

## **Query No. 12**

**Subject:** *Accounting treatment of interest free loan received from the State Government as a viability gap funding.*<sup>1</sup>

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

1. A Company, which is a Public Limited Company (hereinafter referred to as ‘the Company’), registered under the Companies Act is listed on stock exchanges and thereby governed under the relevant Regulations. It is a Maharatna Public Sector Undertaking under the administrative control of Ministry of Petroleum and Natural Gas, Government of India and is engaged in the business of refining and marketing of petroleum products. The Company conceived a project to set up a 9 Million Metric Tonne Per Annum (MMTPA) Grass-root Oil Refinery at Paradip and sought fiscal incentives for viability of the project from the State Government as, without incentives, the Project’s Internal Rate of Return (IRR) was not sufficiently covering the cost of capital. The State Government decided to give a package of incentives to make it economically viable and the same was formalised in the form of a Memorandum of Understanding between the State Government and the Company in 2004. The incentives as per the MOU have been detailed in subsequent paragraphs.

2. Pre-commissioning tax incentives:

- i) Exemption from the charge, levy and payment of royalty on sand and other materials under applicable mining law and/or license(s) from and in respect of entire land filling and construction and other activities related to Project.
- ii) Exemption from the charge, levy and payment of Octroi, Entry Tax, Terminal Tax or any other tax of similar nature on the entry of materials, machinery and equipment required for construction of Project.
- iii) Exemption from the charge, levy and payment of tax on Works Contract or sales tax on transfer of goods under Works Contract or other similar tax, howsoever designated on the construction of Project.

Post-commissioning tax incentives:

- iv) Deferment of State sales tax for product sales in the State for 11 years from the date of commercial production.
- v) Exemption from the charge, levy and payment of Central sales tax on products of the Refinery for a period of 30 years from the commencement of commercial production.
- vi) Exemption from the charge, levy and payment of Octroi, Entry Tax, Terminal Tax or any other tax of similar nature on crude oil required by the Refinery.
- vii) Exemption from the charge, levy and payment of sales tax on materials, machinery and equipment or any other purchase required for the operation and maintenance of Project/Refinery for a period of 11 years from the commencement of commercial production.
- viii) Exemption from the charge, levy and payment of electricity duty for 5 years from the commencement of commercial production by the Refinery.

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<sup>1</sup> Opinion finalised by the Committee on 22.7.2021.

The combination of these incentives led to improvement in IRR through reduction in initial outlay during construction phase and improvement of subsequent inflows during payback period by way of exemption/deferment of statutory liabilities payable, facilitating repayment of capital expenditure borrowing. Out of all incentives, the deferment of State Sales Tax as per point 2(iv) above was significant and covered 78% of total incentives.

3. The querist has stated that even with these incentives, the Project IRR was not adequate, and the capacity was further enhanced from 9 MMTPA to 15 MMTPA. With the increased capacity, the commercial production commenced on 22<sup>nd</sup> November 2015 as against the targeted completion of the project was 2009-10.

4. State Government expressed inability to provide the interest free loan (Point 2(iv): Deferment of State Sales Tax on product sales in the State for 11 years from the date of commercial production) in view of several factors including delay in commencement of the Project and issued Notification dated 22<sup>nd</sup> February 2017 rescinding the relevant Gazette Notification but keeping other incentives intact.

5. A Working Group comprising of representatives from the Company, State Government and the Ministry of Petroleum and Natural Gas (MoPNG), was constituted in March'16 to resolve the issue but the issue could not be resolved. Thereafter, the demand notice was raised by authorities for the deferred VAT amount during the period December'15 to December'16, which was challenged by the Company in the Hon'ble High Court of the State. The Hon'ble High Court directed the Working Group, constituted earlier, to take up the matter for resolving the differences.

