

Query No. 1

Subject: *Accounting treatment under Ind AS for depreciation of ‘enabling assets’, amortization of leasehold land and project insurance in case of a new company formed for setting up of new urea plant which is under construction phase.*¹

A. Facts of the Case

1. A company (hereinafter referred to as the ‘company’) is a joint venture company promoted by two fertilizer manufacturing companies (X Ltd. and Y Ltd.) and an engineering consultancy PSU, Z Ltd. The company was incorporated on 17th February, 2015 in terms of the mandate of the Government of India (GoI) of setting up of new gas based ammonia-urea complex at the closed ABC unit of Y Ltd. in terms of nomination by the Cabinet Committee of Economic Affairs (CCEA), GoI decision dated 4th August, 2011 for revival of closed fertilizers units of Y Ltd., which includes ABC unit.

2. The querist has informed that as per the process of revival of closed ABC unit of Y Ltd., the old plant was dismantled and sold off by Y Ltd. and the company is setting up a new state of art gas based ammonia-urea complex with production capacity of 2200 MTPD of ammonia and 3850 MTPD of urea (1.27 million MT urea per annum) at fertilizer city, ABC. For setting up urea plant, the company opened its project office at New Delhi for execution of the project on 1st October, 2015 and subsequently with the commencement of construction activities at ABC, site office was made operational.

3. As per the querist, shareholding of the company as on 31st March 2018 is as under:

S.No.	Particulars	% of Shareholding
1.	X Ltd.	26
2.	Y Ltd.	11
3.	Z Ltd.	26
4.	State Government	11
5.	Others (Un-tied)*	26

* Tie up of balance equity is under process and shall be completed in the current financial year 2018-19.

4. Abridged statement of affairs of the company as on 31st March 2018 is as under:

Particulars	Amount INR
Equity Share Capital	602.12 Crore
Outstanding Term Loan from Consortium of Banks	1104.52 Crore
Capital Work in Progress	1341.83 Crore
Reserve & Surplus	(4.41 Crore)

5. As further stated by the querist, the project is being executed on Engineering Procurement & Construction Management (EPCM) route. The company after entering into contracts with technology suppliers and licensors for ammonia & urea and engaging Z Ltd. as EPCM Consultant, declared zero date of the project on 25th September, 2015 and the project is anticipated to be completed in the first quarter of financial year 2019-20. The project is in the advanced stage of construction and achieved physical progress of 85.5% as on 15th June,

¹ Opinion finalised by the Committee on 9.4.2019.

2018. The total project cost envisaged is Rs. 5254.28 crores with debt-equity ratio of 75:25. Total debt of Rs. 3940.71 crores has been lined up and loan agreement has been entered into with consortium of 6 banks led by the State Bank of India.

6. Since the date of incorporation of the company, i.e., 17th February 2015, its first annual accounts were prepared for the period of 17th February 2015 to 31st March 2016 as per Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006. Annual accounts for the financial year 2016-17 were prepared in terms of Indian Accounting Standards (Ind ASs) in terms of the Companies Act, 2013. Comptroller and Auditor General of India (C&AG) decided not to conduct the supplementary audit of the financial statements of the company for the year ended 31st March, 2017 under section 143(6)(a) of the Act. Annual accounts for the financial year 2017-18 (duly audited by statutory auditor appointed by C&AG) have been prepared in terms of Ind ASs, which have been adopted and approved by the board at its last meeting held on 28th April 2018 (copy of the accounting policies has been supplied separately by the querist for the perusal of the Committee). The audited accounts were submitted to C&AG on 3rd May, 2018.

7. The querist has stated that the audited accounts of the company for the financial year 2017-18 were selected by the C&AG under section 143(6)(a) of the Companies Act, 2013 for supplementary audit. C&AG has raised provisional comments which are given below:

C&AG Provisional Comments:

“Balance sheet

Non-current assets

Capital work-in-progress

The above includes an amount of Rs. 47.36 crore (Rs. 28.95 crore for the financial year 2017-18) being expenses incurred and taken to capital work-in-progress (CWIP) for capitalisation by the company. The said expenses were of revenue nature and were not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating. Through these expenses mainly represented the overheads costs, but not charged as expenses and taken to CWIP for capitalisation which is not in line with provisions of Ind AS 16.

