

Query No. 13

Subject: *Accounting treatment under Ind AS for Financial Year 2019-20 for research expenses in case of a new Company formed for setting up of new Urea Plant and 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 A Ltd., B Ltd. and C Ltd. The Company was incorporated on 17th February, 2015 in terms of Government of India’s mandate of setting up of new Gas based Ammonia-Urea Complex at the closed Ramagundam unit of C Ltd. in terms of nomination by the Cabinet Committee of Economic Affairs (CCEA), Government of India decision dated 4th August, 2011 for revival of closed fertilizers units of C Ltd., which includes Ramagundam.

2. As per the process of revival of closed Ramagundam unit of C Ltd., the old plant was dismantled and sold off by C 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 Karimnagar, Ramagundam, Telangana.

3. 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 constructions activities at Ramagundam, Site Office at Ramagundam was made operational.

4. Planned Shareholding of the Company is as under:

| S.No. | Particulars | % of Shareholding |
|-------|---|-------------------|
| 1. | A Ltd. | 26 |
| 2. | B Ltd. | 26 |
| 3. | C Ltd.(in lieu of land to the Company on leasehold basis and other usable assets) | 11 |
| 4. | State Government of Telangana | 11 |
| 5. | X Ltd. | 14.30 |
| 6 | Y Consortium | 11.70 |

5. Abridged Statement of Affairs as on 31st March’ 20

| Particulars | Amount (INR) in crs. |
|---|----------------------|
| Equity Share Capital | 1299.12 |
| Outstanding Term Loan from Consortium of Bank | 3399.20 |
| Capital Work In Progress | 4017.78 |
| Reserve & Surplus | (67.87) |

6. The querist has informed that the project is being executed on Engineering Procurement & Construction Management (EPCM) route. The Company after entering into contracts with technology suppliers & licensors for Ammonia & Urea and engaging B Ltd. as EPCM Consultant, declared zero date of the project on 25th September, 2015 and the project is

¹ Opinion finalised by the Committee on 22.7.2021.

commissioned in March' 21. The total project cost envisaged is Rs. 5900 crores. Total debt has been lined up and loan agreement has been entered into with Consortium of 6 banks led by the State Bank of India.

7. 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 issued by the Institute of Chartered Accountants of India (ICAI). All annual accounts for all the financial years (F.Y.) from F.Y. 2016-17 onwards were prepared in accordance with Indian Accounting Standards (Ind AS) in terms of Companies Act, 2013. Annual accounts for the F.Y. 2019-20 (duly audited by statutory auditor appointed by the Comptroller and Auditor General (CAG)) have been prepared in terms of Ind ASs, which have been adopted and approved by the Board of Directors at its meeting held on 8th June 2020.

8. The querist has further informed that the audited accounts of the Company for the financial year 2019-20, were selected by Government audit for audit under section 143(6)(a) of the Companies Act, 2013 for supplementary audit. Government audit has raised comment - 1 which is given below.

(a) Government Audit's Provisional Comment:

“Assets

Non Current Assets

Intangible Assets under development (Note 7): Rs. 2.83 lakh

The above does not include an amount of Rs. 18.90 lakh incurred on intangible assets under development (consultancy charges for project of ERP implementation). An amount of Rs. 20.31 lakh was incurred in 2018-19 out of which Rs. 18.90 lakh was charged to profit and loss account in the year of occurrence. Since this expenditure was incurred for an ERP implementation project which is an Intangible asset, consultancy charges should have been included in the Intangible assets under development instead of charging to Profit and Loss (P&L) Account.

This has resulted in understatement of Intangible assets under development by Rs. 18.90 lakh and overstatement of other expenses and loss for the year by the same amount.”

The Company's Management Reply to Provisional comment:

In connection with Provisional Comment-1, it is submitted that:

(i) The subject amount of Rs 18.90 lakh was paid to a Consultant during F.Y. 2018-19 and accounted for during that year. The expenditure being in the nature of research, it was charged to P&L Account during F.Y. 2018-19. This accounting treatment was accepted by statutory as well as government auditors in that year.

(ii) The amount was paid to Consultant for “ERP Strategy & Roadmap for conducting of ERP study of ‘As is process’ including preparation of specifications, selections of module of ERP, estimated cost of hardware, recurring annual expenses, benefit analysis including road map and assessment of IT infrastructure required for Data Center”.

