

Query No. 27

Subject: *Accounting implication of the following in relation to subsidy accounting:*

- (a) Recognition of Expected Credit Loss (ECL) in respect of subsidy receivables*
- (b) Need for discounting of subsidy receivables.¹*

A. Facts of the Case

1. The querist has stated that one of the key objectives of introduction of fertilizer subsidy in India was sustained agricultural growth and to promote balanced nutrient application. It is imperative that fertilizers are made available to farmers at affordable prices. With this objective, urea being the only controlled fertilizer, is sold at statutory notified uniform sale price, and decontrolled Phosphatic and Potassic fertilizes (P&K) are sold at indicative maximum retail prices (MRPs). The problems faced by the manufacturers in earning a reasonable return on their investment with reference to controlled prices, are mitigated by providing support under the New Pricing Scheme for urea units and the Concession Scheme for decontrolled P&K (or relevant subsidy policies from time to time). The statutorily notified sale price and indicative MRP are generally less than the cost of production of the respective manufacturing unit. The difference between the cost of production and the selling price/MRP is paid as subsidy to manufacturers as a part of total price of the product to the manufacturers. As the consumer prices of both indigenous and imported fertilizers are fixed uniformly, financial support is also given on imported urea and decontrolled P&K. In addition to this, freight on account of goods movement is reimbursed on the basis of actual rail freight/notified rates in case of movement by road.

2. The querist has further stated that with the objective to monitor the import, production and movement of various subsidised fertilizers and processing subsidy claims, different software systems were introduced by the Department of Fertilizers (DOF), viz., Fertilizer Management System (FMS), Mobile Fertilizer Management System (mFMS) and Integrated Fertilizer Management System (iFMS). These software systems help the manufactures/importers to file the subsidy claims from the Department of Fertilizers (DOF)/Government of India (GOI). The key thing to note here is that these claims cannot be filed in FMS etc. unless the GoI has opened the option to file the claims in the portal and generally there is a time lag between the sale of urea to distributors / farmers by the manufacturers and the time when GoI opens the portal for filing of claims of subsidy by the manufacturers.

3. The querist has given the *process/key dates for subsidy accounting, claim submission and collections in the table below:*

Revenue Accrual	Claim submission in FMS/Contractual obligation	Collections
(A)	(B)	(C)
Revenue is recorded in the books when the goods are sold to the customer (dealers) with a corresponding receivable from the GoI for the subsidy and cash	Subsidy claim is generated in FMS when the GoI gives the option in FMS for the company* to file the subsidy claim, generally after the relevant notification/policy is released (except for certain on-account payment as explained in the note below).	Once the GoI pay for the subsidy claim, the collections are recorded in the books.

¹ Opinion finalised by the Committee on 8.1.2019.

(MRP amount) that is received from the dealer.	Since there is no due date as per the contractual obligation with the GoI, the subsidy becomes due immediately on submission of subsidy claim on the portal.	
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** Industry/Manufacturer/Fertilizer company (referred to as 'company' for ease of reference)*

Note to (B): The companies upload the bill on the GoI portal (for claim submission) based on last updated rates in the portal awaiting the notification from the Government for the amount of actual subsidy for the goods sold for a particular period. Generally, a provisional payment is received from the Government before the actual subsidy rates are notified for that particular period. Once the final rate of subsidy is notified, the upward/downward adjustment is made in the bill raised earlier and accordingly dues are settled with the Government.