This has resulted in overstatement of capital work in progress (Note 4) by Rs. 47.36 crore, ‘Reserve and Surplus’ by Rs 18.41 crore and understatement of loss for the year by Rs. 28.95 crore.”

8. Management had submitted reply with justification of inclusion of these expenditure in CWIP. (The reply of the company to C&AG has been separately supplied by the querist for the perusal of the Committee.) Based on the reply of the company and discussions held, C&AG dropped all its observations except recording of insurance, amortisation on lease hold land and depreciation in CWIP.

9. During deliberations, C&AG stated that insurance and depreciation & amortization expenses should be expensed in the statement of profit and loss and should not be capitalised. The company maintained its stand that these expenditure are directly attributable to the project and accordingly capitalized as CWIP. Thereafter, it was agreed that the company shall refer the matter to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for its opinion. Subsequently, C&AG issued Nil comments on the company’s financial statements for the financial year 2017-18.

10. The company's submission is given as below:

- a) *The accounting policy at Note No. 1(h) of the financial statements* - Expenditure incurred during the construction period and directly attributable to the construction activity has been capitalised as capital work in progress and will be allocated to the fixed assets at the time of capitalisation of the project (Notes to the financial statements for the year ended March 31, 2018 have been supplied by the querist for the perusal of the Committee). Accounting treatment is in line with accounting policy of the company.
- b) *Depreciation and amortisation expenses – capitalised to CWIP* – This represents amortisation of leasehold land from Y Ltd. at project site, ABC and depreciation expenses on project enabling assets. The break-up of depreciation and amortisation expenses is as under:

(Rs. in lakhs)

Financial Year	Depreciation	Amortization	Total
2016-17	69.25	-	69.25
2017-18	185.44	342.18	527.62
	254.69	342.18	596.87

As per paragraph 16(b) of Ind AS 16, 'Property, Plant and Equipment', "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."

Further paragraph 49 of Ind AS 16 states as follows:

"49 The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see Ind AS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with Ind AS 38, *Intangible Assets*."

The company is of the view that the intent of paragraphs 49 and 16 (b) of Ind AS 16 is that allocated costs of fixed assets which are used in the construction of other fixed assets must be included in the cost of those assets. Since, land is an essential asset on which project related activities are undertaken for construction of a fertilizer plant, its amortisation cost up to the date of completion of project is to be included in the cost of construction of the fertilizer plant.

11. The querist has stated that one of the object of the approval of the Cabinet Committee on Economic Affairs (CCEA) dated 4th August, 2011 (the letter has been separately provided by the querist for the perusal of the Committee) was to increase the urea production capacity in the country and therefore approved award of closed fertilizer units of Y Ltd. to selected parties on concession basis. As per paragraph 6.2 of CCEA approval, land shall be provided to concessionaire (the company) on right to use basis for the period of concession and during

the concession period, Y Ltd. would retain a board seat in the Special Purpose Vehicle (SPV) (the company) to safeguard its rights in the land. Therefore, the company has no choice but to construct plant on leasehold land and amortise the same in accordance with Ind AS.

12. Similarly, the company has charged depreciation in respect of project enabling assets which are required for execution of project and same has been disclosed as depreciation and amortisation in Note 4 relating to 'Capital Work in Progress'. Further it is submitted that these costs are unavoidable and essential to be incurred to execute the project. Land is acquired by the company for executing project on leasehold basis as per terms of agreement as specified above.

13. *Insurance Expenses – Capitalised to CWIP*– The company has taken marine cum erection insurance policy for coverage of all its equipments, storage and erection and commissioning of the equipment which also includes other project related insurance for associated costs for delayed commencement of project due to insured perils. All these policies shall expire immediately upon commissioning of project. The expense of Rs. 6.38 crore (Rs. 2.23 crore for F.Y. 2016-17 and Rs. 4.15 crore for F.Y. 2017-18) was charged to CWIP.

