

Query No. 14

Subject: *Capitalisation of costs attributable to rolling stock constructed under a contractual arrangement (identified as RS-10) in which, a portion of costs linked to milestones in performance, is yet to be settled.*¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’), which is a joint venture company with equity participation from the Government of India (GoI) and the Government of National Capital Territory of Delhi, has been entrusted with the responsibility of construction and operation of the rail-based Mass Rapid Transit System (MRTS). The Company entered into a Contract (Contract ‘RS-10’) with H Company (hereinafter referred as ‘the Contractor’) for design, manufacture, supply, testing, commissioning and training of 486 cars, i.e., 81 train sets including spares valuing Rs. 4,426.98 crore.

2. The contract is a ‘Fixed Lump Sum Price’ contract. The whole of works including design, is divided into cost centres, which represent a major item associated with the works. The lump sum price for the whole of works is apportioned among various cost centres. The apportioned amount for each cost centre is further distributed among various milestones included in that cost centre.

3. The contract clauses related to ‘Contract Price and Payment’ are set out in Clause 11 of General Conditions of Contract (GCC), the relevant extract of which is reproduced as under:

GCC clause 11.4.1 – “In case of ‘Lump Sum’ contract with cost centre and Milestone payment, the fixed Lump Sum Price shall be apportioned by the Contractor amongst the various Cost Centres. The amount thus apportioned under each Cost Centre will be further apportioned amongst various Milestones with the approval of the Employer. *The contractor shall be entitled to submit to the Engineer requests for interim payments only upon the achievement of one or more of the Milestones described in the Cost Centre ...*”.

(Emphasis supplied by the querist)

4. Accounting practice followed by the Company in respect of Contract ‘RS-10’ is as follows:

(i) Payments made to the contractors on completion of milestones of respective cost centers are transferred to Capital Work in Progress (CWIP) till the time the Rolling Stocks are inducted for carriage of passengers, and the balance incomplete portion of Contract is disclosed as ‘Capital Commitments’.

(ii) On the date of induction of Rolling Stocks for carriage of passengers, amount available in CWIP along with the amount of liability for completed milestones till the date of induction, is capitalised as cost of Rolling Stock.

(iii) Cost of remaining milestones which are to be completed by the contractor after the date of induction of Rolling Stock, will be capitalised with the cost of respective Rolling Stock in the respective year and depreciated over the remaining useful life of respective Rolling Stock.

5. As on 31.03.2019, in the pending items of Contract RS-10, numerous milestone activities in cost centres A to D having value of Rs. 263.47 crore, were not completed on part of the Contractor which will become payable only after completion of the respective activities

¹ Opinion finalised by the Committee on 4.8.2020 and 5.8.2020.

by the Contractor to the satisfaction of Engineer-in-charge and after issue of Milestone Completion Certificate (MCC) as per terms and conditions of the contract.

6. The details of pending works as on 31.03.2019 to be executed by the Contractor for RS-10 contract are given below:

Cost Centre	Milestone No.	Balance Payment (%)	Equivalent INR	Main reasons for partial payment
A	A2	5	89,97,213.00	Pending Interface issues and updation of Interface documents.
	A9	5	74,97,670.00	Submission & updation of test procedures for UTO is ongoing.
	A11	10	1,49,95,340.00	Certain design issues which includes hardware & software engineering changes, Field modifications etc. to improve the reliability of the trains, are ongoing.
	A12	20	1,19,96,272.00	
	A13	30	2,69,91,612.00	Final design document delivery will commence only after completion of balance activities in Milestones A11 & A12 as explained above.
	A14	100	8,99,72,041.00	Even after several reviews and revised submissions as per Engineer's directives, the Contractor's submissions are still not fully in line with Engineer's directives. Hence, the Milestone is not considered as complete and MCC not issued.
	A15	5	74,97,668.00	There are various minor pending issues for which contractor was advised for rectification. However, the same is to be taken up by the contractor.
B	--	--	0.00	Activity completed and capitalised as on 31.03.2019.
C	C43	1	44,56,464.00	For pending issues like Train History Book submission, Commissioning & DLP Spares. It is informed that these pending issues have subsequently been completed and the contractor has applied for payment in the current financial year (in Aug-2019).
	C65	5	1,99,88,463.00	Fitment of certain items in the trains and completion of some tests were pending. Also, the updation of the same in respective Train history books was pending. In view of the pending obligations, partial MCCs were issued. It may be mentioned that for Milestones C65 and C66, these pending issues have subsequently been completed and the contractor has applied for payment in the current financial year (in Aug-2019).
	C66	35	12,14,08,393.00	
	C67	30	10,40,64,337.00	

