

## **Query No. 5**

**Subject:** *Accounting treatment of license fees (lease rentals) paid for use of licensed land for the development of new integrated fuel farm facility.*<sup>1</sup>

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

1. A company had been incorporated by ABC Private Limited (also referred to as the Airport Operator) as a private company limited by shares under the Companies Act, 1956, as its wholly owned subsidiary. Thereafter, on 6<sup>th</sup> March 2014, ABC Private Limited along with three other promoter companies entered into a Shareholders' Agreement cum Share Purchase Agreement so as to effectively form a joint venture company amongst the four parties (herein referred to as "the company"). The company was to achieve the following objective:

- To take-over existing aviation fuelling facilities and businesses including without limitation aviation fuelling stations, tankage, hydrant infrastructure.
- To create, establish, design, construct, develop, upgrade, modernise, integrate, optimise and modify, fuelling facilities for the airport.
- To operate, manage and maintain and to provide services in relation to the fuelling facilities for the airport, on an Open Access basis.

2. The company is in the process of creating a modern and efficient aviation fuel facility to cater to the needs of airlines operating from the International Airport. The company has also undertaken the development of the Integrated Facility and linking thereof to the Hydrant System.

The company has executed a License Agreement with the Airport Operator for two locations, i.e. at Location 1 & Location 2 (A and B). The fuel farm operations are being carried out at Location 1 and the project of development of integrated fuel farm facility is carried out at Locations 2 (A and B).

3. Prior to the formation of Joint venture company, three of the promoter companies had constructed aviation fueling stations, hydrant infrastructure and allied facilities on the land licensed by the airport operator to the respective three promoter companies to enable each of them to supply aviation turbine fuel (ATF) at the airport.

Further, the Airport Operator was in the process of developing a new integrated fuel farm facility at the airport.

4. For the purposes of establishing an integrated aviation fueling facility at a single location, the Airport Operator and the other three promoter companies formed the Joint venture company. These three promoter companies transferred to the company the existing fueling facilities and the Airport Operator (also a promoter) granted to the company the right to use the licensed land on which the fueling stations were erected.

5. The total license fee is Rs. 46,901,329 for the year ended 31 March 2017, out of which:

(A) License fee of Rs. 24,784,597 paid for the licensed land (Location 1) used for the existing fuel farm facility being of revenue nature have been charged to the Statement of Profit & Loss for the financial year 2016-17. This facility is being used for operational purpose until the new integrated fuel farm facility is commissioned.

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<sup>1</sup> Opinion finalised by the Committee on 4.4.2018 and 5.4.2018.

(B) The license fees of Rs. 22,116,732 paid for the use of licensed land (Location 2) admeasuring 37947 sq. mtrs. being directly attributable expenses for the development of the new integrated fuel farm facility under construction have been capitalised in the books of account for the financial year 2016-17 and have been included in cost of Work in Progress (CWIP) as per Ind AS 16, 'Property, Plant & Equipment'.

6. As per the querist, the above treatment is also based on EAC Opinion dated 24 January 1990 (published as Query no. 1.3 of Volume X of the Compendium of Opinions). Further, the same treatment is also emphasized in Ind AS 16 and the detailed analysis is given below by the querist:

In accordance with Ind AS 16, 'Property, Plant & Equipment', all directly attributable expenses incurred by the company for development of the integrated fuel farm facility are capitalised as a part of CWIP. The key question is whether the license fees paid by the company for usage of land/additional land can be considered as being directly attributable to the construction cost. The company has considered these license fees as directly attributable expenses for construction and thus capitalised these costs as a part of CWIP.

As per paragraphs 16 and 17 of Ind AS 16, 'Property, Plant & Equipment':

“16 The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17 Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in Ind AS 19, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) ...”

The cost of the license fee during the construction period is an unavoidable cost of constructing the integrated facility because without the lease, no construction could occur. Hence the license fee paid for land during the construction period should be considered as a directly attributable cost and consequently capitalised.

7. Further, paragraph 19 of Ind AS 16 lays down the examples of costs that **are not** costs of an item of an acquired or constructed property, plant and equipment. They are:

- (a) costs of opening a new facility;
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities);
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- (d) administration and other general overhead costs.

License fees paid for the use of the land in question do not get covered in the type of expenses illustrated in this paragraph 19. (Emphasis supplied by the querist.)

8. The querist has mentioned that this view (i.e. the appropriateness of capitalisation) is also supported by an earlier EAC opinion issued on 24 January, 1990, where the querist had raised an issue pertaining to capitalisation of interest and ground rent payable till the completion of construction of the office building. According to the querist, in this opinion, the ground rent was payable for the land on which the office building was being constructed. In the instant case, the Committee was of the opinion that interest accruing during construction period on the instalments of land *together with the ground rent payable* during the construction period of the building should be capitalised. Further, the Committee also referred to 5.1 of the ‘Guidance Note on Treatment of Expenditure During Construction Period’, and recommended the following in connection with indirect expenditure incidental and related to construction:

*“This paragraph deals with the bulk of the indirect expenditure which would be incurred by a project during its construction period. A characteristic of this type of expenditure is that, for a running concern, it would be of a revenue nature. However, because the expenditure is incurred during the construction period and because, during that period, the expenditure is indirectly related to construction and is incidental thereto, it should be capitalised as part of the construction cost.”*

Though this opinion was issued under Indian GAAP, the core principle of what are directly attributable expenses to be capitalised, is similar under both Ind AS and Indian GAAP.

