

Query No. 15

Subject: Provision for debtors transferred to Franchisee.¹

A. Facts of the Case

1. A company is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May, 2002 after unbundling of erstwhile Madhya Pradesh State Electricity Board (MPSEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP Notification No. 226 dated 31st May, 2005. The company is engaged in the business of electricity distribution in the area of Indore & 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.

2. The company entered into a Distribution Franchisee Agreement (hereinafter referred to as “the DFA”) with the successful bidder with an objective to minimise Aggregate Technical & Commercial Losses, improve distribution and operational efficiency, minimise billing arrears etc., in the area of Ujjain city. (Copy of the DFA has been supplied by the querist for the perusal of the Committee).

3. As per the terms and conditions of the DFA, from the effective date to expiry date i.e., 15 years from the effective date or date of default (in case of a default made by Franchisee), whichever is earlier, the sundry debtors as on effective date excluding amounts collected within three months of the last billing cycle will be handed over to Franchisee. Similarly, on expiry date/date of default, all sundry debtors excluding amounts collected within three months of last billing cycle will be handed over by Franchisee to the company. Accordingly, the company transferred the sundry debtors as on effective date excluding amounts collected within three months of the last billing cycle to Franchisee and makes a provision for doubtful debts by debiting profit and loss account on remaining amount of sundry debtors in the books of account of the company, because, now, as per the agreement, right to recover those debtors is transferred to the Franchisee.

4. While conducting audit of Annual Accounts of the company for FY 2014-15, the government auditor (C&AG Auditor) has made the following observations in this regard:-

“(i) This includes an amount of Rs. 38.84 crore towards the provision for doubtful debts in respect of sundry debtors of Ujjain City circle as on effective date i.e.31.07.2014 (on the date of handing over of the operation to Franchisee). As per terms and conditions of the Franchisee agreement clause 12.5 (i), from the effective date to the expiry date, the distribution franchisee shall be responsible to collect and retain payment of Consumer bills in the Franchisee Area, and as per clause 12.5(ii), the distribution franchisee shall collect the amounts due from the Consumers on day to day basis and remit to the Distribution Licensee on a weekly basis the amount collected against the Consumer bills for the last Consumer billing cycle immediately preceding the effective date up-to a period of three (3) months from the Effective Date.

As per clause 12.5 (iii), on the expiry date, the distribution licensee shall allow the Distribution Franchisee to collect amounts due from the Consumers as per the provisions of Article 32.11.2.

¹ Opinion finalised by the Committee on 23.8.2017.

As per article 32.11.2, amounts due from the Consumer from the billing cycle ending on any date prior to the expiry shall be permitted to be collected by the distribution franchisee up to a maximum period of three (3) months after the expiry date. Thereafter, any such amount collected from the consumer by the distribution licensee shall be retained by the Distribution Licensee and the Distribution Franchisee shall not be entitled for any claim on such amount.

*To sum up, as per the above terms and conditions of the agreement, the sundry debtors as on the effective date excluding the amounts collected within three months of the last billing cycle will be handed over to the franchisee. Similarly, on the expiry date, all the sundry debtors on the expiry date excluding the amounts collected within three months of the last billing cycle will be handed over to the distribution licensee i.e., the company. As such, there is no loss of sundry debtors, it is only transfer of sundry debtors to the Franchisee for franchise period like any other assets transferred to Franchisee for operation and on expiry of the franchise period, the company will receive all the sundry debtors. **Hence, booking the loss on account of sundry debtors which were only transferred to the Franchisee for franchise period considering it as doubtful is imprudent and highly objectionable. It should have been shown under other noncurrent assets as Trade receivable as they will be received on expiry of the franchise period. Hence, making the provision for the doubtful debts on sundry debtors who were only transferred for the franchise period has resulted in overstatement of other expenses and understatement of sundry debtors by Rs.38.84 crore. Consequently, loss for the year is also understated by similar amount.***

5. In response to the above, the company submitted the following reply:-

“Audit observed that no provision is required to be made on the debtors transferred to the Franchisee and, accordingly, there is understatement of sundry debtors. Here, it is stated that sundry debtors is an asset. Hence, kind attention is drawn towards the definition of ‘Asset’ given in the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India, relevant paragraphs of which are reproduced below:-

*“49 (a) 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.”*

“88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.”