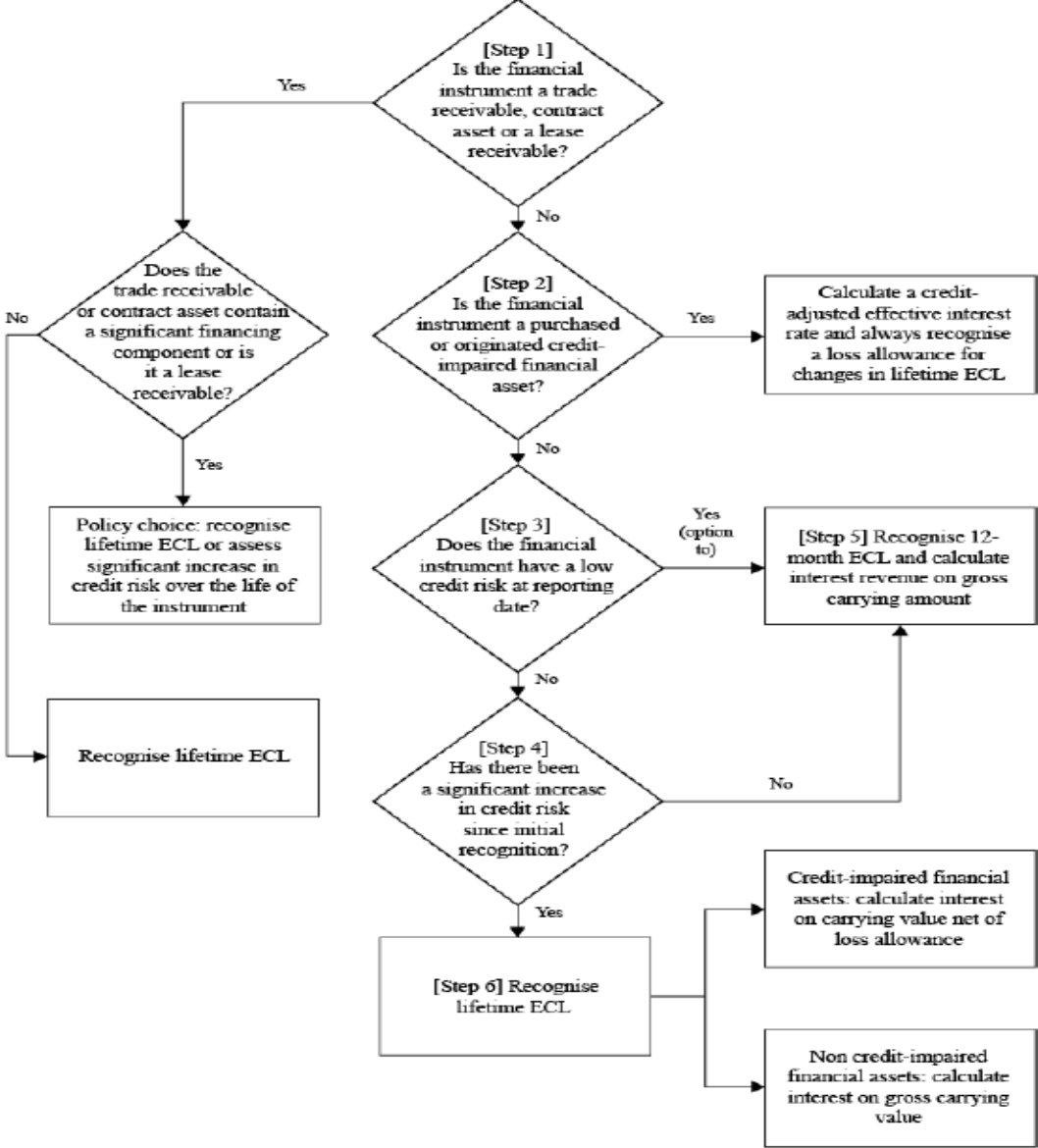
According to the querist, the GoI does not notify any credit period for payment of subsidy from the date of uploading the bill on the portal and it can be reasonably presumed that the company is contractually eligible to receive the subsidy from the Government immediately after uploading the bill claim on the portal.