14. In this regard, the querist has stated that setting up of a project of such a magnitude and bringing property, plant and equipment to its present location without taking insurance policy for coverage is not considered commercially feasible. Hence, insurance policy is an integral part of project activities. The secured handling of project goods, whether in transit or during erection is an utmost project activity for timely completion of project without additional costs towards contingencies. To ensure this, all critical project equipments are inspected / surveyed at loading / unloading points. All these critical items with other project goods are got covered under the insurance policy. The premium paid under the insurance policy is directly attributable to project.

15. This Policy covers the risk of marine and erection of plant under construction. In case, the company had not taken this policy, then individual supplier and contractor would have taken the specific policy for marine as well as erection and had included this cost in their quoted price. Thus, as per the querist, the insurance cost is an essential cost to be incurred for successful execution of project and the same is to be included in the project cost eligible for capitalisation as per paragraph 16 (b) of Ind AS 16.

16. Reference to legal cases -While capitalising the insurance cost, landmark decision on actual cost by the Supreme Court in case of *Challapalli Sugars Ltd. vs CIT* [98 ITR 167 (SC) (1975)] was kept in mind. (Copy of the same has been separately supplied by the querist for the perusal of the Committee.) In this case, according to the querist, the apex Court has held that interest paid before the commencement of production on amounts borrowed for acquisition and installation of plant and machinery form part of the actual cost of the assets.

In arriving at the above decision, the Supreme Court has laid down the following important principles for determination of actual cost:

- (i) As the expression 'Actual Cost' has not been defined, it should be construed in the sense which no commercial man would misunderstand. For this purpose, it would be necessary to ascertain the connotation of the expression in accordance with the normal rules of accountancy prevailing in commerce and industry.
- (ii) The accepted accountancy rule for determining cost of fixed assets is to include all

expenditure necessary to bring such assets into existence and to put them in working condition.

Other cases settled where directly attributable cost including insurance cost is to be capitalized –

- CIT vs New Central Jute Mills [135 ITR 736 (Cal) (1982)]
- CIT vs Polychem Ltd [98 ITR 574 (Bom) (1975)]
- Madras Fertilizers Ltd vs CIT [209 ITR 174 (Mad)]
- Hotel Bombay Complex vs CIT [198 ITR 361 (Kar) (1992)]

17. The querist has also separately provided certain additional information which is as follows:

(i) *With regard to marine-cum-erection insurance policy:* The company has placed various orders for project equipments including orders on foreign suppliers. Further, the company has entered into various package contracts which involve supply, installation and erection of equipment as well as various civil and erection contracts. For protection from transportation, erection and commissioning risks, taking of insurance policy is either included in the scope of suppliers and contractors and cost of insurance becomes part of cost of supply of equipment/ contract value or composite insurance is taken by project owner. The company has taken composite marine-cum-erection insurance policy for all project equipments and contracts; and accordingly the purchase orders and contracts placed by the company are exclusive of insurance cost.

The project is funded from debt and equity in debt equity ratio of 75:25. For entering into loan agreements with banks, one of the pre-commitment condition as per loan sanction letter of banks (copy of the letter has been supplied by the querist for the perusal of the Committee) was appointment of Lenders' Insurance Advisor (LIA). The scope of services of LIA is to advise on the insurance policy to be taken by the project owner and if policy has been already taken, to examine and see the adequacy of the insurance policy. Thus, without insurance policy in place, the company could not have arranged the debt and project had to be closed.

Further, in case of imports, the company is required to establish Letter of Credits (LCs). Establishment of LCs is governed by Uniform Customs and Practice (UCP) for Documentary Credits, issued by International Chamber of Commerce. UCP are rules that apply to any documentary credits (including letter of credit) and binding on all parties unless expressly modified or excluded from credit. For issuance of LCs by bank, it has to be UCP compliant. Presently, UCP 600 is in force and Article-28(iii) of UCP 600 provides as follows:

“The insurance document must indicate that risks are covered at least between the place of taking in charge or shipment and the place of discharge or final destination as stated in the credit.”