Cost Centre	Milestone No.	Balance Payment (%)	Equivalent INR	Main reasons for partial payment
D	D1 to D14	52	38,50,65,717.00	As per RS-10 contract (Note No. 3, Instructions to Tenderers-Annexure ITT-2B), 50% of the apportioned amount against each Milestone in the Cost Centre 'D' shall be payable on successful commissioning of train in 'GoA2' and balance 50% amount shall become payable on successful commissioning of train in GoA3/GoA4.
	D15 to D81;	55	197,71,16,938.00	
	D89			Hence, 50% payment against D milestones was only due at this stage. However, due to some pending obligations, viz. implementation of Hardware & Software engineering changes, fine tuning of systems for operation in ATO, etc., another (i) 2% for 14 Nos. Milestones, namely D1 to D14 & (ii) 5% for 68 Nos. Milestones, namely D15 to D81 & D89, were withheld from the Milestone Certificates.
	D88, D90	100	10,17,68,048.00	
D85, D85A, D86, D86A, D87, D91, D92, D93, D94, D95, D96 (Variations)			-24,70,77,175.00	Negative Variations
Sub-Total			2,63,47,39,001.00	Say 263.47 Crore
B	B21, B22, B23		6,61,58,233.00	Price for Unqualified withdrawal of conditions, qualification, deviation etc.
C	C62, C63, C64		21,47,19,109.00	
D	D82, D83, D84		3,12,05,575.00	
Total Balance Payment (A+B+C+D)			2,94,68,21,917.00	Say 294.68 Crore

7. It is clear from the above table that the balance amount of Rs. 294.68 crores (including Rs. 263.47 crore relating to capitalisation of Rolling Stock which is disclosed under 'Capital Commitments') will become payable only after execution of the work and issue of Milestone Completion Certificate (MCC) as per terms and conditions of the contract and capitalised in the respective year. Further, the amount of Rs. 263.47 crore, not being due as on 31.03.2019, hence not capitalised as on 31.03.2019, however, disclosed as 'Capital Commitments – estimated amounts of contracts remaining to be executed on capital account and not provided for' in the Balance Sheet as on 31.03.2019.

Observations raised by Resident Audit Party of C&AG:

8. During supplementary audit of annual accounts of the Company for the financial year (F.Y.) 2018-19, Government Audit Party of Comptroller and Auditor General of India (C&AG) issued provisional comment which is reproduced below:

“Other current liabilities (Note No. 20) do not include Rs. 263.47 crore being the amounts payable to the contractor (RS-10) for design, manufacture, supply, testing and commissioning of 81 train sets (cost centre A to D). As per the contract dated 24-05-2013, the performance of the contract shall be measured as per milestones/key dates ending on 06-11-2017. Subsequently, the same was extended upto 19-12-2018.

As per cost centre D relating to pricing documents, the total amount was apportioned in cost centres A, B, C and D. As per cost centre D, 50 % of the apportioned amount against each milestone in the cost centre 'D' shall be payable on successful commissioning of train in 'GoA2' and balance 50 % amount shall become payable on successful commissioning of train in 'GoA3/GoA4'.