4. *Direct Benefit Transfer (DBT)*

The querist has also mentioned that in the recent years, the GoI has introduced Direct Benefit Transfer (DBT) mechanism. In the Union Budget for 2016-17, it was stated that based on successful experience of DBT (Direct Benefit Transfer) in Liquefied Petroleum Gas (LPG), DBT would be introduced on pilot basis for fertilizers in few districts in the country to provide quality delivery services to the farmers. Seventeen districts were selected for the pilot project on direct transfer of fertilizer subsidy. To accomplish this objective, integrated fertilizer management system (iFMS) was developed. Fertilizer industry has been vociferously advocating for DBT of fertilizer subsidy to the bank accounts of the farmers, but the Government has said that true DBT implementation is not possible in fertilizer sector as was done in LPG, where beneficiaries are identified. Finally they implemented DBT in the form that subsidy will be given post sale of fertilizer through point of sale (POS) but to the companies and not to the farmers.

5. The pilot project was initiated from Krishna and West Godawari districts in Andhra Pradesh in October 2016. GoI started rolling out the scheme in various states in stages w.e.f. 1st September, 2017. It was rolled out in all the states by 1st March, 2018. The fertilizer industry purchased and installed the POS machines at all retail outlets across the country and provided training to the retailers about the operation of POS machines. As per the policy, the disbursement of subsidy is linked to sale of fertilizers to farmers through POS machines on weekly basis. As per the querist, there have been numerous methods of the GoI to pay subsidy to the companies at different point in time. However, over the years, GoI has implemented many ways to control the timing and mechanism of releasing payment for subsidy due to manufacturers. It is imperative to note that all of the changes are only changes in the billing / collection mechanism and no changes have been directed or implemented or proposed to be implemented which have or will cause the obligations of the parties involved in the chain to change. In essence, GoI has employed different mechanism / controls for payment of subsidy to ensure that the subsidised fertilizer reaches to the right person (i.e. farmer) and also in time.

6. The querist has analysed Indian Accounting Standard (Ind AS) 109, 'Financial Instruments' and created the following decision tree w.r.t. determining which method of recognising Expected Credit Loss (ECL) should be followed in case of subsidy receivables:



Step 1 - Is the financial instrument a trade receivable, contract asset or a lease receivable?

Response – Yes

Step 2 - Does the trade receivable or contract asset contain a significant financing component or is it a lease receivable?

Response – No

The querist has stated that as per Ind AS 18, 'Revenue' revenue shall be measured at the fair value of the consideration received or receivable. In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash

or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is determined by reference to the prevailing rate for a similar instrument of an issuer with a similar credit rating; or a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue using effective interest method as set out in Ind AS 109.

In case of fertilizer industry, once the revenue is accrued, the company expects that it will be able to realise the subsidy immediately as all the accruals are made as per the relevant applicable policy notification and notification of the rate is a procedural matter outside the control of the company. Again, it is important to emphasise that neither there is any financing component envisaged in the GoI policy/notification nor the recipient considers any financing component in the subsidy. Release of final notification / ability to raise bills in the portal are only procedural matters in the process of claiming subsidy. While historically, the time gap between revenue accrual and date of registering of claim in respect of upward/downward adjustment has been more than 365 days, it is imperative to note here that the event of opening of portal by the GoI for registering subsidy claims is entirely outside the control of the company and going forward, the time gap may be narrower than 365 days depending on availability of funds with the GoI. Thereby, at the time of recording revenue it is difficult to conclude whether the contractual due date of collection (date of claim) will be more than or less than 365 days away. Management believes that at the time of recording revenue, there is no significant financing component in the subsidy receivable from the Government and, hence, no discounting of revenue or related receivable is required.

Step 3 - Recognize lifetime ECL

Response: No

7. The querist has stated that as per paragraph 5.5.15 of Ind AS 109, the company shall always measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables that result from transactions that are within the scope of Ind AS 115, 'Revenue from Contracts with Customers'. Lifetime expected credit losses are defined in Ind AS 109 as the expected credit losses (the weighted average of credit losses with the respective risks of a default occurring as the weights) that result from all possible default events over the expected life of a financial instrument.