*“96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. **An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.**”*

From the above, it may be noted that an item can be recognised as an asset only if it is a ‘resource controlled by the enterprise’ and future economic benefit will flow to the enterprise. Thus, it is the control over the resource that is important for recognising an expenditure as an asset. An entity that controls a resource can generally deal with it as it pleases. For example, the entity having control of a resource can exchange it for other assets, employ it to produce goods or services,

charge a price from others to use it, use it to settle liabilities, or distribute it to owners. Further, an indicator of control would be that the entity can restrict the access of others to the benefits derived from that resource. This view is also supported by the principles enunciated in paragraph 14 of Accounting Standard (AS) 26, 'Intangible Assets', reproduced below:

“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. ...”

In the present case, the Discom has transferred the debtors to the Franchisee. The collection of those debtors shall be done by the Franchisee and the said collection shall be retained by the Franchisee. No economic benefits shall be received by the Discom. Hence, the debtors transferred to Franchisee does not fulfil the definition of an asset and recognition criteria for an asset. Hence, the Discom made provision on those debtors and recognised expenses as per the requirements of para 96 of the 'Framework' quoted above.

*Audit further observed that at the end of Franchise period, the company will receive the outstanding debtors of the Franchisee and, hence, booking the loss on account of sundry debtors which were only transferred to the Franchisee for the franchise period considering it as doubtful is **imprudent and highly objectionable**.*

Here, in this regard, it is submitted that the transfer of debtors from the Discom to the Franchisee and from the Franchisee to Discom are two different transactions and cannot be correlated, because, debtors will be outstanding at the end of the franchise period of 15 years and no one can forecast how much amount shall be transferred. Possibility of outstanding dues in the private operation is very rare and even after 15 years when technology will get change tremendously.

*Audit party termed the action of the Discom making provision as **imprudent**. Here, kind attention is drawn towards the definition of 'prudence' given in AS 1, 'Disclosure of Accounting Policies', reproduced below:*

“17. For this purpose,...

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.”

Discom, while making the provision for debtors transferred to Franchisee, has duly complied with the principle of prudence quoted above in the following manner:-

- (i) Discom made provision on debtors transferred to Franchisee.*
- (ii) Discom has not considered the anticipated benefits which may or may not be received at the end of the franchise period.”*

6. However, the CAG audit has not considered the company's response and issued the following comments:-

“This includes an amount of Rs.38.84 crore towards provision for doubtful debts made in respect of sundry debtors of Ujjain City circle as on 31.07.2014. The

company entered into a Distribution Franchisee Agreement (DFA) on 31.07.2014 with successful bidder with an objective to minimise Aggregate Technical & Commercial Losses, improve distribution and operational efficiency, minimise billing arrears on the date of handing over of the operation to Franchisee. As per terms and conditions of the Franchisee Agreement from the effective date (31.07.2014) to the expiry date (15 years from the effective date or in case of a default by the Franchisee ,the date of default whichever is earlier), the sundry debtors as on effective date excluding the amounts collected within three months of the last billing cycle will be handed over to the Franchisee. Similarly, on the expiry date/date of default, all the sundry debtors excluding the amounts collected within three months of the last billing cycle will be handed over by the distribution Franchisee to the distribution licensee, since the debtors were only transferred to the Franchisee for the specific period but the ownership and title remained with the company.

Thus, making provision for doubtful debts on sundry debtors which were only transferred as a temporary measure during agreement period has resulted in overstatement of other expenses and understatement of sundry debtors by Rs.38.84 crore. Consequently, loss for the year is also overstated by similar amount.”

