

## **Query No. 22**

**Subject:** *Whether transport subsidy can be treated as capital receipt.*<sup>1</sup>

### **A. Facts of the Case**

1. The querist has stated that the partnership firm (hereinafter referred to as 'firm') is engaged in the business of manufacture of cement in the state of Assam. Being located in the North Eastern Region (NER) the firm is enjoying / availing various subsidies and incentives under the North East Industrial Policy 1997, North East Industrial and Investment Promotion Policy (NEIIPP), 2007, Industrial Policy of Assam 2008 and Industrial and Investment Policy of Assam 2014.

2. The firm has been treating the subsidies and incentives in the nature of *Transport Subsidies* as revenue receipts till the Financial Year 2015-16. However, in the Financial Year 16-17, the concern has treated the incentive (*Transport Subsidy*) as capital receipts by transferring the same to Capital Reserve, relying upon the following case / judgement:

- ✓ Shiv Shakti Flour Mills Pvt. Ltd. V/s. C.I.T. (2017) 390 ITR 346 (Gauhati) holding transport subsidy as capital receipt.

3. The querist has also stated that as per AS 12 ***“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.”***

### **B. Query**

4. (a) The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) that “Whether the firm can treat the said subsidy (transport subsidy) as capital receipt?”
- (b) In case it cannot be treated as capital subsidy, then whether the querist needs to qualify / give observations in their report (Form 3CB) or do they refer to the notes on accounts wherein the management discloses the facts and consequences of the change in the accounting policies.

### **C. Points considered by the Committee**

5. The Committee notes that the basic issue raised in the query relates to whether the transport subsidy received by the firm can be treated as a capital receipt? In case it is not a capital receipt then does the querist need to qualify/give observations in their report (Form 3CB) or refer to the notes to accounts wherein the management discloses the facts and consequences of the change in the accounting policies. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise from the facts of the case. The Committee wishes to point out that its opinion is expressed purely from accounting perspective and not from the perspective of interpretation of court orders etc. Further, the Committee also wishes to point out that since AS 12 has been referred to in the facts of the case, the Committee has expressed its views, hereinafter in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs).

6. With regard to the issue raised, the Committee notes the following extracts of “New Industrial Policy and other concession in the North Eastern Region’ 1997” as follows:

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<sup>1</sup> Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

## Transport Subsidy Scheme:

### 6. Details of the Scheme

- (i) A transport subsidy will be given to industrial unit located in the selected areas in respect of raw materials which are bought into and finished goods which are taken out of such areas.
- (iv) \*In the case of North-Eastern region comprising the States of Assam, Meghalaya, Nagaland, Manipur, Tripura and the Union Territories of Arunachal Pradesh and Mizoram the transport subsidy will be given on the transport costs between Siliguri and the location of the industrial unit in these States/Union Territories. While calculating the transport costs of raw materials the cost of movement by rail from Siliguri to the railway station nearest to the location of the industrial and thereafter the cost of movement by road to the location of the industrial unit will be taken into account. Similarly, while calculating the transport costs of finished goods the costs of movement by road from the location of industrial unit to the nearest railway station and thereafter the cost of movement by rail to Siliguri will be taken into account. In the case of North-Eastern region, for raw materials moving entirely by road or other mode of transport the transport costs will be limited to the amount which the industrial unit might have paid had the raw materials moved from Siliguri by rail upto railway station nearest to the location of the industrial unit and thereafter by road. Similarly in the case of movement of finished goods moving entirely by road or other mode of transport in the North-Eastern region, the transport costs will be limited to the amount which the industrial unit might have paid had the finished good moved from the location of the industrial units to the nearest railway station by road and thereafter by rail to Siliguri.
- (vii) + Freight charges for movement by road/sea will be determined on the basis of transport/transshipment rates fixed by the Central Government/State government/Union Territory Administration concerned from time to time or the actual freight paid, whichever is less.
- (viii) £ Costs of loading or unloading and other handling charges such as from railway station to the site of industrial unit will not be taken into account for the purpose of determining transport costs.
- (ix) £ All New Industrial units located in the selected areas will be eligible for transport subsidy equivalent to 50 per cent or the transport costs of both raw materials as well as finished goods.
- (x) £ Existing industrial units in the selected areas are also eligible for transport subsidy in respect of addition transport costs of raw materials and finished goods arising as result of substantial expansion or diversification effect by them after the commencement of the Scheme. Transport Subsidy in such cases will be restricted to 50 per cent of the transport costs of the addition raw materials required and finished goods produced as a result of the substantial expansion or diversification.
- (xi) + Transport subsidy will also cover 50 per cent of the transport charges for movement of steel from Guwahati Stockyard of M/s Hindustan Steel Limited to the site of the industrial unit in the North-Eastern region and for movement of industrial raw materials from the State Corporation's depot situated in the hill

districts of Uttar Pradesh to the sites of the industrial units located in the hill districts of the State.