The entire line 7 and line 8 except 1.5 km section were commissioned on 31-12-2018 after successful trial and obtaining certificate of Commissioner of Metro Rail Safety (CMRS). As on 31-03-2019, the Company capitalised the cost of 82 train sets (including 1 train sets quantity variation for certain section) amounting to Rs. 263.47 crore (including cost centre A, B, C and D).

As the train operation has been commenced and asset (rolling stock) has been put to use w.e.f 31-03-2019, the amount mentioned in cost centres (A to D) should have been capitalised as asset and necessary liability should be provided in the books of account. This has resulted in understatement of Rolling Stock (Property, Plant and Equipment) by Rs. 263.47 crore, and understatement of current liabilities to the extent of Rs. 294.68 crore as well as depreciation to the extent of Rs. 2.05 crore $[90/365 \times (263.47 \times 0.95)/30]$.”

Management Reply:

9. The querist has informed that the management has given the following reply to the above C&AG comments:

(i) As per terms and conditions of Para 11.4.1 of the General Conditions of Contract (GCC) of RS-10 contract, the procedure for issue of interim payment certificate has been mentioned, which is reproduced below:-

“In case of ‘Lump Sum’ contract with cost centre and Milestone payment, the fixed Lump Sum Price shall be apportioned by the Contractor amongst the various Cost Centres. The amount thus apportioned under each Cost Centre will be further apportioned amongst various Milestones with the approval of the Employer. The Contractor shall be entitled to submit to the Engineer requests for interim

payments only upon the achievement of one or more of the Milestones described in the Cost Centre.”

- (ii) As on 31.03.2019, there are many activities having total value Rs. 294.68 crore (including Rs. 263.47 crore relating to capitalisation of Rolling Stock) which are pending due to non-achievement of milestone as per terms and conditions of the contract and the same has been included in capital commitment and disclosed vide item no. 2 (b) of Note No. 29 to financial statements. The details of pending works to be executed by the Contractor for RS-10 contract are already explained in paragraph 6 above.
- (iii) Accordingly, the Contractor is not entitled to raise any claims as on 31.03.2019 regarding issue of MCC for the non-completed activities mentioned above. However, it is to apprise here that during current Financial Year 2019-20, the Contractor, vide letter dated 07.08.2019, has intimated for completion of balance work of milestone no. C43, C65 & C66 and requested for issuance of No Objection Certificate (NOC) and Milestone Completion Certificate (MCC). The issue of MCC against this work will be due to be accounted for only during F.Y. 2019-20.
- (iv) Hence, it is clear that the pending obligations under Cost Centres ‘A’, ‘B’, ‘C’ and ‘D’ do not affect the revenue operation and passenger safety in any manner. However, the respective milestones shall become eligible for release of balance payment only after completion of the work by the contractor and compliance of contractual requirements.
- (v) In view of above, it is submitted that since the benefit of GoA3/GoA4 for the train sets of RS-10 contract does not accrue and due to non-achievement of MCC related to cost centre A to D till 31.03.2019, the liability cannot be provided against these activities and the capitalisation of cost centres A to D also cannot be possible; hence, question of charging depreciation does not arise for the year 2018-19.
- (vi) *Further, it is submitted that clearance from the Commissioner of Metro Rail Safety (CMRS) is one of the activities related to the safety aspects of running of the trains and issue of CMRS certificate does not make the contractor eligible for claiming the payment under respective milestones. There may be still certain obligations, though not directly affecting the safety of the trains, yet without completion of which milestones cannot be certified as completed. Pending activities mentioned in the table, CMRS issued certificate for opening of the line 7 and line 8 for public, which does not mean that all project activities have been completed.*
- (vii) During previous year, HM15 was issued on similar grounds and the same was dropped on the basis of assurance, which is reproduced below:

“As regards creation of liability towards Rolling Stock in terms of contract agreement vis-à-vis use of Rolling Stock in opening of line, it is assured that the complete accountal will be re-examined on merits and necessary entry will be made in books of account in the current financial year 2018-19.”
- (viii) During the year 2018-19, the accounting system was re-examined by the company, internal auditors and statutory auditors and it was concluded that the practice followed by the company is in line with the provisions of Indian Accounting Standard (Ind AS) 16, ‘Property, Plant and Equipment’ and capitalisation of amount shall be made on completion of milestones of successful commissioning of train in GoA3/GoA4. *Hence, the capitalisation of these activities is not linked with the rolling stock which has been put to use.*

- (ix) Based on the above submission, there is no understatement of Rolling Stock by Rs. 263.47 crore and understatement of current liabilities of Rs. 294.68 crore. The question of depreciation does not arise.
- (x) However, it is assured that the whole issue relating to accounting of RS-10 contract will be referred to the Expert Advisory Committee of the Institute of Chartered Accountants of India for its opinion.
- (xi) In view of the above, the Audit is requested to drop the Provisional Comment.

(Emphasis supplied by the querist.)

10. The querist has submitted the following points for consideration of the Expert Advisory Committee:

- (i) Pending various milestone activities having value of Rs. 263.47 crore, the same has not been capitalised on the ground that it is not payable to Contractor as on 31.03.2019, but the amount has been disclosed under the head 'Capital Commitments' vide item no. 2(b) of Note 29 to the financial statements.
- (ii) The Contractor, vide its letter dated 16.09.2019, has also confirmed the pendency of these milestone activities as on 31.03.2019 (A copy of the same has been separately provided by the querist for the perusal of the Committee).
- (iii) Clearance from the Commissioner of Metro Rail Safety (CMRS) is one of the activities related to the safety aspects of running of the trains and issue of CMRS certificate does not make the Contractor eligible for claiming amounts under respective milestones. There may still be certain obligations as explained in the table, though not directly affecting the safety of the trains, yet without completion of which milestones cannot be certified as completed. Pending these activities, CMRS issued certificate for opening of the line 7 and line 8 for public, which does not mean that all project activities have been completed.

Present status of all pending activities as on date is given below:

Cost Centre	Milestone No.	Balance Payment (%)	Equivalent INR	Remarks
A	A2	5	89,97,213.00	Milestones still pending
	A9	5	74,97,670.00	
	A11	10	1,49,95,340.00	
	A12	20	1,19,96,272.00	
	A13	30	2,69,91,612.00	
	A14	100	8,99,72,041.00	
	A15	5	74,97,668.00	
B	--	--	0.00	Activity completed and capitalised as on 31.03.2019.
C	C43	1	44,56,464.00	Milestones achieved on 15.10.2019 & capitalisation will be done during current F.Y. 2019-20.
	C65	5	1,99,88,463.00	
	C66	35	12,14,08,393.00	

	C67	30	10,40,64,337.00	
D	D1 to D14	52	38,50,65,717.00	Milestones still pending
	D15 to D81; D89	55	197,71,16,938.00	
	D88, D90			
	D85, D85A, D86, D86A, D87, D91, D92, D93, D94, D95, D96 (Variations)			
Sub-Total			2,63,47,39,001.00	
B	B21, B22, B23		6,61,58,233.00	Milestones still pending
C	C62, C63, C64		21,47,19,109.00	
D	D82, D83, D84		3,12,05,575.00	
Total Balance Payment (A+B+C+D)			2,94,68,21,917.00	

11. The querist has further provided the following information:

- (i) GOA stands for Grade of Automation. GOA is a standard term defined in international standard IEC-62290-1 and reproduced herein under:

GOA2: This is ‘Semi-automated train operation’. In this grade of automation, the driver is in the front cabin of the train observing the guideway and stops the train in the case of a hazardous situation. Acceleration and braking is automated and the speed is supervised continuously by the system. Safe departure of the train from the station is the responsibility of the operations staff (door opening and closing may be done automatically).

GOA3: This is “Driverless train operation”. In this grade of automation, additional measures are needed compared to GOA2 because there is no driver in the front cabin of the train to observe the guideway and stop the train in case of a hazardous situation. However, in this grade of automation, a member of the operations staff is necessary onboard. Safe departure of the train from the station, including door closing, will be the responsibility of the operations staff.