The insurance policy taken by the company covers transit risk of domestic goods, risks associated with storage of project goods waiting for use, risks arising out of erection of equipment and other incidental risks. Therefore, incurrence of insurance cost is directly attributable to project cost as it is unavoidable and has to be incurred for execution of the project. (Copy of UCP 600 and copy of a LC issued by bank has been supplied by the querist for the perusal of the Committee.)

In the instant case, the company has taken insurance policy and disclosed insurance cost separately in financial statements. Alternately, insurance cost would have been taken by all the suppliers to cover their risk in case of any loss in supply of goods. Similarly, the contractors would have also covered their risk in execution of contract, and this cost would have been a part in their consolidated contract / supply price. The company has taken insurance policy of its own to ensure that in case of any eventuality, insurance claim can be made by the company and also to ensure that all possible risks from movement of goods till its complete erection are covered, instead of piecemeal approach for insurance covers.

As per the querist, the execution of the project of such a magnitude is not possible unless the associated risks of the project are duly mitigated. Lenders do not extend the loan facility unless and until adequate insurance cover has been taken by the project owner and the insurance policy is monitored by LIA for lenders. For opening of letter of credits, insurance policy is mandatory under UCP 600.

Thus, various insurance policies taken by the company are an integral part of the project. (Copies of four insurance policies have been supplied by the querist for the perusal of the Committee.)

(ii) *With regard to leasehold land:* Cabinet Committee on Economic Affairs at the meeting held on 4th August, 2011, mandated revival of ABC unit of Y Ltd. by forming a Special Purpose Vehicle (SPV)/Joint Venture (JV) between X Ltd., Y Ltd. and Z Ltd. As per the concession agreement between the company and Y Ltd., approved by the Government, leasehold rights of the land (owned by Y Ltd.) have been given to the company for a period of 99 years. The lease, according to the querist, is a finance lease and has been capitalised by the company.

The company has acquired this right to use of land as an intangible right from Y Ltd. Since the company is having right to use and it will derive future benefits from it, thereby it fulfils the capitalisation requirements of Ind AS 38; therefore, this right has got capitalised in books. (The copy of lease deed has been supplied by the querist for the perusal of the Committee.)

(iii) *With regard to enabling assets:* In order to commence, monitor and provide support in carrying out the construction activity, the company was required to create 'enabling assets', which are directly related to project activities, such as:

- (a) Construction power system;
- (b) Construction water network;
- (c) Warehouse / stock yards;
- (d) Security watch towers;
- (e) Generators for power backups;
- (f) Technical and other buildings at site;
- (g) IT equipment / furniture and fixtures etc.

All the above activities are essential for commencement of project construction and are directly attributable to the project. Accordingly, the 'enabling assets' as above have been capitalised. Further, the querist has separately clarified that these enabling assets have been capitalized as separate individual items of property, plant and equipment and

would be continued to be used by the company after the construction of the project is complete, for the operations of the project also.

B. Query

18. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on following issues:

- a) Whether expenses on account of project insurance consisting of marine-cum-erection insurance policy for coverage of all the equipments and site activities during construction and commissioning periods are directly attributable to the project activity and eligible for capitalisation.
- b) Whether expenses on account of depreciation on enabling assets during construction period are directly attributable to the project activity and eligible for capitalisation.
- c) Whether expenses on account of amortization of leasehold rights of the land which have been given by Y Ltd. (on finance lease) are directly attributable to the project activity and eligible for capitalisation.