In accordance with Ind AS 109, credit loss is the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to

reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

Further, the querist has stated that paragraph 5.5.17 of Ind AS 109 states as follows:

“5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;**
- (b) the time value of money; and**
- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.”**

Essentially, ECL is a probability-weighted estimate of credit losses. A credit loss is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive discounted at the original effective interest rate. ECL considers the amount and timing of payments, thus a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

8. As per the querist, in manufacturer’s case, there is an insignificant risk of default on the subsidy receivables, since these are recoverable from the GoI and historically, there has been insignificant defaults in the payment of subsidy by the GoI. Additionally, since the various subsidies are of similar nature from the same party (GoI) and are paid by the GoI from time to time, it is imperative to note that these subsidy receivables relate to essential commodity and are governed/administered through notified policies of the GoI and hence, are in the nature of sovereign debt.

9. However, if there is a significant gap between date of accrual and date on which the consideration is received, the time value of money shall be taken into account in order to measure the expected credit losses of a long term subsidy receivable. Considering paragraph 5.5.17 of Ind AS 109, delayed payments from the GoI indicate that a provision for expected losses shall be recognised considering that the company might be losing interest on such receipts caused due to such delayed payments. The provision for such expected loss of interest (time value of money) shall be measured by discounting the subsidy receivables outstanding from the contractual due date to the date they are expected to be recovered. According to the querist, over the past few years, there have been procedural delays due to various reasons beyond the control of the company and are dependent on Government policies which are usually influenced by:

- a. financial conditions of the economy
- b. Political will of the Government

Also, it is imperative to note that there is no specific trend in these delays as it majorly depends on the Government notifications, for example, the GoI has recently introduced the direct benefit transfer (DBT) for subsidies and company can claim from 2018-19, which would mean that the companies would not be able to predict the timing of the DBT.

10. The fact is that the reasons known for these delays are also of different nature. The querist has given the following analysis of significant nature of subsidy dues where there are significant delays (the list below is only indicative):

S.No.	Nature of Subsidy	Nature of Delay
1	Additional fixed cost	Subsidy is due however it is yet to be notified for years after 2014-15 by the GoI. For the year when it was notified, the GoI has not opened portal for filing of the claim.
2	Differential freight claim	Notification for this came in 2012, however portal for filing the revised claims have been opened in the recent years.
3	Escalation/De-escalation	Subsidy is due however it is yet to be notified by the GoI.
4	DBT	Subsidy is due however bills are yet to be generated from the m FMS system.
5	Freight Bill	Subsidy is due and subsidy bills are filed with the GoI, however, the GoI is yet to release the subsidy.
6.	Balance Claim (5%)	Subsidy is due to the GoI, however it is yet to be notified by the GoI.

Considering the above facts, subsidy receivable is of the same nature and from the same party, it is important to analyse the lead time taken for collection (allocation on FIFO basis since the nature of due and the party from whom it is receivable is the same) to evaluate the 'delay' for the purpose of ECL.

(Emphasis supplied by the querist)

Analogy with Ind AS 115 as given by the querist

Further, Ind AS 115 (paragraph 63) provides a practical expedient that an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

Considering above and applying the analogy given in paragraph 63 of Ind AS 115, it is not required to account for the provision for ECL on the subsidy receivables as the lead time is less than 12 months / 365 days.

B. Query

11. In view of the above facts, the querist has sought the opinion of the Expert Advisory Committee of the ICAI on the following issues:

- (i) Considering that there is no financing component in the amount of revenue booked and the manufacturer/company expects to realise the amounts with the accrual, whether it is correct to take a view that no discounting of revenue is required.