GOA4: This is “Unattended Train Operation”. In this grade of automation, additional measures are needed compared to GOA3 because there are no onboard operations staff. Safe departure of the train from the station, including door closing, has to be done automatically.

More specifically, the system supports detection and management of hazardous conditions and emergency situations such as the evacuation of passengers. Some hazardous conditions or emergency situations, such as derailment or the detection of smoke or fire, may require staff interventions.

- (ii) GOA2, GOA3 and GOA4 are covered in RS-10. These are mentioned in contract specification and are standard terms as per international standard IEC62290-1. Contract conditions specify design requirement as per IEC62290-1.

- (iii) With regard to the link between GoA2, GoA3, and GoA4 - and line 7 or 8, the querist has informed that RS-10 rolling stock for Line 7 and Line 8 have to be commissioned and operated under GOA 2, GOA3/GOA4. But, at present, RS-10 rolling stock is being operated upto GOA2 and the commissioning work for GOA3/GOA4 is the ongoing process. When the upgradation is complete, CMRS clearance will be taken again and then the Rolling Stock will be available for use and capitalised in the manner intended by the management.
- (iv) Under negative (-) variation, amount is recovered from the contractor for the items or service which are not required by the company under present conditions whereas in positive variation the amount is paid to the contractor for the additional work which is beyond the contract specification. These variations are related to change in scope and both positive (+) and (-) variations are initiated by the Company.
- (v) With regard to the point/event at which the physical construction of the rolling stock or its installation can be considered to be complete and therefore, the asset (rolling stock) can be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by the management as per the requirements of Ind AS 16, the querist has informed that at first, the Rolling Stock is considered to be complete after inspection and approval of the corridor by Commissioner of Metro Railway Safety (CMRS). However, CMRS gives clearance for operation of trains at certain point of time i.e. GoA2, on which the Company capitalises the cost of work completed upto date of clearance. There are certain activities relating to GoA2, GoA3 and GoA4, which are physically required to be completed after CMRS clearance. The cost incurred for these activities are treated as additional capitalisation by the Company, as and when these are completed.

B. Query

12. In view of the facts explained above, opinion of the Expert Advisory Committee is required on the following issues:

- (i) Whether the accounting treatment followed by the Company for capitalisation of Rolling Stock in line with the provisions of Contract 'RS-10' i.e. on the basis of completion of milestones is correct.
- (ii) If not, what should be the correct accounting treatment?

C. Points considered by the Committee

13. The Committee notes that the basic issue raised by the querist relates to recognition and measurement of an item of Property, Plant and Equipment (Rolling Stock) when the cost of that item is incurred and becomes payable at different stages (called milestones) of the construction of the PPE. The Committee has, therefore, while expressing the opinion, restricted itself to the issues raised in paragraph 12 above and has not examined any other issue that may arise the Facts of the Case, such as, whether negative or positive variations in pricing, per se, have a direct link to achievement or non-achievement of milestone activities, or whether the contract price includes any element that does not qualify to be a component of cost of asset, measurement and presentation of the liability, if any, to be recognised in respect of milestones not yet completed etc. The Committee has also not examined tax implications, if any, applicable in this case. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

14. With regard to whether the Rolling Stock covered by the Contract RS-10 forms a part of assets grouped as Property, Plant and Equipment (PPE), the Committee notes paragraph 7 of Ind AS 16, 'Property, Plant and Equipment', which states as follows:

“7 The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

- (a) it is probable that future economic benefits associated with the item will flow to the entity; and**
- (b) the cost of the item can be measured reliably.”**

The Committee notes that the facts furnished by the querist does not indicate any uncertainty on fulfilment of either of the above conditions. Therefore, Rolling Stock, and other related items such as spare parts qualify to be recognised as a class of assets under PPE. As regards measurement of rolling stock, the Committee notes the following requirements of Ind AS 16:

“15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.”

