

Query No. 22

Subject: *Accounting treatment of expenditure relating to cost of utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. which are compulsorily required to be incurred for construction of Mass Rapid Transit System (MRTS) project.*¹

A. Facts of the Case

1. The opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) is being sought on accounting treatment of expenditure relating to cost of utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. which are compulsorily required to be incurred for construction of Mass Rapid Transit System (MRTS) project. According to the querist, these are the directly related expenditure without incurrence of which construction of MRTS project could not have taken place.

Background

2. Ministry of Urban Development (MoUD) vide sanction Order dated 26.09.2011 has given an investment approval of the Union Cabinet for Mass Rapid Transit System (MRTS) Phase III project based on detailed project report (DPR). The capital cost of the project as stated in the DPR includes civil engineering works, depot, utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement, traction and power supply, signaling and telecommunication works etc. According to the Querist, for the total cost of the project including utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc, funds have been arranged by the Government of India (GoI) and Government of National Capital Territory of Delhi (GNCTD). In view of the above arrangement, the cost incurred on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. was considered as part of the cost of the MRTS project. This practice is continuously followed since inception in Phase I and Phase II also.

Observation raised by Resident Audit Party of Comptroller and Auditor General (C&AG):

3. The querist has informed that on the above accounting treatment during the year 2014-15, Resident Audit Party of C&AG has issued half margins which are reproduced below along with the management reply:

“Balance sheet

Fixed assets- Capital work-in-progress – Rs. 11,410.61 crores

The above includes Rs. 78.40 crores (46.78 crores during 2014-15 and previous years Rs. 31.62 crores) being expenditure incurred towards road diversion works, renovation work of drains, strengthening/upgradation of existing road, provision of new/temporary works, road renovation works and utility shifting on temporary land. The same should have been charged off to revenue in the year of incurrence for the following reasons:

¹ Opinion finalised by the Committee on 16.1.2017.

- As per Accounting Policy No. 6.7 of the company- *“Expenditure on the items, ownership of which is not with the company is charged off to revenue in the year of incurrance of such expenditure”*. As per the nature of expenses incurred towards road diversion works, renovation works of drains, strengthening/upgradation of existing roads, provision of new /temporary works, road renovation works and utility shifting on temporary land are incurred on land not owned by the company. Hence, classifying the same as capital works in progress as against expenditure is not in accordance with the stated accounting policy of the company.
- As per paragraph 49 of the Framework for Preparation and Presentation of Financial Statements, *“An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise”*. Further, as per the provisions of Accounting Standard (AS) 26, ‘Intangible Assets’, *“An asset is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise”*. Hence, though the expenditure incurred on the said items are incidental to construction, since the company does not have exclusive rights over the use of such assets and also cannot restrict the access of general public for use of such assets, these expenses do not qualify as an ‘asset’.
- In Query No. 2 of Volume XXX of Compendium of Opinions, the Expert Advisory Committee of the Institute of Chartered Accountants of India had opined on the accounting treatment relating to ‘enabling assets’ which comprise accounting treatment of expenditure on items like roads, railway sidings etc., which are incurred to facilitate the construction of a project and subsequently to facilitate its operations and the ownership of which does not vest with the company. The Committee opined that *since the ownership of the 'enabling assets' does not vest with the company, the assets are available for general public use; hence, although the company is entitled to use these assets for the purpose of completing its own projects and subsequently for operational purposes, it has no say on the use of such assets by others. Thus, 'enabling assets' are not resources controlled by the company and, therefore, the expenditure incurred by the company on such 'enabling assets' cannot be capitalised as a separate tangible asset*. The EAC opinion also stipulated that *expenditure on 'enabling assets' was not a directly attributable cost, and accordingly, the same cannot be capitalised as a fixed asset*. Hence as per EAC opinion, the expenditure on 'enabling assets' should be expensed by way of charge to the profit and loss account of the period in which the same is incurred.
- The EAC Opinion also further stated that expenditure on such assets not owned by the company appearing as CWIP, being an error should be rectified and disclosed as a 'prior period item' as per the requirements of Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’ in the financial statements of the period in which such rectification is carried out.

Hence, classifying the same under CWIP is not in compliance of the stated accounting policy of the company, the definition of ‘control’ embodied in the definition of asset and also an EAC opinion in this regard.