7. The querist has separately clarified the following:

- (i) Debtors transferred to the Franchisee amounting to Rs.38.84 crore exclude both the amount collected within three month from the effective date as well as arrear in litigation. Further, right of collection and retention of the collected amount was granted to the Franchisee.
- (ii) The company has appointed the distribution Franchisee through competitive bid process. In the bidding process, all the conditions were made available to the bidder by way of bid and bidders were asked to submit to their Price Bid, mentioning the input rate for input energy for each year of the contract period, applicable for the energy to be injected by the Distribution Licensee at the input point(s) in the Franchisee Area. In the bidding process, the bidder who has offered the maximum levelised input rate for the input energy to be injected by the Distribution Licensee at the input point(s) in the Franchisee Area has been selected. The bidders were required to quote input rate considering all its obligations and other terms and conditions mentioned in the bid document. All these terms and conditions now form part of the Franchisee agreement.

In view of above, as per conditions of bidding/agreement, the Franchisee shall receive payment on the basis of input energy and quoted rates. These rates were quoted by Franchisee considering all the conditions. Transfer of arrears is also one of the conditions of the bidding. No separate consideration is paid by the distribution Franchisee to the company for transfer of such arrear.

- (iii) After following a transparent bidding process, by way of agreement, the Franchisee was authorised for collection and retention of such collected amount from debtors (arrear). Except this agreement, no other legal deed/instrument was executed. In substance, beneficial owner of such arrear is the Franchisee. Such transfer of arrear to the Franchisee results in the following:
 - (a) it transfers from the company to Franchisee, the contractual rights to receive the cash flows from the debtors; and

- (b) it transfers from the company to Franchisee substantially all the risk and rewards relating to such debtors.
- (iv) Since the contractual right to receive cash flows has been transferred to the Franchisee, the arrear amounting to Rs. 38.84 crore does not fulfil the definition of asset in the books of the company.
- (v) The company, by way of legally enforceable agreement, has transferred the arrear to Franchisee and now the company cannot deal with such arrear as it pleases. Therefore, in the absence of 'control', asset should be charged to the profit and loss account for the period in which the company lost control, even though some indirect and remote economic benefits are expected to flow to the enterprise. In this regard, paragraph 56 of AS 26, 'Intangible Assets', provides as follows:
- “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. ...”
- (vi) In the present case, since right of collection from debtors and retention of the same were transferred to Franchisee, as per 'Prudence' concept, loss on such transfer should immediately be recognised, even if any remote or estimated gain is possible.
- (vii) While making the provision, the company has not derecognised the transferred debtors. However 100% provision has been made on transferred arrear. Even when the company has made the provision, instead of derecognising the asset, presentation on the face of the balance sheet is not changed because, in the balance sheet, debtors is being presented net of provision on the face of the balance sheet as per provisions of the Companies Act.

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the booking of loss upon transfer of debtors is correct or not as per Generally Accepted Accounting Principles.
- (ii) As observed by the C&AG in its comments, the amount of provision for doubtful debts on such sundry debtors is Rs.38.84 crore against the total turnover of Rs. 8,268.45 crore for the company. Whether, in the light of principle of materiality, the treatment given by the company in its books of account is correct or not.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to booking of loss on transfer of debtors of Rs.38.84 crore to the Franchisee by way of provision for doubtful debts. 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. The Committee notes from the facts of the case that the arrears under litigation have not been transferred by the company to the franchisee and also no provision has been created on debtors on account of being doubtful of recovery, therefore the Committee presumes that revenue recognition in respect of the transferred debtors of Rs.38.84 crore was appropriate and that