“6 ...

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, eg Ind AS 102, Share-based Payments.

...”

“10 An entity evaluates under this recognition principle all its property, plant and equipment costs *at the time they are incurred*. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. ...”

“12 Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the ‘repairs and maintenance’ of the item of property, plant and 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...”**

“22 The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset

for sale (see Ind AS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. Ind AS 23, *Borrowing Costs*, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.”

The Committee notes that the assets covered under Contract RS-10 are in the nature of self-constructed assets. Further, in terms of paragraph 22 of Ind AS 16, the cost of a self-constructed asset is determined using the same principles as for an acquired asset. Therefore, in the extant case, only those elements of costs that can be included as costs for ‘acquired assets’ are eligible for capitalisation under Ind AS 16 for the assets covered under the contract.

15. The Committee further notes paragraph 20 of Ind AS 16, which deals with when the recognition of costs in the carrying amount of an item of PPE should cease:

“20 Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

- (a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;
- (b) ...”

The Committee notes from the above that when an item is *in the location and condition necessary for it to be capable of operating* in the manner intended by management, recognition of costs in the carrying amount of such item should cease even though there is a possibility of the item operating at less than full capacity. The Committee now considers the issue of determining the point in time when an item is in the location and condition necessary for it to be capable of operating in the manner intended by the management. The Committee is of the view that in the case of self-constructed assets, the generally accepted practice is that a policy decision is made and applied consistently as to what event or activity characterises the point at which an asset's physical construction or installation is complete and when that asset can be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by the management as per the requirements of Ind AS 16, so that all costs incurred up to that point can be included in the cost of the self-constructed PPE.

16. In this context, the Committee notes from the Facts of the Case that the event or activity that characterises the point at which an asset's physical construction or installation is complete, is the event when the Commissioner of Metro Railway Safety (CMRS) after inspection and approval of the corridor, gives clearance for operation of trains. The Committee is of the view that such a clearance implies that Rolling Stock is in the location and condition necessary for it to be capable of operating in the manner intended by the management as per the requirements of Ind AS 16.

17. The Committee also understands from the Facts of the Case that presently, the rolling stock is being operated under the second stage of Automation, that is GoA2 and upgradation of the rolling stock to level GoA3 or GoA4 is in the process. From this, the Committee notes that the costs incurred or to be incurred by the Company relate to different stages of the performance of the PPE.

18. The Committee notes that Ind AS 16 also deals with the recognition of costs incurred subsequently to add to, replace a part of, or service a previously recognised item of PPE. The general recognition principles set out in paragraph 7 of Ind AS 16 are applied to such expenditure also, however any costs of day-to-day servicing should be accounted for as an expense. As per the requirements of Ind AS 16, all major subsequent expenditure is permitted to be capitalised when it meets requirements of paragraph 7 of Ind AS 16. Accordingly, the Committee is of the view that any major upgradation cost in the extant case can be considered as an addition or replacement cost and capitalised as subsequent costs, subject to meeting the requirements of paragraph 7 of Ind AS 16.

19. The Committee further notes that the querist has stated that the amount pending to be released under the Contract RS-10 is Rs. 294.68 crores. However, a separate break-up of amounts relatable to upgradation of level of automation, is not discernible. While this amount represents the aggregate of various elements such as retentions, price variations, subsequent upgradation costs, etc., the Committee is of the view that it should be possible for the Company to identify a specific breakup of costs that would be attributable to upgradation of level of automation of train operations, from the present level of GoA2 to GoA3 or GoA4. The Committee notes that the costs attributable to ‘upgradation of automated train system’ from GoA2 level to GoA3 or GoA4 levels, are in the nature of major upgradation costs, and qualify to be treated as subsequent costs, as discussed above.