This has resulted in overstatement of CWIP, understatement of expenditure and consequent understatement of loss to the extent of Rs.78.40 crores (46.78 crores during 2014-15 and Rs. 31.62 crores for the prior period).”

Management Reply

4. The management reply to CAG is as follows:

“Ministry of Urban Development (MoUD) vide sanction order dated 26.9.2011 has given an investment approval of the Union Cabinet for MRTS Phase III project based on detailed project report (DPR). *The capital cost of the project as stated in the DPR includes civil engineering works, depot, utility diversions, environmental protection, other miscellaneous works including road diversions, road signages, rehabilitation and resettlement including road restoration, traction and power supply, signaling and telecommunication works etc.*

As already explained that the total cost of the project including utility diversions, environmental protection, compensatory afforestation will be funded by the Government of India (GoI) and Government of National Capital Territory of Delhi (GNCTD) in equal proportions.

As per the above mandate, utility diversion work has been done which is essential activity before start and during execution of MRTS Phase III project. These are the expenditures without the incurrance of which, the construction of MRTS project could not have taken place and the project could not be brought to its working condition. Further, by incurring such expenditure, no separate asset item in the nature of enabling assets is created. Hence, the question of ownership of enabling assets, either with the company or not with the company, does not arise. Rather, these activities are ancillary type of activities which are required to be completed before completion of MRTS project. This is exactly in the nature of an attributable cost of bringing the MRTS project to its working condition for its intended use.

The company in turn raised demands from the respective Governments for financial assistance in line with the mandate of the total project cost which includes utility diversion, road diversion, renovation work of drains, strengthening/upgradation of existing road etc. Hence, the cost of these utility diversions are completely funded by the GOI and GNCTD in their respective shares as part of the total cost of MRTS project.

Further, in an opinion given by the Expert Advisory Committee (EAC) on 6.4.2013 in response of Query No. 6, Volume XXXIII of the Compendium of Opinions, on an issue raised in context of a metro rail project, the Committee considered the following contents of paragraphs 9.1, 9.2, 20 and 21 of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’ and opined as below:

“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use, any trade

discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

- (i) site preparation;
- (ii) initial delivery and handling costs;
- (iii) installation cost, such as special foundations for plant; and
- (iv) professional fees, for example fees of architects and engineers.”

“9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.”

“20 The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.

21 The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.”

“From the above paragraphs of AS 10, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to a fixed asset under construction is that it should be directly attributable to the construction of the fixed asset for bringing it to its working condition for its intended use. These are the expenditures without the incurrence of which, the construction of fixed asset could not have taken place and the asset could not be brought to its working condition, such as, site preparation costs, installation costs, professional fees, etc.”

“The Committee is further of the view that the above principles of capitalisation relating to a fixed asset are equally applicable to a group of assets including a project. Accordingly, the expenses incurred in the instant case are specifically incurred for the project and are directly attributable to it, hence capitalised as discussed in paragraph 9 above. Charging of such expenditure to the statement of profit and loss will be in contravention of the provisions of paragraph 9.1 of AS 10.”

Further, the auditor commented that the accounting treatment of expenditure incurred by the company towards utility diversion including improvement/diversion of roads is not in consonance with the opinion of Expert Advisory Committee (EAC) in Query No. 2 of Volume XXX of the Compendium of Opinions as it is in the nature of ‘enabling assets’ which do not construe as directly attributable expenses. In this reference, it is to clarify that the referred opinion has been given by the EAC for a public sector undertaking (PSU) engaged in refining and marketing of petroleum products. In this opinion, the querist had clearly stated that for setting up of a new refinery, it had to incur expenditure on the construction/development of certain assets, like electricity, transmission line, railway siding, roads, culverts, bridges, etc. in order to facilitate construction of the project and subsequently to facilitate its operation. The ownership of such assets is referred to as ‘enabling assets’.

The nature of expenditure towards utility diversion including improvement/diversion of roads incurred by the company in the extant case is entirely different from the expenditure incurred by the querist company in that case because unlike the above PSU, the company is not going to create any such enabling asset by incurring such type of expenditure, rather these are the expenditures without the incurrence of which, the construction of MRTS project could not have taken place and the project could not be brought to its working condition.

