th Five Year Plan. To continue the support to distribution reforms during the 11th Five Year Plan, GOI has reintroduced R-APDRP (Restructured APDRP) with revised terms and conditions. The R-APDRP primarily aims at reducing Aggregate Technical and Commercial (AT&C) losses in urban areas. It is a necessary condition of the scheme that the utilities would need to demonstrate performance improvement for availing financial benefits provided under the scheme. The R-APDRP programme covers urban areas - towns and cities with population of more than 30,000 (10,000 in case of special category states). MOP, GOI has appointed ABC as the nodal agency for implementing this programme. R-APDRP programme is being taken up in two parts. Part-A includes the projects for establishment of baseline data and information technology (IT) applications for energy accounting/ auditing and IT based consumer service centers. Part-B includes regular distribution strengthening projects. Scope of works of Part-A and Part-B are as follows:

Part-A includes among others:

¹ Opinion finalised by the Committee on 26.10.2016.

- Consumer Indexing
- GIS Mapping, Asset Mapping
- Metering of Distribution Transformers / Feeders
- Automatic Data Logging
- Feeder Segregation/ Ring Fencing
- IT applications for redressal of consumer grievances, meter reading, billing & collection,
- Energy Audit
- Establishment of the Base Line data System

Part-B will include among others:

- New 33/11 KV substation.
- Augmentation of power transformers (PTs) and installation of additional PTs.
- 33 KV line on single and double suspension with Panther conductor.
- New 33 KV and 11 KV line with AAA Dog conductor/XLPE Cable.
- Augmentation of conductor size of existing 33 and 11 KV lines.
- HVDS scheme using 16 KVA and 25 KVA transformer.
- Installation, augmentation and relocation of distribution transformers.
- New LT line & re-conditioning by XLPE AB Cable size 3x50+1x35+1x16 sq.mm and replacement of bare conductor by 3x95+1x70+1x16

5. *Funding of Schemes/ Projects:*

- GoI through ABC is providing 100% loan for Part A of the schemes including IT applications and projects for establishing base line data.
- GoI through ABC is providing 25% loan for Part B of the schemes (90% for special category States).
- The counterpart funding (75%) has been arranged from another corporation, XYZ.

6. *Conversion of GoI Loan to Grant:*

- The entire amount of GoI loan (100%) for Part A of the project shall be converted into grant after establishment of the required base-line data system within a stipulated time frame and duly verified by monitoring agency.
- Upto 50% (90% for special category States) loan provided by the GoI for Part-B projects shall be converted into grant progressively on achievement of AT&C loss reduction targets.

7. The querist has stated that there is a time gap between receiving of funds and actual utilization of funds. Therefore, the company temporarily parks / invests the idle funds which are not utilised immediately in nationalised banks for earning opportunity cost on such idle funds. The interest earned on such investments is treated as interest income and is shown under the income head of the financial statements for the year.

8. The querist has also submitted that the company is an electricity distribution licensee and being governed under the Electricity Act, 2003, the *tariff* (sale price) of electricity is decided by the Madhya Pradesh Electricity Regulatory Commission (MPERC). As per the

MPERC regulation and practice followed by MPERC, while determining the *tariff* (sale price), MPERC reduced interest earned on fixed deposit from total cost of supply of power and only remaining amount is allowed to recover from the consumers as revenue from sale of power.

9. Due to above treatment of interest income while computing *tariff*, since total interest income (earned on investment as well as earned on advance) is adjusted against the cost of supply to determine the tariff of power, the company is of the view that the appropriate treatment of interest earned on unutilized idle project funds is to treat it as revenue income rather than to reduce the interest from capital work in progress. The querist has also stated that the work under RAPDRP scheme is being executed by the company through contractor selected on the basis of tendering system on turnkey basis. As per the provision of the tender document, various types of advances are provided by the company to the turnkey contractor. The company charges interest on such advances from the contractors. This interest is shown as other income in the accounts of the company. However, Comptroller and Auditor General (CAG auditor) is of the view that same has to be credited in the cost of work and therefore, opinion of the Committee is also sought on this matter.

10. The querist has referred to paragraphs 6, 7 and 8 of an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) finalised on 22/04/2000 (published as Query No. 6 of Volume XX of the Compendium of Opinions) on the subject 'Treatment of interest earned on idle project funds', which are reproduced as under:

“6. The Committee notes from the facts of the query that the final product of the company is compulsorily acquired by the government at the compensation rate fixed by the government. The Committee also notes that in determining the compensation rate, any interest (or other similar income) earned by the company from investment of idle funds is deducted from the cost of production.