C. Points considered by the Committee

19. The Committee notes that the basic issues raised in the query are whether expenses on account of project insurance (marine-cum-erection insurance policy) during the construction period, expenses on account of depreciation and amortisation of assets created for construction (referred to as ‘enabling assets’ by the querist) and ‘right to use’ of land in connection with the project, respectively, are directly attributable to project. 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 for other expenses incurred during the construction period, accounting treatment of equity shares issued in lieu of the plant (including leasehold land) to Y Ltd., measurement of minimum lease rent, commencement of amortization, allocation of consideration of plant acquired by the company between consideration for land and for other plant facilities, manner of determination of depreciation on leasehold land, etc. Further, the Committee has expressed its opinion purely from the accounting perspective and not from tax perspective or from the perspective of legal interpretation of UCP 600 and various judgements of High Court/Supreme Court, as referred to by the querist. At the outset, the Committee notes from the Facts of the Case that certain assets have been created by the company in order to commence, monitor and provide support in carrying out the construction activity, which have been termed and capitalized as ‘enabling assets’ by the querist. In this connection, the Committee wishes to point out that the nature of these assets as ‘enabling asset’ has not been examined by the Committee. The Committee also wishes to state that it has not examined the accounting for ‘enabling assets’ as such and has presumed that the recognition and measurement of the ‘enabling assets’ has been done correctly by the company considering the applicable accounting principles.

Expenses on account of project insurance (consisting of marine-cum-erection insurance)

20. The Committee notes that the company has taken marine-cum-erection insurance policy for coverage of all equipments and site activities during construction and commissioning period. In this regard, the Committee notes paragraph 16(b) and 17 of Ind AS 16, Property, Plant and Equipment, notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as the ‘Rules’), which state as follows:

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

- ...
- (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.
- ...”

“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) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- (f) professional fees.”

From the above, the Committee notes that the expenses that are 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 should only be capitalised. The Committee also notes the examples of directly attributable costs as given in paragraph 17 of Ind AS 16 above. Thus, in the extant case, the accounting treatment of expense on account of marine-cum-erection insurance policy would depend upon whether or not the same is directly attributable to the construction/acquisition of the project/related asset(s).

The Committee notes that an insurance policy is normally taken to protect/safeguard against the loss that may arise in unforeseen future and may not be ordinarily essential for or will contribute to construction activity as such. Therefore, it cannot be considered as directly attributable to construction/acquisition of the project. In the extant case also, the Committee notes that the marine-cum-insurance policy has been taken to ensure that all the possible risks from supply/installation of goods/equipment till their complete erection are covered. Accordingly, considering the facts provided by the querist and considering the nature of directly attributable costs as per paragraphs 16 and 17 of Ind AS 16 reproduced above, the Committee is of the view that in the extant case, the expenses on account of project insurance cannot be considered as directly attributable costs and should accordingly be recognized in the statement of profit and loss.

In the above context, the Committee also wishes to mention that the fact that insurance is required to obtain loan/credit facilities does not make it directly attributable to the construction/acquisition of the project as in that case, these costs of insurance are incurred for obtaining loan and establishing letter of credit, i.e., for obtaining funds for the project as such and not for constructing/acquiring the project/equipments.

Depreciation on assets used during construction (referred to as 'enabling asset' by the querist; the expression 'enabling asset' has been used in the discussion below only for reference to these assets).

21. The Committee notes from the Facts of the Case that in order to commence, monitor and provide support in carrying out the construction activity, the company has acquired/constructed various assets, such as, power system, water network, warehouse, stock yard, security watch towers, generators for power back-ups, technical and other buildings at site, IT equipment/furniture and fixtures etc. These have been capitalised as separate individual items of property, plant and equipment and would be continued to be used by the company after the construction of the project is complete, for the operations of projects also. With regard to inclusion of depreciation on these assets during construction period in the cost of project/assets being capitalized (CWIP), the Committee notes paragraphs 48 and 49 of Ind AS 16, 'Property, Plant and Equipment', notified under the Rules, which state as follows:

“48 The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset.

49 The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see Ind AS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with Ind AS 38, *Intangible Assets*.”

From the above, the Committee notes that the depreciation charge for each period is recognized in the profit and loss unless it forms part of *another asset*. Thus, depreciation on an asset can only be capitalised with another asset if the future economic benefits embodied in that asset are absorbed in producing other asset. The Committee further notes that the querist has specifically stated in paragraph 12 above that these costs on 'enabling assets' under query are unavoidable and essential to be incurred to execute the project. Accordingly, the Committee is of the view that in the extant case, depreciation on such 'enabling assets' under query to the extent and till the time the future economic benefits embodied in the aforementioned assets are absorbed in construction of the project/other assets, should be capitalized along with the project/other assets under construction. The Committee is also of the view that the depreciation on such assets should be allocated appropriately and on a reasonable and systematic basis to other asset(s) or the project after ascertaining the benefit being obtained from these assets.