In view of this, it is to mention here that the grounds raised by the querist in the aforesaid opinion are not similar as that of applicable to the company, as the nature of expenditure incurred by the company towards utility diversion including improvement/diversion of roads is different and not related to the category of enabling assets.

However, the company has an accounting policy No. 6.7 in place, which states that any expenditure which comes under the category for creation of enabling assets is charged off to revenue in the year of incurrence of such expenditure.

In true spirit, the above policy is approved for some special type of works, like creation of sub-station on behalf of Delhi Vidyut Board, drainage system on behalf of civic agencies, etc. which are very well covered under the definition of enabling assets as pointed out by audit. But this policy does not cover the cost, which is directly attributable to bringing the MRTS project to its working condition for its intended use. Hence, cost incurred by the company towards road diversion work, strengthening/upgradation of existing roads and other utility diversion works to the extent it requires to start-up the construction of MRTS project are not covered in accounting policy no. 6.7 of the company, rather these are directly attributable cost of bringing MRTS project to its working condition for its intended use in line with the provisions of AS 10².

In view of the facts mentioned above, it is clear that the grounds of reference as mentioned by the audit in the accounting policy no. 6.7 of the company, paragraph 49 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountant of India and EAC opinion in Query No. 2 of Volume XXX of the Compendium of Opinions are not in line with the nature of expenditure incurred by the company on utility diversion including improvement/diversion of road etc.

Since the grounds of reference of EAC opinion in Query No. 2 of Volume XXX of the Compendium of Opinions are different from the grounds of directly attributable cost incurred by the company for construction of MRTS Project, there is no question of error or omission incurred by the company as per the requirements of AS 5.

Further, it is not out of place to mention here that the accounting treatment of capitalisation of the cost/ expenditure incurred for construction of MRTS project is in accordance with the funding arrangement of the Government of India. The Expert Advisory Committee in another

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

earlier opinion, published as Query No. 1 of Volume XXXIV of the Compendium of Opinions, raised by the company also accepted the accounting treatment for capitalisation of interest paid on enhanced compensation as cost of land upto the date of the court's order whereas this interest element is charged to revenue in case of other companies as mentioned in EAC opinion on Query No. 28 of Volume XXV of the Compendium of Opinions.

The company has been consistently following the same practice since inception.

In view of above submission, the audit is requested to drop the preliminary audit observation.”

(Emphasis supplied by the querist.)

Assurance given by the company to C&AG

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

“Regarding expenditure of Rs. 76.46 crores incurred on compensatory plantation and Rs. 78.40 crores towards road diversions/renovation work etc. during construction phase, it is assured that the complete accounting treatment on the above expenditure shall be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India.”

Points for consideration of the Expert Advisory Committee

6. In this whole issue, the querist has submitted the following for consideration of the Expert Advisory Committee before issue of an expert opinion:

- (i) The funding of capital cost of MRTS project of Phase III as stated in the detailed project report (DPR) is fully arranged by the Government of India and Government of National Capital Territory of Delhi which also includes the part cost relating to utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc.
- (ii) These are the expenditure without incurrence of which the construction of MRTS project could not have taken place and the project could not be brought to its working condition.
- (iii) These expenses are directly attributable to MRTS project and required to be incurred only in case of execution of the MRTS project *otherwise not*.
- (iv) Further, it is not out of place to again mention here that accounting treatment of capitalisation of the cost/expenditure incurred for construction of MRTS project is in accordance with the funding arrangement made by the Government of India.
- (v) The company is consistently following the same practice since inception in Phase I and Phase II also of MRTS project.

- (vi) The relevant paragraphs of AS 10 defining components of cost of an item of fixed asset which, in the view of the querist, also covers the direct cost of utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. required to be incurred for construction of MRTS project are reproduced below:

“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

- (i) site preparation;
- (ii) initial delivery and handling costs;
- (iii) Installation cost, such as special foundations for plant; and
- (iv) professional fees, for example fees of architects and engineers.

9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized as an indirect element of the construction cost.

...

10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

20. *The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.*

21. *The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.*

B. Query

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

- (i) Whether the company’s accounting treatment to capitalise cost of utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. is in line with the provisions of Accounting Standard 10.

