

Query No. 25

Subject: *Treatment of payments made and materials supplied for construction of assets not owned by the company and its subsequent recovery in instalments.*¹

A. Facts of the Case

1. A public sector company (hereinafter referred to as ‘the company’) is engaged in the manufacture of steel products from five integrated steel plants and three special steel plants. The company also has a number of iron ore, limestone and dolomite mines in various parts of the country. The annual turnover of the company during the financial year 2015-16 was Rs. 43,367 crore.

2. The company has been granted mining lease of an iron ore mine at a remote location. In order to transport ore from the mine, the company has entered into a Memorandum of Understanding (MoU) with Indian Railways, State Government and another public sector company for construction of a railway line in two phases – Phase I for 95 kms and Phase II for 140 kms.

3. The MoU states that the company will pay the entire cost of constructing Phase I, and a part of the cost of the Phase II. In turn, Railways will pay the company 7% per annum of the cost of the project over 37 years from the time the freight traffic starts. The MoU also states that the company should ensure a minimum freight traffic of 4 million tonnes per annum in the first two years, and 9 million tonnes per annum thereafter. The freight traffic is to be calculated over a period of 4 years, i.e., 36 million tonnes in a period of 4 years. In case of shortfall in traffic, the payment of the 4th year shall be kept on hold till the shortfall is made up.

4. The issue of accounting for these payments was earlier referred to the Expert Advisory Committee (EAC), who opined (published as Query No. 20 of Volume XXXI of Compendium of Opinions) that:

a. The amount paid to Railways is, in substance, interest-bearing advance, and it is irrelevant how the amount is being utilised by the Railways.

b. The amount paid in cash is to be treated as advance, and the amount paid in kind (steel) is to be recognised as revenue at the time the material is supplied to Railways and disclosed as ‘Sundry Debtors’

c. On receipt of each instalment, the interest element is to be recognised as ‘Other Income’. The company has followed the accounting treatment suggested by the EAC. However, according to the querist, as far as the accounting for interest is concerned, it appears that the EAC has proposed cash based accounting, although Accounting Standard (AS) 9, ‘Revenue Recognition’ stipulates that “revenue should be recognised when no significant uncertainty as to measurability or collectability exists”. Therefore, it needs to be reviewed whether any ‘significant uncertainty’ exists as regards realisation of the amount from the Railways. The following facts may be noted:

¹ Opinion finalised by the Committee on 16.1.2017.

- (i) The construction work of the railway line is going on in full swing. With the posting of almost 5,000 paramilitary forces along the rail-route and mining area, the insurgency threat (endemic to that region) has been effectively contained. The first 17 kms has already been completed and train movement has started. Work is now going on in the 17- 45 km stretch. There is no reason to believe that the project will not be completed by 2021-22.
- (ii) The company has floated a tender for engaging a Mines Developer-cum-Operator (MDO) for operating the mine. The MDO will do the mining and will despatch ore to the company, and will be paid on a per-tonne basis. The contract with the MDO stipulates a minimum ore despatch of 14 million tonnes per annum, below which liquidated damages (LD) are levied. The minimum railway freight traffic of 9 million tonnes per annum is 40% less than the minimum ore despatch quantity. The quantity needs to be seen in the context of the company's annual ore requirement of 14 million tonnes. Therefore, there is no uncertainty, whatsoever, in fulfilment of the freight target.
- (iii) The 9 million tonnes freight traffic is to be calculated over a period of 4 years, i.e. 36 million tonnes to be transported in 4 years. A shortfall in one year can be made up in the next year. Even assuming, as a worst-case scenario, that steel plant of the company is unable to transport 36 million tonnes in 4 years, it would only mean that the payment of the 4th year will be kept on hold till the shortfall is made up. The payment for the first 3 years will be paid as usual.

5. It can be seen from the above facts that there exists absolutely no uncertainty in realisation of money from the Railways and therefore, the company is of the opinion that in accordance with AS 9, the accrued interest needs to be accounted for. The company has paid Rs. 270 crore to the Railways during the period 2006-07 to 2015-16.