6. After several rounds of discussion and meetings of the Working Group, State Government and the Company agreed to the Viability Gap Funding (VGF) and an agreement was signed on 25<sup>th</sup> September 2017. The salient features of the VGF scheme were as follows:

- i) Viability Gap Funding (VGF) for the Refinery was revised to ₹700 crore per annum, in four equal instalments of ₹175 crore in each quarter, in the form of interest free loan for 15 years starting from the financial year (F.Y.) 2016-17.
- ii) The Company to deposit applicable VAT/GST as per law. The State Government shall pay the VGF in the form of interest free loan in each quarter. The repayment of amount will start in 16<sup>th</sup> year for each instalment.
- iii) VAT collected by the Company during the financial years 2015-16, 2016-17 and 2017-18 was to be deposited immediately. State Government to provide interest free loan to the Company for financial year (F.Y.) 2016-17 onwards and waive interest and penalty.
- iv) In line with the agreed VGF, instalments and its repayment are as follows:
  - a) Seven instalments relating to period April'16 to December'17 was released by the State Government in 2<sup>nd</sup> week of January'18.
  - b) Thereafter, one installment was scheduled for release on the last week of each quarter, till the last week of March'31.
  - c) The quarterly repayment by the Company to start from last week of June'31 and to continue till last week of March'46.

7. Thus, under the new agreement, the State Government shall provide fiscal incentive to the Company as Viability Gap Funding in the form of interest free loan at quarterly installments of ₹175 Crores (₹700 Crores per annum) over the period of 15 years starting from F.Y. 2016-17, the total of which turns out to ₹10,500 Crores. The Company is to make

repayment in quarterly installments of ₹175 Crores within next 15 years starting from F.Y. 2031-32.

*Analysis of VGF from State Government:*

8. Nature of Incentive:

The relevant paragraphs of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance' and Ind AS 109, 'Financial Instruments' are as follows:

- i) As per paragraph 3 of Ind AS 20, Government grants are assistance by government in the form of transfer of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.
- ii) As per paragraph 10A of Ind AS 20, the benefit of a government loan at a below-market rate of interest is treated as government grant. The loan is recognised in accordance with Ind AS 109, 'Financial Instruments'. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for in accordance with this Standard.
- iii) Basis for Conclusions (BC) 4 of International Accounting Standard (IAS) 20, issued by the International Accounting Standards Board: "It believed that the imputation of interest provides more relevant information to a user of the financial statements. Accordingly, the Board amended IAS 20 to require that loans received from a government that have a below-market rate of interest should be recognised and measured in accordance with IAS 39. The benefit of the government loan is measured at the inception of the loan as the difference between the cash received and the amount at which the loan is initially recognised in the statement of financial position. This benefit is accounted for in accordance with IAS 20."
- iv) As per paragraph 5.1.1 of Ind AS 109, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

As is evident from the above Ind AS paragraphs, the assistance to be received from the State Government in the form of interest free loan is a grant under Ind AS 20. Ind AS 20 requires that loan at below-market rate of interest shall be recognised and measured in accordance with Ind AS 109. As the Company has a contractual obligation to pay back each loan component after 15 years, it meets the definition of financial liability. Further, where the effect of time value of money is material, a loan should be discounted and should be shown at its present value at the time of its initial recognition. The difference between the transaction amount and fair value will form part of government grant.

Further, it was concluded that each tranche of interest free loan (i.e., instalment of ₹175 crores) from the State Government shall be treated separately and the booking of loan liability and government grant is carried out upon receipt of loan proceeds on quarterly basis. In other words, accounting is carried out converting ₹175 crores into fair value based on the Company's borrowing rate for next 15 years on the date of receipt (which may differ for each instalment) and the difference between fair value of

loan and proceeds received are accounted as government grant. Separate accounting for each instalment is in line with paragraph 10A of Ind AS 20, which prescribes calculation of benefit as the difference between initial carrying value and proceeds received. Further, the treatment done by the Company is also supported by BC4 of IAS 20 which emphasises on accounting at the inception of the loan as the difference between the cash received and the amount at which the loan is initially recognised.

9. Type of Incentive:

As per paragraph 3 of Ind AS 20, grant related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Grants related to income are government grants other than those related to assets.