7. The 'Guidance Note on Treatment of Expenditure During Construction Period', issued by the Institute of Chartered Accountants of India, recommends that interest from investment of idle project funds should be adjusted in the capital cost of the project (paragraphs 8.1, 15.2 and 17.11). The Committee is of the view that this general principle is not applicable in the present case due to its special circumstances. As mentioned earlier, interest arising from investment of idle project funds (as well as other funds) is reduced from the cost of production and a return on capital employed is added to the resultant figure to determine the compensation rate for the final product. Thus, there is a clear nexus between interest earned and sale proceeds from the final product. The higher the interest earned, the lower the sale proceeds, and vice versa. The Committee is of the view that the accounting treatment of interest should clearly reflect its nature as discussed above.

8. Based on the above, the Committee is of the view that interest earned by the company on investment of idle funds should be treated as of revenue nature and shown separately in the financial statements, if material. The Committee is of the view that under the facts and circumstances of the case, adjusting the interest earned on investment of idle project funds against the project cost would not be appropriate.”

11. The querist has submitted that the facts and grounds of the above opinion are similar to that of the company. If the company earns less interest, then MPERC shall allow more revenue from sale of power and vice-versa. Based on the above opinion, the company is of the view that the accounting treatment of interest earned on idle funds as interest income seems appropriate instead of adjusting with cost of the project or showing as payable towards funding agency.

12. However, while conducting audit of annual accounts of the company for the financial year (F.Y.) 2013-14, the Government auditor (CAG auditor) observed that as the company has incurred an extra expenditure on the scheme by way of payment of interest; hence, any income realised should be adjusted against the project cost instead of treating as income. (The querist has supplied a copy of CAG comments issued to the company for the perusal of Committee.)

13. The querist has also informed that the auditor was requested to consider the above opinion of the Expert Advisory Committee of the ICAI on the same subject matter but it was not considered by them.

14. Further, the querist has stated that as per general instruction no.3 to the Companies (Accounting Standards) Rules, 2006, the Accounting Standards are intended to apply only to items which are material.

B. Query

15. In light of the above facts and EAC opinion, the Committee is requested to provide the opinion on the following issues:

- (i) Accounting treatment of interest earned on unutilised idle funds received as loan /equity / grants from the governments / financial institution for executing the capital projects and interest earned on advances from the contractors.
- (ii) As observed by the CAG in its comment, the amount of interest earned on surplus fund is Rs. 11.79 crore as against the total turnover of the company, which is Rs. 6956 crore. Therefore, in the light of principle of materiality, whether the treatment given by the company in its books of account is correct or not.

C. Points considered by the Committee

16. The Committee notes that the basic issues raised in the query relate to accounting treatment of interest earned on unutilised idle funds received as loan /equity / grants from the governments / financial institution for executing the capital projects and interest on advances from the contractors. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, whether the projects/assets coming into existence under RAPDRP scheme can be considered as 'qualifying asset' under Accounting Standard (AS) 16, 'Borrowing Costs', accounting for interest on borrowed funds, accounting for conversion of loan into grant, etc. Further, the Committee has expressed its opinion purely from accounting perspective and not from the perspective of determination of tariff by MPERC. At the outset, with regard to the contention of the querist in respect of the earlier opinion of the Committee, the Committee wishes to point out that the earlier opinion had been given considering the requirements of the Guidance Note on

Treatment of Expenditure during Construction Period, which was withdrawn by the Council of the ICAI in August, 2008 and therefore, the opinion expressed considering the requirements of the said Guidance Note is not relevant in the extant case. Moreover, there are other earlier EAC opinions on the similar subject which, although have not been referred to by the querist but may be relevant in the extant case. Further, the Committee wishes to point out that since the query refers to the financial year 2013-14, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification. At the outset, the Committee has also presumed from the Facts of the Case that during the financial year 2013-14, there was no reasonable assurance that the conditions for conversion of loan into grant will be complied with and therefore, the funds provided by the GoI are being treated as loan.

17. With regard to interest income earned on idle funds invested, the Committee notes that as per the requirements of paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', "all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise". Thus, the income in the extant case can be adjusted against the project cost only when an Accounting Standard requires the same. In this regard, the Committee notes that in case of borrowed funds, requirements of AS 16 shall be applicable. Accordingly, the Committee notes paragraphs 10 and 11 of AS 16, notified under the Rules as follows:

"10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred."