(iii) It may be seen from (ii) above that fee was in respect of study, which is called as Research in Ind AS 38, 'Intangible Assets'. Relevant extracts from Ind AS 38 provide as follows:

“Recognition of an expense

68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18 to 67); or

...

69 In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised...In the case of supply of services, the entity recognises the expenditure as an expense when it receives the services. For example, expenditure on research is recognised as an expense when it is incurred (see paragraph 54)...”

(iv) The relevant paragraphs 54 and 56 of Ind AS 38 are reproduced below:

“54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.”

“56 Examples of research activities are:

- (a) activities aimed at obtaining new knowledge;
- (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;
- (c) the search for alternatives for materials, devices, products, processes, systems or services; and
- (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.”

(Emphasis supplied by the querist.)

(v) The payments made by the Company as mentioned in (ii) above, are squarely covered by definition of research as mentioned in paragraph 54 of Ind AS 38 i.e. for study (research), estimation and selection of available software/alternatives etc. in form of evaluation.

(vi) Further to above, Appendix A, 'Intangible Assets—Web Site Costs' to Ind AS 38, refers to an issue at paragraph 2(a) as below:

“...

- (a) Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences.”

The accounting principle for above has been addressed at Appendix A to Ind AS 38 in paragraph 9(a) as given below:

“the Planning stage is similar in nature to the research phase in paragraphs 54-56 of Ind AS 38. Expenditure incurred in this stage shall be recognised as an expense when it is incurred.”

Since, expenditure of F.Y. 2018-19 was completely identical to research activity as defined in Ind AS, as mentioned above, it was correctly accounted for by charging to P&L Statement. In view of above, it was requested to drop provisional comment. Based on the reply of the Company and discussions held, government auditors did not agree with submissions and issued the same as a comment as stated below:

(b) *Government Audit Final Comment:*

“Govt. Audit observed that consultancy charges of Rs. 18.90 lakh for implementation of ERP accounted for during F.Y. 2018-19 should have been included in the ‘Intangible Assets under development’ instead of charging to Statement of Profit and Loss.”

The Company’s Management Reply to Provisional comment:

“The subject consultancy fee was incurred for feasibility study for implementation of ERP in the company particularly for benefit analysis, recurring annual expenses, assessment of IT infrastructure, estimated cost etc. As per Ind AS 38, these expenses are categorised as ‘Expenditure on Research’ and no intangible asset arising from expenditure on research can be recognised.

In view of difference arising in understanding and interpretation, the matter shall be reviewed in accounts of F.Y. 2020-21.”

9. *Nature of transaction related to Government Audit Comment*

The Company has awarded a contract to consultant for giving consultancy for ERP implementation assistance on 22nd May 2018 at a fee of Rs. 36.34 lakh (Cloud Based Solution Option-2). (A copy of Contract awarded to Consultant has been supplied separately by the querist for the perusal of the Committee.) The salient features of the Contract are as follows:

Contract completion and eligible payment split into 3 milestones:

- (1) Phase-I: ERP strategy and roadmap for implementation of ERP study of ‘As is Process’ including preparation of specifications, selection of modules of ERP, estimated cost of licensing, cost of hardware, recurring annual expenses benefit analysis including road map and assessment of IT infrastructure required for data center.
Milestone Payment of Rs. 17.80 Lakh + GST

- (2) Phase-II: Preparation of RFP for selection of implementation partner, preparation of evaluation document based on offers & finalisation of purchase order on Implementation partner for both ERP & Data Centre.
Milestone Payment of Rs. 4.00 Lakh + GST
- (3) Phase-III: Program management for implementation of ERP including compliance review of Data Centre.
Milestone Payment of Rs. 9.00 Lakh + GST

Contractual provision enables termination of Contract vide clause No. 10(iii), which provides:

“...in the event it is decided not to implement ERP solution after completion of phase-I of the scope of work, contract can be short closed....”.

Recognition of payments under the contract in financial statements is as follows:

- (a) The Company has charged the expenses (inclusive of taxes) related to Phase I (considering as research phase) in the Statement of Profit and Loss Accounts totaling to Rs. 18.90 lakh in F.Y. 2018-19.
- (b) The payment of Rs. 2.83 lakh, related to Phase II, paid in 2 equal instalments during F.Y. 2018-19 & 2019-20, recognised as ‘Intangible Asset under development’. Payment under Phase II (considered as development phase) and were released as implementation of ERP in the Company was found to be feasible.