before the transfer of those debtors, no portion of the same was impaired/doubtful and, hence, there was no need for any provision for doubtful debts *before* the said transfer. The Committee notes that in paragraph 4 above, there is incorrect reference to understatement of loss for the year which is set right in paragraph 6 above which makes reference to overstatement of loss for the year. This, however, does not affect the opinion of the Committee. Further, in paragraph 7(ii) above, the querist has stated that as per conditions of bidding/agreement, the Franchisee shall *receive* payment on the basis of input energy and quoted rates. The Committee notes that actually Franchisee shall *make* payment to the company on the basis of input energy and quoted rates and, therefore, proceeds on that factual position. The Committee also notes the statement of the querist in paragraph 5 above that the possibility of outstanding dues in private operation is very rare whereas in paragraph 7(v) above it is stated that some indirect and remote economic benefits are *expected* to flow to the enterprise. In this regard, the Committee relies on the statement in paragraph 5 above in preference to the statement in paragraph 7(v) above. Incidentally, the Committee notes the use of the term ‘Discom’ in paragraph 5 above, which is an acronym of ‘Distribution Company’.

10. The Committee notes that for the transfer of debtors of Rs.38.84 crore on the effective date, no separate consideration is received by the company from the Franchisee. Instead, the input rate was quoted by the Franchisee taking into account the transfer of debtors to the Franchisee *and* various obligations undertaken by the Franchisee under the Franchisee agreement. The Committee is of the view that as the Debtors have been transferred in the extant case, the same should be derecognized and the carrying amount of the transferred debtors should be transferred to an appropriate account (alternate asset). Subsequent clearance from this account should be made in an appropriate manner taking into account the nature and quantum of benefits expected to be obtained by the company during the Franchise period under the Franchisee agreement (for e.g., expected increase in *net* revenue during the Franchise period). The Committee does not consider this issue further, since, this is not an issue raised by the querist. Since the transferred debtors should be derecognised under the above treatment with concurrent recognition of another asset for equal amount, the question of making any loss or provision for doubtful debts does not arise at all in the extant case. Further, the Committee is of the view that derecognition of the transferred debtors is appropriate in the extant case, since, irrespective of legal title, the significant risks and rewards of ownership of the said debtors have been substantially transferred to the Franchisee. This is due to the fact of transfer to the Franchisee of the right to collect cash from the transferred debtors and retain the same, though uncollectible debtors, *if any*, out of the transferred debtors at the end of the Franchise period will be retransferred to the company, which is very rare in view of the querist’s statement in paragraph 5 above and having regard to the length of the Franchise period (15 years in the absence of default by the Franchisee). (See also paragraph 11 below).

11. The Committee agrees with the querist that possible return of the uncollectible transferred debtors to the company at the end of Franchise period is a contingent asset. Such possible future return meets the definition of contingent asset given in paragraph 10.5 of Accounting Standard (AS) 29, ‘Provisions, Contingent Liabilities and Contingent Assets’, notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the ‘Rules’) which reads as below:

“10.5 A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the

enterprise.”

The Committee notes that paragraph 30 of AS 29, notified under the Rules, prohibits recognition of contingent assets.

12. The Committee does not agree with the querist that derecognition and provision for doubtful debts, which is offset against gross carrying amount of debtors, have the same effect on the presentation in the balance sheet. Derecognition means removal of an item from the balance sheet whereas offset does not result in such removal. For example, derecognition of an asset, which is not accompanied by concurrent recognition of another asset for equal amount, results in a gain or loss whereas offset of a liability or a valuation allowance or an allowance for impairment loss against an asset does not result in any gain or loss, though provision for doubtful debts has an impact on profit, which, however, is not correct in the extant case for the reasons stated in paragraph 10 above.

13. With regard to the issue raised by the querist in relation to materiality aspect of the amount involved, 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.”

14. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If information is not material, on the consideration of materiality as mentioned in the paragraph 13 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. In the extant case, on the basis of information available in the facts of the case the amount appears to be not material, however, the Committee is of the view that it needs to be determined under the specific facts and circumstances of the company as to whether the amount involved is material, 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. An entity should assess whether information either individually or in combination with other information is material in the context of its financial statements. Moreover, materiality concept should be seen in totality.

D. Opinion

15. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 8 above:

- (i) The booking of loss upon transfer of debtors is not correct. The correct treatment should be as explained in paragraph 10 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 determined 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 13 and 14 above.