The Committee notes from paragraphs 10 and 11 of AS 16 above that the income earned from temporary investment of specific borrowed funds while the project is in the stage of construction is to be adjusted with the borrowing costs to be capitalised with the qualifying assets only in case the funds are borrowed specifically for qualifying assets. Since in the extant case, the company is receiving borrowed funds from ABC/Government for specific capital projects, the funds can be considered to be specific borrowed funds. Therefore, the Committee is of the view that if the projects undertaken under RAPDRP scheme or the assets coming into existence therefrom can be considered as qualifying assets under AS 16, income earned from temporary investments of the borrowed funds during the construction period should be set-off against the borrowing costs to be capitalised with the qualifying assets as per the principles of AS 16.

18. With regard to interest income earned on advance to contractors, the Committee notes from the Facts of the Case and the extracts of the RAPDRP scheme provided by the querist that two types of advances (mobilisation advance and material advance) have been provided by the company to the contractor. One advance payment, which is 70 percent of the contract price appears to be given for purchase of materials by the contractor and the other 10 percent payment is being made at the beginning of the contract after receipt of an irrevocable advance payment security for the equivalent amount in favour of the company. Thus, from the facts of the case, it appears that the advances in the extant case are incidental to construction activity of the project and are an integral part of the contract with contractors and therefore, the Committee is of the view that interest earned thereon can be considered to be arising from activities that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its working condition for its intended use. In this regard, the Committee notes that as per the requirements of Accounting Standard (AS) 10, 'Accounting for Fixed Assets'², notified under the Companies (Accounting Standards) Rules, 2006, only those items of costs which are directly attributable to bringing the fixed asset to its working condition can be included in the cost of the asset. The Committee is of the view that the same principles can also be extended in respect of an item of income arising during the acquisition/construction of a fixed asset/project. Thus, only those items of income arising from the activities would go on to reduce the fixed asset/project cost, that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its working condition for its intended use. Accordingly, interest earned on the advances out of the borrowed funds in the extant case should be adjusted against the cost of the relevant fixed asset/project, to the extent of interest expense capitalised.

19. In other cases, viz., when the project/asset(s) under RAPDRP scheme cannot be considered as qualifying asset(s) or where funds are received as equity or as grant, considering the above-reproduced requirements of AS 16 and since there is no other specific requirement in any other accounting standard for adjusting such interest income with the cost of the project/fixed asset(s), the Committee is of the view that such income from temporary investment of the these funds cannot be adjusted against the cost of the project/fixed asset(s) and should be recognised in the statement of profit and loss.

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

"c. Materiality

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."

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

21. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If an information is not material, on the consideration of materiality as mentioned in the paragraph 20 above, its accounting would not have any effect on the decisions of the users of the financial statements. Thus, assessment of materiality is a matter of judgement and needs to be determined under the specific facts and circumstances of the company concerned. Accordingly, in the extant case also, the Committee is of the view that it needs to be determined under the specific facts and circumstances of the company as to whether interest income (earned on investment as well as earned on advances), if not accounted for appropriately, can influence the decisions of the users of the financial statements. For this purpose, apart from the volume of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered. Moreover, materiality concept should be seen in totality.

D. Opinion

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

- (i) (a) If the projects undertaken under RAPDRP scheme or the assets coming into existence therefrom can be considered as qualifying assets under AS 16, income earned during the construction period from temporary investments of the borrowed funds in the extant case should be set-off against the borrowing costs to be capitalised with the qualifying assets as per the principles of AS 16. Further, with regard to interest income earned on advances to contractors out of the borrowed funds, the same in the extant case can be adjusted against the cost of the project/fixed asset, to the extent of interest expense capitalised, as discussed in paragraph 18 above.
- (b) In case the funds are borrowed for non-qualifying assets, or if the funds were received as equity funds/grant, the interest earned on the temporary investment of such funds cannot be adjusted against the cost of the project/fixed asset(s) and should be recognized in the statement of profit and loss, as discussed in paragraph 19 above.
- (ii) The aforesaid opinion of the Committee would be applicable only if the amounts involved are material and the considerations of materiality should be applied in the specific facts and circumstances of the company. For this purpose, apart from the volume of transactions and quantum of turnover, other factors such as nature of the item, impact on profit/loss etc., should also be considered, as discussed in paragraphs 20 and 21 above.