Expenses on account of amortisation of leasehold rights of the land

22. The Committee notes that the company has applied Ind AS 38, 'Intangible Assets' instead of Ind AS 17, 'Leases', which includes leases of land in its scope. In this context, the Committee also notes paragraph 3(c) of Ind AS 38, 'Intangible Assets', notified under the Rules, which states that "If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For Example, this Standard does not apply to: ... (c) leases that are within the scope of Ind AS 17, *Leases*". The Committee also notes paragraph 3 of Ind AS 17, 'Leases', notified under the Rules, which states that "This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or

maintenance of such assets. This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other". As in the extant case, right to use the land has been transferred by Y Ltd. to the company, the Committee is of the view that accounting for the same will be governed by Ind AS 17, 'Leases' and not Ind AS 38, 'Intangible Assets'.

23. Further, the Committee is of the view that answer to the issue regarding inclusion of expenses on account of amortization of leasehold land would depend upon whether such lease is operating lease or finance lease. The Committee notes the following paragraphs of Ind AS 17, 'Leases', notified under the Rules:

"A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An operating lease is a lease other than a finance lease."

"10 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

- (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent."

"15A When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life."

24. From the above, the Committee notes that a key criterion to determine the type of lease is whether or not it transfers substantially all the risks and rewards incidental to ownership of an asset. However, application of this criterion is subjective and depends on the substance of the transaction rather than the form of the contract and requires exercise of judgement considering various situations and indicators of situations, as prescribed in paragraphs 10 and 11 of Ind AS 17, such as, transfer of ownership of the asset by the end of lease term, option to purchase the asset at the end of the lease term at a price substantially lower than the fair value at the date the option becomes exercisable, economic life of the asset covered by the lease term, present value of minimum lease payments, conditions for cancellation and renewability, accrual of gains or losses from the fluctuation in the fair value of the residual etc.

25. The Committee notes the following relevant paragraphs of the lease deed:

“3. The absolute ownership, rights, title and interests of the Facility Area shall continue to remain with the Lessor only and the Lessee shall have right to enjoy the Facility Area for the Term of this Lease Deed and in accordance with the terms and conditions of this Lease Deed.”

“5.2.1 In the event, the Concession Agreement is extended, the Parties agree that the Term of this Lease Deed shall be extended to the extended term of the Concession Agreement on mutually agreed terms and conditions. The Lessor agrees not to unreasonably object to such an extension of the Term.”

“5.3 **Reversion**

On expiry of the Term or early termination of Lease Deed, for any reason whatsoever, the Lessee shall handover, the Facility Area, Facility and Facility Capital Assets to the Lessor in accordance with the terms of the Concession Agreement.”

“7.1 **By Lessee**

The Lessee shall obtain prior written consent of the Lessor with respect to Clause nos. 7.1.1 and 7.1.4

7.1.1 assign, mortgage (including equitable mortgage), charge, deal with, sub-license or otherwise grant rights in the Lease Deed, or any of its obligations or liabilities under this Lease Deed;

7.1.2 cause or permit any person, firm or company (other than any department of Government of India/Relevant Authorities) at any time to use (except for the purpose of construction of the Facility) any part of the Facility Area;

7.1.3 assign its rights to any payment(s) hereunder by way of security for its obligation in relation, directly or indirectly, to any Borrowings;”

“12.6 The Lessor assures and represents to the Lessee that the lease granted in terms of this Lease Deed is irrevocable for the term, except in accordance with the provisions of this Lease Deed and/or the Concession Agreement.”