Initial MOU signed in 2004 was for the package of incentives to make the refinery economically viable; thus, there is this primary condition of construction of grass root refinery and since the new agreement is in substitution to one of the provisions of initial MOU entered with State Government, according to the querist, benefit on interest free loan (VGF) under the new agreement is 'grant related to asset' as per Ind AS 20.

Additionally, the amount of VGF is receivable upon compliance of setting-up a grass root refinery and without requiring any future compliance or condition. It is not a compensation for expenses or losses already incurred or for financial support with no future related cost (paragraph 20 of Ind AS 20), which further corroborates the grant being considered as related to asset.

10. Recognition of Incentive:

The relevant paragraphs of Ind AS 20, as per the querist, are as follows:

- (i) As per paragraph 12 of Ind AS 20, **“Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.”**
- (ii) As per paragraph 17 of Ind AS 20, grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

The installments under the VGF scheme have commenced (from April'16) after the commissioning of the Refinery (in November'15) and hence the same did not have any impact on the capitalisation value of refinery or the resultant depreciation. The related cost that is recognised in the Statement of Profit and Loss is interest resulting from unwinding of the financial liability and the benefit of the grant will be enjoyed by the Company for next 15 years till the loan is repaid.

Accordingly, the grant is being amortised on a systematic basis over the period of loan, i.e., 15 years over which the unwinding is being done.

11. To summarise, following transactions are being recorded towards interest free loan (VGF) from the State Government:

- Upon receipt of each new installment of ₹175 crores, loan is recognised in accordance with Ind AS 109 based on the Company's borrowing rate for next 15 years on the date of receipt. The difference between fair value of loan and proceeds received are accounted for as government grant. As the borrowing rate varies periodically and amount of grant can only be ascertained on the date of receipt, separate accounting of each installment is carried out.
- Unwinding of interest in each quarter on respective loan amounts received till date is provided (separately for each installment received) in the Statement of Profit and Loss based on its designated borrowing rate used during initial recognition.
- Grant received till date is amortised over the loan period, i.e., 15 years and recorded in the Statement of Profit and Loss. As the benefit of interest free loan commences upon receipt of the loan and concludes upon repayment, the amortisation of grant over this period is considered most appropriate.
- However, looking into the nature and purpose of the grant by the State Government, the item was depicted/ disclosed under capital grant. Ind AS 20 states that grant related to depreciable assets are *usually* recognised in profit or loss over the periods in which depreciation expense on those assets is recognised. Unlike the usual case, the grant is neither forming part of the capitalised value of the asset nor the depreciation charge.
- Though the accounting practice was specifically deliberated with statutory auditors and reviewed by Comptroller and Auditor General (CAG) Auditors in the year of implementation, i.e. F.Y. 2016-17 but in view of the transaction gaining its significance on financial statements year by year, it was felt prudent to take the opinion of the Expert Advisory Committee of ICAI specifically on the issue of disclosure/ depiction under capital grant.

## **B. Query**

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

- (i) Whether the accounting treatment of Viability Gap Funding, considering each installment separately and recognising the loan amount and grant amount based on the Company's borrowing rate for next 15 years on the date of receipt of that installment, is in line with the requirements of Ind AS.
- (ii) Whether the amortisation basis and amortisation period of grant based on the tenure of each installment, adopted for by the Company, is in order or whether the same should be linked to depreciation of the underlying asset.
- (iii) Does the Standard require mandatory recognition of likely grant on the entire loan of ₹10,500 crore on notional basis before its actual receipt and include the same mandatorily as part of the asset capitalised at the inception itself?
- (iv) Whether the depiction/ disclosure of Viability Gap Funding in the form interest free loan in the financial statement of the Company as grants related to assets (capital grants) in order.