6. The criteria set by AS 9, i.e. 'collectability' and 'measurability' have also been examined by the querist as follows:

Collectability: Railways will repay the advance @ 7% per annum. This is an annuity payment in which both the principal and interest components are embedded. It is not possible to treat one component as doubtful and the other component as certain. If the interest is considered doubtful, one must also treat the principal as doubtful (because both will be repaid together in the same annuity). In that case, the whole investment in the railway line must be provided for as doubtful asset, and every payment made hereafter should be immediately provided for. Since there is no reason to doubt the recovery of the principal, it follows that there can be no reason to doubt the collectability of interest either.

Measurability: The MoU stipulates that Railways will repay the advance at the rate of 7% per annum over 37 years, which works out to 259% (including repayment of principal). Therefore, the interest component is 159% of investment payable over 37 years. Interest needs to be calculated on time-proportion basis on the outstanding amounts. The annual rate of interest is not given in the MoU, but can be derived by calculation, depending on

the year-wise phasing of expenditure and the year-wise repayment over 37 years from the expected date of commissioning of the railway line.

7. Since all the conditions of AS 9 are met, the querist is of the opinion that the interest accruing on the advance and debtors should be recognised on time proportion basis, as and when payment is made to Railways without waiting for actual repayment to start.

B. Query

8. A clarification is required from the Expert Advisory Committee whether the interest accruing on advance to the Railways can be accounted for immediately without waiting for actual repayment to start.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised is with regard to timing of recognition of interest viz., whether on accrual basis or on receipt basis. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case such as, calculation of interest on advance, accounting for component of interest on debtors/receivable portion, apportionment of the recovery amount towards principal portion and interest, etc. The opinion expressed hereinafter is from the perspective of the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not from the perspective of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee presumes from the Facts of the Case that the freight rate charged by the Railways from the company on completion of railway line and after start of freight traffic is not different from the rate charged by the Railways from other customers.

10. At the outset, the Committee notes that in the earlier opinion referred to by the querist, the issue of recognition of interest on accrual basis was not specifically raised and, therefore, was not specifically examined by the Committee. Further, the term ‘recovery’ or ‘receipt’ in the earlier opinion was used more in the context of bifurcation of principal and interest portion at the time of recovery, as was specifically raised by the querist and not in the overall context. Moreover, the requirements of Accounting Standard (AS) 9, ‘Revenue Recognition’ had also been referred to in the earlier EAC opinion and therefore, the opinion should be read considering the requirements of AS 9.

11. With regard to the issue of timing of recognition of interest on advance payments, the Committee notes the following paragraphs of Accounting Standard (AS) 9, Revenue Recognition, notified under the Companies (Accounting Standards) Rules, 2006:

“4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.”

“8.1 The use by others of such enterprise resources gives rise to:

(i) interest—charges for the use of cash resources or amounts due to the enterprise;

...

8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.”

“9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.”

“9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.”

“13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: On a time proportion basis taking into account the amount outstanding and the rate applicable.

...”

12. From the above, the Committee notes that interest arising from the use of resources by others is considered as revenue and governed by the principles of AS 9. The Committee further notes from the above-reproduced requirements of AS 9 that the basic condition for recognition of revenue under AS 9 is that no significant uncertainty should exist regarding collectability and measurability of revenue. The Committee is of the view that whether there is uncertainty or not regarding these two aspects is a matter of judgement, which should be applied by the company itself, considering various factors affecting the certainty of revenue to the company, in its own facts and circumstances. However, considering the Facts of the Case, the Committee presumes that the measurement and collection of interest on advances to Railways is not significantly uncertain in the extant case. Further, from the above-reproduced requirements of AS 9, the Committee notes that the revenue arising from the use by others of enterprise’s resources yielding interest, accrues from the time these resources are transferred for use by others and

should be recognised on a time proportion basis taking into account the amount outstanding and the rate applicable, provided no significant uncertainty as to measurability or collectability exists. Accordingly, the Committee is of the view that in the extant case also, the company should recognise the interest income accruing on advances given to Railways on a time proportion basis and not when the same is received/ recovered, as per the requirements of AS 9.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the interest accruing on advance to Railways should be recognised on a time proportion basis, provided no significant uncertainty as to measurability or collectability exists, as per the requirements of AS 9, as discussed in paragraph 12 above.