26. The Committee notes that the lease, in the extant case, is an irrevocable lease for a period of 99 years. Further, the Committee notes from the lease deed that the absolute ownership, rights, title and interests of the facility area shall continue to remain with lessor and the lessee shall have the right to enjoy the facility area for the terms of the lease deed. It is also stated in the lease deed that the lease can be extended on mutually agreed terms and

lessor will not unreasonably object to such extension. The lease deed also states that on expiry of the term or early termination, the lessee shall handover the Facility Area, Facility and Facility Capital Assets to the Lessor in accordance with the terms of the Concession Agreement. The Committee also notes that the lessee needs to obtain written consent of the lessor to assign/mortgage, charge, deal with, sub-licensing or otherwise grant rights in the lease deed or permit anyone (other than Government department) to use any part of facility area, assign its rights to any payment etc.

However, the Committee notes that various other factors for determining the type of lease, such as, the fair value of land, transfer of ownership at the end of lease term, option to purchase, cancellation of lease etc. have not been explicitly provided in the facts of the case and the lease agreement. Accordingly, the Committee is of the view that in the extant case, for a lease of land for 99 years, if it is likely that at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset (viz., land), then, such lease will be classified as 'finance lease'. It may also be, however, noted that land normally has an indefinite economic life. Therefore, where in substance there is no transfer of risks and rewards, it should be considered as an operating lease. Some of the indicators to consider in the overall context of whether there is transfer of risks and rewards incidental to ownership include the lessee's ability to renew lease for another term at substantially below market rent, lessee's option to purchase at price significantly below fair value, etc. Accordingly, classification as operating or finance lease requires exercise of judgement based on evaluation of facts and circumstances in each case, by considering the indicators enumerated above.

27. On the basis of the above, the Committee is of the view that if the company after a detailed evaluation, concludes that the lease is an operating lease, the lease payments should be capitalised along with the capital work-in-progress till the time the asset/project is ready for the intended use as the same can be considered as 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 as per paragraph 16(b) of Ind AS 16, Property, Plant and Equipment. When the asset/project is ready for its intended use, the lease rent shall be recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit as given in paragraph 33 of Ind AS 17, 'Leases', notified under the Rules, reproduced below:

“33 Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless either:

- (a) another systematic basis is more representative of the time pattern of the user's benefit even if the payments to the lessors are not on that basis; or**
- ...”

If the company after detailed evaluation concludes that the land lease is a finance lease, then it will account for and present the asset as property, plant and equipment and provide depreciation considering useful life, limits on the use of the asset (including legal/contractual limits), whether there is any reasonable certainty that the lessee will obtain the ownership of the asset by the end of the lease term in accordance with the requirements of Ind AS 16, 'Property, Plant and Equipment' and Ind AS 17. Further, the depreciation so determined should be included in the cost of the capitalized asset/project as acquisition of the land is directly attributable to the construction of the project/related assets.

D. Opinion

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

- (a) Considering the nature of directly attributable costs as per paragraphs 16 and 17 of Ind AS 16, in the extant case, the expenses on account of project insurance cannot be considered as directly attributable costs and should accordingly be charged to the statement of profit and loss, as discussed in paragraph 20 above.
- (b) Depreciation expense on 'enabling assets' under query to the extent and till the time the future economic benefits embodied in these assets are absorbed in the construction of the project/other assets should be capitalised along with the project/other assets, as discussed in paragraph 21 above.
- (c) With regard to inclusion of expenses on account of amortization of leasehold land in the cost of the project, the same would depend upon whether such lease is operating lease or finance lease, which should be determined by exercising judgement, considering various criterions/indicators of Ind AS 17, as discussed in paragraph 26 above. If the company after detailed evaluation concludes that the land lease is an operating lease, the lease payments should be capitalised along with the capital work-in-progress till the time the asset/project is ready for the intended use. When the asset/project is ready for its intended use, the lease rent shall be recognized as an expense in the statement of profit and loss. In case after detailed evaluation, it is concluded that land lease is a finance lease, the company should provide depreciation considering useful life, limits on the use of the asset (including legal/contractual limits), whether there is any reasonable certainty that the lessee will obtain the ownership of the asset by the end of the lease term in accordance with the requirements of Ind AS 16, 'Property, Plant and Equipment' and Ind AS 17, 'Leases'. Further, the depreciation so determined should be included in the cost of the capitalized asset/project as acquisition of the land is directly attributable to the construction of the project/related assets, as discussed in paragraph 27 above.