- (ii) If no, what is the alternative accounting treatment available with the company regarding:
 - (a) treatment of such expenditure relating to utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system, rehabilitation and resettlement etc. and also
 - (b) treatment of funds received by the company from the GOI and GNCTD towards financing of such expenditure.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting treatment of expenditure incurred on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement. Accordingly, the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of expenditure other than stated above. At the outset, the Committee wishes to point out that the issue raised in the extant case is with regard to accounting treatment of the aforementioned expenditure and not whether the same are of the nature of 'enabling asset'. Accordingly, the Committee has not examined the issue as to whether the expenditure incurred can be considered as 'enabling asset'. Moreover, it may be mentioned that the term 'enabling asset' is not an accounting term and the accounting for an item of expenditure essentially depends on the nature of such item. The Committee, while expressing its opinion, has presumed that the MRTS project is owned and controlled by the company and the company is not acting only as an implementing/executing agency of the Government. Further, the Committee wishes to point out that since the query refers to the financial year 2014-15, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

9. At the outset, the Committee wishes to mention that in the absence of specific details regarding nature of activities undertaken on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement etc. and nexus/relation of the expenditure incurred with the construction activity of the MRTS project, the Committee has, hereinafter laid down only the principles to be followed while accounting for such kind of expenditure. In this context, the Committee notes paragraphs 9.1, 9.2, 10.1, 20 and 21 of AS 10 as reproduced in paragraphs 4 and 6 above. From a holistic reading of the above paragraphs of AS 10, the Committee notes that an item of cost should be capitalised with the cost of a fixed asset/project under construction only when it is directly attributable to the construction of the project/fixed asset for bringing it to its working condition for its intended use. The Committee is of the view that the costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are *generally* those directly related costs without the incurrence of which, the project/ fixed asset could not be brought to its working condition for its intended use, such as, site preparation costs, installation costs, profession fees, etc. Thus, the accounting for each of the item of expenditure depends on the nature thereof and the same can be capitalized as a part of the cost of the

project/fixed asset(s) only if it can be considered to be directly attributable to the construction activity of MRTS project/fixed asset(s). The Committee is further of the view that in the extant case, for qualifying an item of expenditure to be capitalised as a part of the MRTS project cost, it should not merely be incidental to the construction activity or only agreed to be incurred as a part of the MOU or agreement or understanding with the Government while approving the construction project. For example, if an expenditure, say, on renovation of existing road/environmental protection is being incurred only as a part of the understanding with the Government to be incurred while approving the project and not because it is directly attributable to the construction activity of the MRTS project/fixed asset, the same should not be capitalised. On the other hand, if an expenditure, say on road diversion/utility diversion, the diversion work is in the nature of site preparation activity of the MRTS project/fixed asset(s), the same can be considered to be directly attributable to the construction of the MRTS project/fixed asset(s) and therefore, capitalised as a part of the cost of MRTS project/fixed asset(s). Accordingly, the Committee is of the view that considering the above-mentioned factors, the company in the extant case, should evaluate the nature of each item of expenditure, as raised in the query as to whether the same is directly attributable to construction of MRTS project/fixed asset(s) or not and on that basis, decide whether the same needs to be capitalized or not with the cost of the project/fixed asset(s) concerned.

D. Opinion

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

- (i) Whether the treatment made by the company to capitalise the expenditure incurred on utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement which is compulsorily required to be incurred for the construction of MRTS project is in accordance with AS 10 or not would depend upon the nature of each item of expenditure and whether such expenditure can be considered to be directly attributable to the construction of MRTS project/fixed asset(s), considering various factors, as discussed in paragraph 9 above.
- (ii) In case, considering the nature of the expenditure incurred and other factors, as discussed in paragraph 9 above, an item of expenditure is not considered to be directly attributable to the construction of MRTS project/fixed asset(s) and therefore, not capitalised, the same should be charged to the statement of profit and loss in the year of incurrence of such expenditure. Further, the treatment of funds received by the company from the GOI and GNTCD towards financing of such expenditure would depend upon whether the funds received are of the nature of equity contribution or in the form of Government grant or debt to the company. In the absence of specific details with respect to that, the Committee has not expressed its views in respect of the same.