### C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to accounting treatment of interest free loan (Viability Gap Funding) received by the Company from the State Government for 15 years. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting for any other incentive/exemption/benefit provided by the Government, adjustments/accounting on transition to Ind ASs, determination of fair value of interest free loan as per Ind AS 113, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the perspective of interpretation of any Act/Rules/Agreements, such as, Memorandum of Understanding and the Agreement entered between the Company and the State Government. The Committee wishes to point out that the Indian Accounting Standards referred to in the opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

14. With regard to accounting treatment of viability gap funding in the form of interest free loan, the Committee notes that since this is provided to the Company in the extant case in return for past or future compliances with certain conditions relating to operating activities of the entity, the same should be considered as government grant as per Ind AS 20. The Committee further notes that in respect of recognition of benefit of interest free loan received from Government, paragraph 10A of Ind AS 20 states as follows:

“10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with Ind AS 109, *Financial Instruments*. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.”

In the extant case, the Company has received interest free loan from the Government in various tranches/quarterly instalments for fifteen years and therefore, gets economic benefit in the form of waiver of interest on receipt of the government loan. Further, the Committee notes that the interest free loan on its receipt from the State Government is in the nature of financial liability and should be accounted for as per the following requirements of Indian Accounting Standard (Ind AS) 109, ‘Financial Instruments’:

**“5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.”**

“B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and Ind AS 113). However, if part of the consideration

given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.”

15. From the above, the Committee is of the view that Ind AS 109 requires financial liabilities to be initially recognised at their fair value minus transaction costs (if not classified as subsequently measured at fair value through profit or loss). Therefore, each tranche of the interest free government loan, received at various intervals, at its initial recognition should be measured at its fair value, ascertained as per Ind AS 113, ‘Fair Value Measurement’, plus or minus transaction costs that are directly attributable to the acquisition of the government loan. The Committee is of the view that the initial fair value of each tranche of the loan would be the present value of the future payment of instalments of loan, discounted using the market rate of interest for a similar loan with similar term etc. for the term of loan, which is fifteen years in the extant case. Subsequently, interest will be imputed to the loan using the effective interest method, taking account of any transaction costs.

Further, the difference between the fair value of each tranche of the government loan on the transaction date and the proceeds received should be recognised as a government grant, and accounted for in accordance with Ind AS 20. The Standard stresses that the entity has to consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

16. With regard to classification of government grant, the Committee notes the following requirements of Ind AS 20 ‘Accounting for Government Grants and Disclosure of Government Assistance’:

**“Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.**

**Grants related to income are government grants other than those related to assets.”**

“16 It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see Ind AS 1, *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.

- 17 In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. Thus grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.”

From the above, the Committee notes that Grants related to assets are those grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire long-term asset and other grants are classified as grant related to income. Thus, in case of grants related to assets, primary condition is purchase, construction or acquisition of long-term assets. In this regard, the Committee notes the following from the Memorandum of Understanding between the Company and the State Government, made on 16<sup>th</sup> February, 2004:

“...with a view to improve the economic viability of the project, state government granted sales tax exemption/deferment for the project...The package of incentives provided inter alia for the issue of bonds of a 7 (seven) years...in payment of State Sales tax for a period of 11 years on petroleum products produced by the Refinery established pursuant to the project.”

#### **“ARTICLE III - COMPANY’S OBLIGATIONS**

1. The Company will initiate all necessary steps to expedite implementation of the Project to complete the construction of the Refinery in the year 2009-10. However if favourable market conditions in the country allowing higher level of domestic sale of products from the Refinery as compared to earlier estimate emerge, the Company will endeavour to complete the project in 2008-09. Milestones for implementation of the project are given in Schedule-1 annexed hereto.
2. ...”

Further, the State Gazette Notification dated 1<sup>st</sup> June, 2004 inter alia provides as follows:

“In exercise of powers conferred by section 7 of the Orissa Sales Tax Act, 1947 ... the State Government do hereby direct that the Paradeep Refinery at ...of the company (hereinafter called the unit) shall be allowed to defer payment of sales tax collected and payable in the return prescribed under the said Act ... on the sale of finished products manufactured or processed ... subject to the following conditions and restrictions namely:-

- (1) Deferment of sales tax shall be allowed from the date of the commercial production of the unit ...
- (2) The deferment of sales tax shall be subject to the following conditions:-
  - (i)...
  - ...
  - (v) In case of default or if the unit is closed either before or after the expiry of the period of deferment,... the Sales Tax Officer concerned shall ... revoke the benefit of deferment from the date it was allowed and thereupon the entire amount of sales tax

deferred, upto the date of such revocation, shall be payable by the unit forthwith in one instalment along with the interest ...”