- (ii) In case the historical trend for receiving the payments is less than 365 days (including the current and expected trends under the DBT regime) and applying the analogy from the practical expedient in Ind AS 115, whether there is no need to create a provision for ECL against subsidy receivable.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to accounting for delays in the subsidy receivable from the Government. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, presentation and disclosure of subsidy receivable, timing of recognition of subsidy receivable, accounting for revenue generated from sale of fertilizers to the consumers/farmers, etc. Further, in the absence of any contrary information, the Committee presumes that the company has complied with all the applicable conditions in order to become eligible to receive the subsidy.

13. At the outset, the Committee notes that since the activities of the fertilizer company are subject to rate regulation, (viz., the price for the fertilizer to be charged from the consumers is regulated by the concerned Regulator (DoF)), the company in the extant case conducts rate-regulated activities. In this context, the Committee notes that Ind AS 114, 'Regulatory Deferral Accounts' specifies financial reporting requirements for regulatory deferral account balances that arise when an entity provides goods and services to customers at a price or rate that is subject to rate regulation. However, the Committee notes that as per the requirements of paragraph 5 of Ind AS 114, an entity is permitted to apply the requirements of Ind AS 114 in its first Ind AS financial statements if and only if it recognized amounts that qualify as regulatory deferral account balances in its financial statements in accordance with its previous GAAP. In the absence of any information in this regard in the Facts of the Case, the Committee presumes that the company in the extant case has not recognised any regulatory deferral account balances and accordingly the requirements of Ind AS 114 shall not be applicable in the extant case.

14. The Committee notes from the Facts of the Case that to make fertilizers available to the farmers at affordable prices, it is sold at statutorily notified sale price and indicative MRP which is generally less than the cost of production. Thus, the difference between the cost of production and the selling price is paid by the Government as subsidy to manufacturers along with other financial supports and reimbursement of freight to provide support to the manufacturers. In this context, the Committee notes the following paragraphs of Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance':

“Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity...”

“6 Government grants are sometimes called by other names such as subsidies, subventions, or premiums.”

“20 A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised in profit or loss of the period in which it becomes receivable.”

“22 A government grant may become receivable by an entity as compensation for expenses or losses incurred in a previous period. Such a grant is recognised in

profit or loss of the period in which it becomes receivable, with disclosure to ensure that its effect is clearly understood.”

From the above, the Committee notes that government grants are assistance by government in the form of transfer of resources in return for compliance with certain conditions. The Committee notes that in the extant case, the Government is providing subsidy to the fertilizer manufacturers in the form of compensation for the difference between the cost of production and the selling price and include compensation for expenses or losses already incurred. Accordingly, the subsidy receivable by the company in the extant case is ‘Government grant’ as per the requirements of Ind AS 20. In this regard, the Committee notes that the querist has made reference to Ind AS 115, ‘Revenue from Contract with Customers’ for subsidy receivable. However, the Committee is of the view that since the subsidy in the extant case is grant receivable from the Government and not arising from the customers or any contract with customers, the requirements of Ind AS 115 are not relevant for accounting for the subsidy receivable.

15. A question now arises is whether subsidy (government grant) receivable is a financial asset within the scope of Ind AS 32, ‘Financial Instruments: Presentation’ and Ind AS 109. In this regard, the Committee notes the following paragraphs of Ind AS 32:

“A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

- (a) cash;**
 - (b) an equity instrument of another entity;**
 - (c) a contractual right:**
 - (i) to receive cash or another financial asset from another entity; or**
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity;**
- or**

...”

“13 In this Standard, ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.”

The Committee notes from the Facts of the Case that the Government provides support to manufacturers in fertilizer industries through various relevant subsidy policies introduced from time to time. The Committee is of the view that although under such schemes/policies, there may not be a one to one agreement between the entity and the Government as to the rights and obligations but there is an understanding between the Government and the manufacturer/company that on complying with the stipulated conditions, if any, attached to the scheme/policy, the entity will be granted benefits of the scheme/policy. Accordingly, in the extant case, when the company complies with the required conditions (for example, selling the fertilizer at lower than the cost of manufacturing) then it rightfully becomes entitled to such incentive/subsidy as per the policy and the subsidy receivable will fall under

the definition of ‘financial instruments’ and should be accounted for as a ‘financial asset’ as per the requirements of Ind AS 109, ‘Financial Instruments’.

