

## **Query No. 15**

**Subject:** *Accounting treatment of certain indirect administrative overheads (i.e., salary of the KMPs, directors' sitting fees, audit fees, statutory and other levies) incurred during construction phase of the Power Plant.*<sup>1</sup>

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

1. A company (hereinafter referred to as 'the company'), a joint venture of ABC Limited (Government of India enterprise) and XYZ Ltd. (State Government enterprise) is setting up a coal based supercritical thermal power plant with a capacity of 1980 MW (3 X 660 MW) with 51:49 equity participation.
2. The company was incorporated in the year 2012 to construct and operate 3 x 660 MW Thermal Power Project in Uttar Pradesh. The electricity tariff of the Power Plant will be decided by CERC as per the applicable CERC regulation. The Government of India (GoI) has accorded sanction for the project on 27.07.2016 with the sanctioned cost of Rs.17,237.80 crores and the schedule for completion of the project is 52 months, 58 months and 64 months from the date of GoI sanction for the 1st, 2nd and 3rd unit of 660 MW each respectively.
3. The company prepares its annual financial statements as per the provisions of the Companies Act, 2013 as amended from time to time. The financial statements are audited by the statutory auditors appointed by the Comptroller and Auditor General of India (C&AG). The C&AG auditors had also undertaken supplementary audit under section 143(6) of the Companies Act, 2013. The company being a power generating company, tariff of the company will be as per regulations of Central Electricity Regulation Commission (CERC).
4. As informed by the querist, presently the construction activities of the power plant are going in full swing and a capital expenditure of Rs. 6590.70 crores is spent till 30.06.2019. All expenditure incurred till March 2018 was booked under capital work in progress in balance sheet except the pre-incorporation expenditure of Rs. 200.21 lakh. During the year 2018-19, as per the provisions of Indian Accounting Standard (Ind AS), Rs. 28.40 lakh of indirect administrative overheads was charged to the statement of profit and loss.
5. The querist has further informed that C&AG auditors have expressed the following views during their supplementary audit:

*“Balance Sheet as on 31.03.2019*

*Assets*

*Capital Work in Progress – Rs. 4,988.34 Crore.*

Sub-para (a) of paragraph 17 of Ind AS 16 provides that the 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 would form the directly attributable cost of an item of property, plant and equipment.

During the review of the expenditure charged in the profit and loss account for the year ended 2018-19, it was noted that it includes mainly the salary of the Company Secretary, certification fees, and other employees related benefits. It was noticed that the company is in the construction phase of its only plant. All the concerned staff is deputed at construction site including the company secretary and other related sections. As still the major construction work is in progress, the main agenda of different

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<sup>1</sup> Opinion finalised by the Committee on 21.11.2019.

meetings (BoD etc.) is construction work only. In the light of the facts, it can be determined that the mentioned expenditure are directly related to project. Hence, same should have been capitalised instead of charging it off in the profit and loss account.

Non-capitalisation of the mentioned expenditure has resulted into understatement of Capital Work-in-Progress and over statement of expenditure by Rs. 0.28 crore.”

6. The company has submitted the following reply to above Half Margin of C&AG:

“As per Ind AS 16, in paragraph 16 (b), Elements of cost under Measurement at recognition, 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”.

As defined in paragraph 19 (d) of Ind AS 16, administration and other general overhead costs are not costs of an item of property, plant and equipment.

In view of the above paras, indirect administrative overheads like, Company Secretary Salary, Board Meeting Expenditure, Audit Fees totaling Rs. 28.40 lakh are charged to Profit and Loss Account instead of transferring the same to Capital Work in Progress.

It is proposed to seek opinion from experts including our Statutory Auditors, Expert Advisory Committee of the Institute of Chartered Accountants of India, Peer companies during the year 2019-20 and accordingly treat such expenditure in Financial Statements.”

(Emphasis supplied by the querist.)