(Emphasis supplied by the querist).

9. As per note 2.5(iv) of the Notes to Accounts forming part of the Financial Statements for the year ended 31 March 2017, “Cost comprises cost of acquisition or cost of construction and any directly attributable cost of bringing the asset to its working condition for its intended use.”

10. As per note 2.12 of the Notes to Accounts forming part of the unaudited Financial Statements for the six months ended 30 September 2017, the company signed License Agreements with the lessor-promoter as contextually summarized below:

<b>Title of Agreement</b>	<b>Location</b>	<b>Area (sq. metre)</b>	<b>License Period</b>
Short Term Agreement	1	38,890.00	Effective Date to 30 November, 2017 or such later date as may be mutually agreed between the Parties.
Long Term Agreement	2(part A)	30,163.32	Effective Date to 2 May, 2036 subject to any extension in accordance with the Agreement.

Long Term Agreement	2(part B)	7,783.68	Effective Date to 2 May, 2036 subject to any extension in accordance with the Agreement.
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11. During the audit by the Comptroller and Auditor General (CAG), the CAG expressed their opinion (see extract below) that the treatment of capitalisation of license fees of Rs. 22,116,732 is not in accordance with Ind AS 16:

“The License Fee paid to the lessor for the period from 1<sup>st</sup> April 2016 to 31<sup>st</sup> March 2017 for the land area of 37,947 sq. mtrs. of the project site is an operating lease for Integrated Fuel Farm facility at (the airport) for the period from 30<sup>th</sup> December 2014 to 2<sup>nd</sup> May 2036. Considering the nature of lease and in accordance with Ind AS 17 the amount of lease rental should have been charged to Profit and Loss account. This has resulted in understatement of Other Expenses and overstatement of profit.”

### B. Query

12. The company has sought the opinion of the Expert Advisory Committee as to whether the license fees/lease rentals paid for the project site (used for the development of the integrated fuel farm facility- Location 2) has been correctly capitalised as per Ind AS 16.

### C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query is whether certain lease rentals qualify for capitalisation in accordance with Ind AS 16, ‘Property, Plant & Equipment’. 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, accounting treatment of any other expenditure incurred by the company, nor has the Committee verified the factual accuracy of the data and information presented by the querist, including but not limited to the numerical data. The Committee has also not examined whether the lease rentals have been measured in accordance with Ind AS 17 or not. The Committee would further like to mention that the terms “license fees” and “lease rentals” are used interchangeably in this document but are intended to mean lease rentals, considering the substance of the arrangement as outlined by the querist. At the outset, the Committee wishes to point out that the opinion expressed hereinafter, is in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

14. The Committee also wishes to clarify that with regard to the references made by the querist to the earlier ICAI opinions and guidance note during the AS era, the same may not be relevant in the context of Ind AS and accordingly, the Committee has not considered the same.

15. The Committee notes paragraph 16(b) of Ind AS 16, ‘Property, Plant & Equipment’ which states that the cost of “an item of property, plant and equipment comprises **any costs directly attributable** to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management” (emphasis added by the Committee).

16. The Committee is of the view that “directly attributable” costs are generally such costs which are necessary, to enable the construction activity, i.e. these costs are directly related to the construction activity and without the incurrence of which the asset cannot be brought to the location and condition necessary for it to be capable of operating in the manner intended by management.

17. In the extant case, the construction activity is on the leased land that, considering the facts as presented, is rented only for the purpose of creating (and subsequently operating) the

integrated facility. As such, there appears to be a direct relation between the land and the construction activity, leading to the conclusion that the lease rentals of such land are directly attributable to the construction activity.

18. To address the point made by the CAG auditors, i.e. that *“Considering the nature of lease and in accordance with Ind AS 17 the amount of lease rental should have been charged to Profit and Loss account”*, the Committee believes that, while in the current context, Ind AS 17 *Leases* does deal with the accounting for lease rentals, Ind AS 16 provides more specific and relevant guidance to the issue under consideration.

19. In addition, it is important to note that the lease rental costs should be considered for capitalisation only until the point of **“bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management”**, and should stop at that point (highlighted section extracted from paragraph 16(b) of Ind AS 16).

20. Finally, the Committee wishes to highlight that the lease rental costs that require capitalisation should be suitably allocated to the unit or units of measure of the property, plant and equipment. For example, it might be that the querist’s capitalisation unit comprises of two separate assets, i.e. Location 2A and Location 2B. If so, then the lease rentals that require capitalisation should be allocated to these two assets on a reasonable basis using appropriate judgment. In this context, the following extract from paragraph 9 of Ind AS 16 is relevant:

“This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity’s specific circumstances ...”

#### **D. Opinion**

21. On the basis of the facts as presented by the querist, it is apparent that there is a direct relation between the leased land and the construction activity thereon. As a result, the rental cost of such land, upto the time as mentioned in paragraph 19 above, can be said to be directly attributable to the construction activity, as envisaged in paragraph 16(b) of Ind AS 16, ‘Property, Plant & Equipment’. Therefore, the Committee is of the opinion that the accounting policy adopted by the querist, i.e. the capitalisation of the lease rentals of the under-construction integrated facility, is appropriate.