20. From the above, the Committee is of the view that at the first stage of GoA2, the accounting principle to be applied is that of asset being in location and condition necessary for it to be capable of operating in the manner intended by the management. In the next stage of GoA3 or GoA4, the principle of ‘capitalisation of subsequent costs’ will apply subject to paragraph 7 of Ind AS 16. Accordingly, the Committee is of the view that the Company is required to undertake a diligent exercise to review the components of costs, that make up the sum of Rs. 294 crores, to identify and segregate the said total into two elements,

- (a) costs attributable to upgradation of automated train operating system, and
- (b) other costs in the nature of price variations and retentions/payments held back pending resolution of certain glitches in documentation, paperwork, etc.

The element under (a) would qualify to be capitalised, at a later date, as subsequent costs as discussed above. The remaining element requires to be evaluated, as explained in subsequent paragraphs.

21. The Committee further notes the following accounting requirements contained in Ind AS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’:

“A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.”

The Committee notes from the above that when the work is completed as per the required contractual and other specifications, it creates a present obligation (contractual/constructive) and the costs attributable upto that stage in respect of the work done should be provided for irrespective of whether payment on such completed work has become due or not. The Committee is of the view that milestone payment does not necessarily indicate completion of work; rather is related to when the payment is due. Further, the fact that the assets are in operation in the extant case indicates that the work is complete, even though payment has not been made. Accordingly, when the goods or services have been received but not paid, and the

asset itself is physically complete and in the condition and location necessary for it to be capable of operating in the manner intended by management, both contractually and constructively, the Company carries an obligation to pay; and therefore, a liability accrues for the goods received and services rendered and such a liability is to be recognised. In a majority of circumstances, the amount payable is measurable. However, sometimes in situations where there is an element of uncertainty as to the timing and amount of payment, the Committee is of the view that in such situations also, while the existence of a liability cannot be disputed, an estimate should be made and a liability should be recognised.

22. The Committee notes that Ind AS 16 does envisage situations in which, an estimated amount of expenditure to be incurred at a future date can be added as an element of cost of asset, which is evident from the following requirements of Ind AS 16:

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

...

- (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.”

23. The Committee is of the view that the principle embedded in the above-reproduced paragraph may be extended to variations (which are not major upgradation costs, as discussed above and do not result into a separate unit of account or PPE), or claims which have been accepted / approved by the company and are as per contractual terms, but where the amount or timing of cash outflow may not be certain (as the final evaluation of work performed will determine the quantum and timing of payment). Accordingly, it would be appropriate for the Company to make a provision for the liability, to be added to cost of asset at initial recognition. Further, in this context, the Committee notes from the facts supplied by the querist that variations indicated in the computation of contract cost for Contract RS-10, relate to scope of work and this has been initiated by the Company itself. Therefore, the company’s consent/acceptance to such variations can be considered to be more likely and accordingly, in the initial measurement of the cost of an asset, this should also be taken into account.

Thus, on the basis of the above, the Committee is of the following view in the extant case:

- (a) The point in time when the clearance for operation is issued by concerned authority, denotes the time when the Rolling Stock is in the location and condition necessary for it to be capable of operating in the manner intended by management. This is the point in time, when cost capitalisation for rolling stock operated under GoA2 shall cease.
- (b) At that point (event of initial recognition), a measurement is made of costs already incurred and cost likely to be incurred irrespective of the timing when the cash outflow may occur.
- (c) It is the judgement of the management to determine the constituent elements that comprise the unpaid amounts, namely,
 - those that are directly attributable to the development of asset and qualify for capitalisation; where the timing and amount of payment is certain, a determined liability will arise, while in case of uncertainty, an estimate of liability i.e., a provision is made; both these elements are capitalised at the time when the asset is in the location and condition necessary for it to be capable of operating

in the manner intended by management, except for abnormal costs, such as, abnormal delays, that are charged to the Statement of Profit and Loss.

- those costs that are specifically attributable to the upgradation of automation of rolling stock (GoA3 and GoA4), are treated as subsequent costs and evaluated for recognition criteria as per paragraph 7 of Ind AS 16.