- (xii) \*£ The State government/Union Territory Administration will set up a committee consisting of the Directors of Industries, a representative each of State Industries Department and the State Finance Department etc. on which a representative of the Ministry of Industrial Development will also be nominated. The committee will operate at the State/Union Territory level and scrutinise and settle all claims of transport subsidy arising in the State/Union Territory. The claimants should be asked to provide proof of raw materials, 'imported' into and finished goods 'exported' out of the selected State/Union Territory/areas where the unit is situated from the registered chartered accountants. The committee may also lay down the production of any other documents which in their opinion is necessary to decide the eligibility of claimant for the transport subsidy. However, in the case of small units with a capital investment of Rs 1 lakh or less the requirement of production of certificate from Chartered Accountants may be waived subject to the condition that such claims are properly verified by the State government authorities before the subsidy is sanctioned/disbursed. After having scrutinised and settled the claims, the amount disbursed to industrial unit should first be adjusted against the outstanding ways and means of advances made to State government/Union Territory Administration for Centrally Sponsored Scheme in accordance with the procedure outlined in the Ministry of Finance letter No. 2(17) PII/58 dated 12.5.1958 and the balance, if any, shall be paid in cash to the State government/Union Territory Administration.

Provided that in case of small units with a capital investment of Rs 1,00,000 and less, the requirement of production of proof of import of raw material and export of finished products from registered Chartered Accountants will be substituted by an appropriate verification by the State Government authorities.

\* Amended vide Notification No. F. 6(26)/71-IC dated 28.2.1974.

+ Renumbered and amended vide Notification No. 6/3/75-RD dated 19.7.1978.

£ Renumbered vide Notification No. 6/3/75-RD dated 19.7.1978.

\*£ Amended vide Notification No. F. 6(26)/71-IC dated 28.2.1974.

7. Also, the Committee notes the following extracts of "North East Industrial and Investment Promotion Policy (NEIIPP), 2007" as follows:

*(xiv) Transport Subsidy Scheme*

The Transport Subsidy Scheme would continue beyond 31.3.2007, on the same terms and conditions. However, an early evaluation of the scheme will be carried out with a view to introducing necessary safeguards to prevent possible leakages and misuse.

8. Further, the Committee notes the following paragraphs of Accounting Standard (AS) 12, 'Accounting for Government Grants' notified under the Companies (Accounting Standards) Rules, 2006 as follows:

***"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.”*

#### **“Accounting Treatment of Government Grants**

##### *5. Capital Approach versus Income Approach*

5.1 Two broad approaches may be followed for the accounting treatment of government grants: the ‘capital approach’, under which a grant is treated as part of shareholders’ funds, and the ‘income approach’, under which a grant is taken to income over one or more periods.

5.2 Those in support of the ‘capital approach’ argue as follows:

- (i) Many government grants are in 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 and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders’ funds.
- (ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

5.3 Arguments in support of the ‘income approach’ are as follows:

- (i) Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.
- (ii) As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.
- (iii) In case grants are credited to shareholders’ funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.”

“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. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.”

“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.”

***“13. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.”***

***“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.***

***16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.”***

9. On the holistic reading of the above paragraphs, the Committee is of the view that in the extant case, the government grant (transport subsidy) received from the Government are for meeting specific expenditure of the firm, and not granted with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (as in the case of grants of the nature of promoters' contribution). Accordingly, the transport subsidy received by the firm, 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.

10. The Committee further notes the following paragraphs of SA 705, 'Modifications to the Opinion in the Independent Auditor's Report'<sup>2</sup> and SA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report'<sup>3</sup>:

SA 705:

***“Qualified Opinion***

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<sup>2</sup> Standard on Auditing (SA) 705 has although been revised in May 2016, the revised Standard is effective for audits of financial statements for periods beginning on or after April 1, 2018.

<sup>3</sup> Standard on Auditing (SA) 706 has although been revised in May 2016, the revised Standard is effective for audits of financial statements for periods beginning on or after April 1, 2018.

7. The auditor shall express a qualified opinion when:
- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
  - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.”

SA 706:

**“Emphasis of Matter Paragraphs in the Auditor’s Report**

6. If the auditor considers it necessary to draw users’ attention to a matter presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to users’ understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor’s report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.”

11. From the above, the Committee notes that whether the auditor needs to give qualified opinion or emphasis of matter paragraph in the auditor’s report is a matter of judgement which needs to be exercised by the auditor considering various factors such as materiality, etc.

**D. Opinion**

12. On the basis of the above, the Committee is of the following opinion:

- (a) The transport subsidy received by the firm should not be treated as a capital receipt. The same should be treated as revenue and should be recognised on a systematic basis in the profit and loss statements over the period necessary to match them with the related costs which they are intended to compensate. The transport subsidy received by the firm should either be shown separately under ‘other income’ or deducted in reporting the related expenses.
- (b) Further, whether the auditor needs to give qualified opinion or emphasis of matter paragraph in the auditor’s report is a matter of judgement which needs to be exercised by the auditor considering various factors such as materiality, etc.

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