17. From the above, the Committee notes that the purpose of various fiscal incentives, including, deferment of sales tax in the extant case appears to be the successful implementation of Refinery Project and to make it commercially and economically viable for the Company. In case of sale tax deferment incentive, the Company is allowed to retain the sales tax collected from the customers for few initial years of operation of the Refinery after the date of commercial operation for improvement of subsequent inflows during payback period by way of deferment of statutory liabilities payable. Thus, although acquisition/construction of the Refinery is one of the qualifying conditions of the incentives, the main objective of the grant appears to be to improve the cash inflows during the operations of the Refinery and the overall rate of return from the Project. The grant is thus a financial support for the operating activities of the Company and to make the Refinery project viable. However, later on, due to delay in the commencement of the Project and other factors, the State Government withdrew this incentive and instead, in lieu of this incentive, the Company and the State Government entered into an agreement on 25<sup>th</sup> September, 2017, whereby the State Government agreed to provide viability gap funding of Rs. 700 crore p.a. in four equal installments in the form of interest free loan for fifteen years starting from financial year 2016-17. Thus, the Committee is of the view that since the interest free loan is in lieu of deferment of sales tax incentive, its classification from the perspective of Ind AS 20 should be considered in the context of deferment of sales tax incentive. As discussed above, since the main objective of deferment of sales tax incentive is to improve the cash inflows during the operations of the Refinery and the overall rate of return from the Refinery Project, grant in terms of interest free loan cannot be considered as grant related to asset; rather it should be considered as grant related to income.

18. The Committee further notes that in the present case, it is not possible to infer from the Scheme, the costs intended to be compensated by the grant. The purpose of the grant seems to be improvement of inflows during the operation period of Refinery, subject to compliance with the conditions attached with the grant. The various conditions do not clearly indicate the costs intended to be compensated. The Committee notes that paragraph 7 of Ind AS 20 provides that grant should be recognised only when there is a reasonable assurance that the entity will comply with the conditions attached to the grant and that the grant will be received. The Committee is of the view that in the extant case, the conditions relating to recognition of grant would be fulfilled as and when the each installment of loans is received during the operations of the refinery (as the benefit of interest on interest free government loan would not arise/accrue unless the proceeds of loan are received), subject to the reasonable assurance that the other conditions as specified in the scheme are fulfilled. Accordingly, as and when loan installment is received, the element of interest free loan on such installment as per the requirements of paragraph 10A of Ind AS 20, as discussed in paragraphs 14 and 15 above should be recognised as government grant. Further, with regard to the period of amortisation of each tranche of such grant, as the benefit of interest free loan accrues and is available over the tenure of each tranche of loan (which is 15 years in the extant case), the grant should also be amortised over such tenure.

19. With regard to disclosures and presentation in the Statement of Profit and Loss, the Committee is of the view that since interest free loan is a grant related to income as discussed above, it should be presented as per the requirements of paragraph 29 of Ind AS 20 as reproduced below:

“29 Grants related to income are presented as part of profit or loss, either separately or under a general heading such as ‘Other income’; alternatively, they are deducted in reporting the related expense.”

**D. Opinion**

20. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 12 above:

- (i) The accounting for Viability Gap Funding should be done as per the discussion in paragraphs 14 and 15 above.
- (ii) The amortisation basis and amortisation period of grant is discussed in paragraph 18 above.
- (iii) In view of (i) and (ii) above, answer to this question does not arise.
- (iv) The disclosure of Viability Gap Funding in the form interest free loan in the financial statement of the Company should be made as per the discussion in paragraphs 17 and 19 above.

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