16. With regard to initial recognition of the subsidy receivable, the Committee is of the view that the same should be recognized at fair value of the subsidy receivable in accordance with the requirements of Ind AS 20. The Committee also notes that the determination of fair value, as per the requirements of Ind AS 113, ‘Fair Value Measurement’, also takes into account time value of money and expectations of timing of cash flows. Accordingly, the Committee is of the view that in the extant case, on initial recognition of subsidy receivable, the company should consider the expected timing of the cash flows while recognizing it at fair value.

17. Further, on subsequent measurement of subsidy receivable, with regard to the provision for Expected Credit Loss (ECL) to be created for subsidy receivable, the Committee further notes the following paragraphs of Ind AS 109:

“5.5.1 An entity shall recognise a loss allowance for *expected credit losses* on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a *contract asset* or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d).”

“5.5.3 Subject to paragraphs 5.5.13–5.5.16, at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.”

“5.5.5 Subject to paragraphs 5.5.13–5.5.16, if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to *12-month expected credit losses*.”

“5.5.8 An entity shall recognise in profit or loss, as an *impairment gain* or loss, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with this Standard.”

“5.5.10 An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date (see paragraphs B5.5.22–B5.5.24).”

“5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;**
- (b) the time value of money; and**
- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.”**

“B5.5.22 The credit risk on a financial instrument is considered low for the purposes of paragraph 5.5.10, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in

the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which an entity operates."

"B5.5.28 Expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

B5.5.29 For financial assets, a credit loss is the present value of the difference between:

- (a) the contractual cash flows that are due to an entity under the contract; and
- (b) the cash flows that the entity expects to receive."

"B5.5.44 Expected credit losses shall be discounted to the reporting date, not to the expected default or some other date, using the effective interest rate determined at initial recognition or an approximation thereof. If a financial instrument has a variable interest rate, expected credit losses shall be discounted using the current effective interest rate determined in accordance with paragraph B5.4.5."

From the above, the Committee notes that as per the requirements of Ind AS 109, since expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due. Therefore, the Committee is of the view that the company in the extant case should provide for expected credit losses as per the requirements of Ind AS 109 even though as per the querist, there is an insignificant risk of default on the subsidy receivable. The Committee further notes that as per the requirements of Ind AS 109, the company in the extant case should determine whether there has been significant increase in the credit risk since initial recognition. If the credit risk has not increased significantly, 12 months ECL is to be provided for as impairment else life time ECL is to be provided. In this regard, the Committee is of the view that the past experience with the Government of honouring its commitments and the strong capacity and ability of the Government to meet its contractual cash flow obligations (as also evidenced from the past trend) should also be taken into consideration while providing for ECL.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 11 above:

- (i) and (ii) As stated in paragraphs 14 and 15 above, the subsidy receivable in the extant case is a government grant as per the requirements of Ind AS 20, which is also a financial asset and accordingly, requirements of Ind AS 115 are not relevant

in the extant case. On initial recognition of subsidy receivable, the company should recognize the same at fair value of the subsidy receivable as per the requirements of Ind AS 20 and should also consider expected timing of cash flows, as discussed in paragraph 16 above. Further, as per the requirements of Ind AS 109, on subsequent measurement, the fertilizer company should provide for the expected credit loss allowance (irrespective of the fact that historical trend for receiving the payments is less than 365 days) as per the requirements of Ind AS 109 and while providing for such ECL, the past experience with the Government of honouring its commitments and the strong capacity and ability of the Government to meet its contractual cash flow obligations (as also evidenced from the past trend) should also be taken into consideration, as discussed in paragraph 17 above.