24. The Committee further notes that postponing recognition of liabilities or provisions for constituents that are directly attributable to the development of asset and qualify for capitalisation till the time milestone-performance is achieved and becomes payable, even when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management, is also not in conformity with accrual basis of accounting, which is fundamental to financial reporting.

25. While considering the issue of amounts not being due, being disclosed as ‘Capital Commitment’, the Committee notes that Note 6 of General Instructions for Preparation of Balance Sheet in Part I of Division II of Schedule III to Companies Act, 2013 provides, inter alia, as follows:

“6. A company shall disclose the following in the Notes:

...

H. Contingent Liabilities and Commitments:

(to the extent not provided for)

(i) Contingent Liabilities shall be classified as-

...

(ii) Commitments shall be classified as-

- (a) estimated amount of contracts remaining to be executed on capital account and not provided for;
- (b) uncalled liability on shares and other investments partly paid; and
- (c) other commitments (specify nature).

The Committee also notes that the Guidance Note on Division II - Ind AS Schedule III to the Companies Act 2013 (July 2019 Edition)², issued by the ICAI, provides as follows:

“6.9. Note 4 of the General Instructions for Preparation of Financial Statements also states that the Notes should also contain information about items that do not qualify for recognition in Financial Statements. These disclosures normally refer to items such as Contingent Liabilities and Commitments which do not get recognised in the Financial Statements. These have been dealt with in para 8.2.14. below ...”

“8.2.14. Contingent liabilities and commitments

(i) Contingent liabilities shall be classified as:

...

(ii) Commitments shall be classified as:

- (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

² The Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013 (July 2019 Edition) has been subsequently revised in January 2022.

- (b) Uncalled liability on shares and other investments partly paid
- (c) Other commitments (specify nature).

The provisions of Ind AS-37 *Provisions, Contingent Liabilities and Contingent Assets*, will be applied for determining contingent liabilities.”

“8.2.14.4 The word ‘commitment’ has not been defined in the Schedule III. The Guidance Note on Terms Used in Financial Statements issued by ICAI defines ‘Capital Commitment’ as future liability for capital expenditure in respect of which contracts have been made. Hence, drawing inference from such definition, the term ‘commitment’ would simply imply future liability for contractual expenditure. Accordingly, the term ‘Other commitments’ would include all expenditure related contractual commitments apart from capital commitments such as commitments arising from long-term contracts for purchase of raw material, employee contracts, lease commitments, etc. ...”

Further, the Committee notes that the term ‘capital commitment’ has been defined in the ‘Glossary of Terms used in Financial Statements’, issued by the Research Committee of the ICAI, as follows:

“25. Capital Commitment

Future liability for capital expenditure in respect of which contracts have been made.”

From the above, the Committee is of the view that a capital commitment is the projected capital expenditure, representing estimated cost of PPE to be acquired in future, that an entity commits by way of contract. Further, capital commitments are not contingencies, which represent conditions or situations in which amount or timing of settlement of an obligation involves uncertainties.

26. From the above discussion, the Committee is of the view that projected contractual obligations/commitments relating to ‘upgradation of automation of train operating system from GoA2 to GoA3 and GoA4 levels’, which are in the nature of subsequent costs, as discussed above, qualify as capital commitments, as discussed in paragraph 25 above.

D. Opinion

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

- (i) The accounting treatment followed by the Company is not correct, since it does not conform to the principle of accrual.
- (ii) The Company should follow the following accounting treatment:
 - The accounting treatment as explained in paragraphs 18 to 23 above should be followed.
 - The accounting policy of the company pertaining to capitalisation of rolling stock requires to be amended to conform to the principles of Ind AS 16, as discussed above.
 - To the extent committed amounts are attributable to ‘upgradation of automation of train operating system from GoA2 to GoA3 and GoA4 levels’, these would be in the nature of subsequent costs, and may be capitalised as per the requirements of Ind AS 16, when the automation of trains stands upgraded. Until capitalisation, these projected/ estimated costs, may be disclosed as capital commitments.