## **B. Query**

7. On the basis of above, the opinion of the Expert Advisory Committee is requested on whether indirect administrative overheads (i.e., salary of the key management personnel (KMPs), directors’ sitting fees, audit fees, statutory and other levies related to the company etc.) incurred during the construction phase of the power plant shall be capitalized along with the cost of the project or to be charged to the profit and loss account of the respective year even though there is no income generated by the company during its construction phase.

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

8. The Committee notes that the basic issue raised in the query relates to the accounting treatment of certain indirect administrative overheads (i.e., salary of the KMPs, directors’ sitting fees, audit fees, statutory and other levies related to the company etc.) incurred during the construction phase of the 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 any other expense incurred by the company in relation to the power plant project, accounting for pre-incorporation expenditure, consideration of materiality, etc. The Committee has also not examined whether the use of the expression ‘Key management personnel (KMP)’ by the company is the same as defined in Indian Accounting Standard (Ind AS) 24, ‘Related Party Disclosures’ or the Companies Act, 2013. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

9. At the outset, the Committee wishes to point out that various expenses are incurred during construction phase. However, it is not necessary that all expenses incurred during construction phase are eligible to be capitalised to the plant/project being constructed. The capitalisation of an item of cost to a plant/project depends upon the nature of such expenses in

relation to the construction activity in the context of requirements in this regard laid down in the applicable Indian Accounting Standards. Further, the Committee also wishes to state that just because the company is engaged in construction of a single plant at present does not mean that all the costs incurred by the company are directly attributable costs to the construction of the plant/project in accordance with the requirements of Ind AS 16.

10. The Committee notes the following paragraphs of Ind AS 16, 'Property, Plant and Equipment', notified under the Companies (Indian Accounting Standards) Rules, 2015:

“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;

...

- (f) professional fees.”

“19 Examples of costs that are not costs of an item of property, plant and equipment are:

...

- (d) administration and other general overhead costs.”

From the above, the Committee notes that the basic principle to be applied while capitalising an item of cost to a property, plant and equipment (PPE) is that it is 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. 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 incurrance 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.

11. The Committee notes that paragraph 17 of Ind AS 16 gives examples of directly attributable costs and it includes 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. Therefore, the Committee is of the view that the employee benefit expenses arising directly from the construction of the plant/project should only be capitalised and rest should be charged to the statement of profit and loss as and when incurred. With regard to employee benefit expenses relating to KMPs and directors fee, the Committee is of the view that there is normally, no direct relation between the meetings of BoD or activities undertaken by KMPs and the construction activity as the BoD or KMPs are involved in overall supervision, strategic planning and other related activities which are not directly related to construction as such. Further, in this context, the Committee also notes that the company, itself is considering this as administrative overheads. Accordingly, the Committee is of the view that the employee benefit expenses relating to key management personnel and directors' sitting fess in the extant case are not directly attributable to the

construction of project; rather are of the nature of administration and general overheads and therefore, should not be capitalised with the item of PPE.

12. With regard to audit fees, the Committee is of the view that it is purely in the nature of administration expenses, as given in paragraph 19(d) of Ind AS 16, which cannot be considered as 'directly attributable cost' of construction of the project and therefore, it cannot be capitalised as cost of an item of property, plant and equipment. Further, with regard to statutory and other levies, the Committee is of the view that to the extent these levies are directly attributable to construction e.g. fees/charges paid for obtaining license or seeking mandatory approvals/clearances for construction etc., the same should be capitalised and the rest should be recognised as expense in the statement of profit and loss.

#### **D. Opinion**

13. On the basis of the above, the Committee is of the opinion that the employee benefit expenses relating to key management personnel and directors' sitting fee, are not directly attributable to the construction of project; rather are of the nature of administration and general overheads and therefore, should not be capitalised with the item of PPE, as discussed in paragraph 11 above. Further, audit fee is purely in the nature of administration expenses, and therefore, it cannot be capitalised as cost of an item of property, plant and equipment, as discussed in paragraph 12 above. Statutory and other levies, to the extent, these are directly attributable to construction e.g. fees/charges paid for obtaining license or seeking mandatory approvals/clearances for construction etc., should be capitalised and the rest should be recognised as expense in the statement of profit and loss, as discussed in paragraph 12 above.

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