10. The Company’s submission on accounting treatment:

- i. The amount of Rs. 18.90 lakh was paid to Consultant for “ERP Strategy & Roadmap for conducting of ERP study of ‘As is process’ including preparation of specifications, selections of module of ERP, estimated cost of hardware, recurring annual expenses, benefit analysis including road map and assessment of IT infrastructure required for Data Center”.
- ii. It may be seen from (i) above that fee was in respect of study, which is called as Research in Ind AS 38 relating to ‘Intangible Assets’.
- iii. Relevant extracts from Ind AS 38 provide as follows:

“Recognition of an expense

68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

- (a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18-67); or**
...”

“69 In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised....In the case of supply of services, the entity recognises the expenditure as an expense when it receives the services. For example,

expenditure on research is recognised as an expense when it is incurred (see paragraph 54) ...”

iv. The relevant paragraphs 54 and 56 of Ind AS 38 are reproduced below:

“54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.”

“56 Examples of research activities are:

- (a) activities aimed at obtaining new knowledge;
- (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;
- (c) the search for alternatives for materials, devices, products, processes, systems or services; and
- (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.”

(Emphasis supplied by the querist.)

v. Further to above, Appendix A to Ind AS 38, refers to an issue in paragraph 2(a) as below:

“Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences.”

The accounting principle for above issue in paragraph 2(a) has been addressed in paragraph 9(a) as given below:

“the Planning stage is similar in nature to the research phase in paragraphs 54-56 of Ind AS 38. Expenditure incurred in this stage shall be recognised as an expense when it is incurred.”

vi. The payment made by Company as mentioned in paragraph 9(1) above, is squarely covered by definition of research, as mentioned in paragraph 54 of Ind AS 38, i.e., for study (research), estimation and selection of available software / alternatives etc. in form of evaluation and was completely identical to research activity as defined in Ind AS mentioned above; therefore, it was accounted for by charging to P&L Statement.

B. Query

11. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether expenses on account of Phase-I of Contract (considered as Research Phase) and expensed off by the Company during F.Y. 2018-19 are eligible for capitalisation by way of ‘Intangible Asset under development’.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to accounting treatment under Ind AS 38 for expenses incurred by the Company during Phase I of the Consultancy Contract for ERP implementation assistance. 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 the revival of the closed unit including selling off the old plant, accounting for any other expense incurred during any other phase of the contract (Phase II or Phase III), Accounting for debt and the loan taken from consortium of banks, accounting under the previous GAAP, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the legal perspective of interpretation of the consultancy contracts. 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.

13. At the outset, the Committee notes from the Facts of the Case that the Consultancy Contract terms the Phase I for which the issue has been raised as “ERP strategy and roadmap for implementation of ERP study of ‘As is Process’ including preparation of specifications, selection of modules of ERP, estimated cost of licensing, cost of hardware, recurring annual expenses benefit analysis including road map and assessment of IT infrastructure required for data center”. With regard to accounting treatment of the above-mentioned expenditure, the Committee notes the following paragraphs of Ind AS 38, ‘Intangible Assets’:

“21 An intangible asset shall be recognised if, and only if:

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

“53 If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research phase

54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

55 In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

56 Examples of research activities are:

- (a) activities aimed at obtaining new knowledge;
- (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;
- (c) the *search for alternatives* for materials, devices, products, processes, systems or services; and

- (d) the formulation, design, *evaluation and final selection of possible alternatives* for new or improved materials, devices, products, processes, systems or services.

Development phase

57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.**
- (b) its intention to complete the intangible asset and use or sell it.**
- (c) its ability to use or sell the intangible asset.**
- (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.**
- (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.**
- (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.**

58 In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.

59 Examples of development activities are:

- (a) the design, construction and testing of pre-production or pre-use prototypes and models;
- (b) the design of tools, jigs, moulds and dies involving new technology;
- (c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- (d) *the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.*”

(Emphasis supplied by the Committee.)

From the above, the Committee is of the view that the expenses incurred on research activities (or on the research phase of an internal project) should be recognised as an expense when it is incurred. However, the expenses incurred on development activities (or during development phase of an internal project) should be recognised as an intangible asset if, and only if, an enterprise can demonstrate that all the conditions mentioned in paragraph 57 of Ind AS 38 above are fulfilled.

14. With regard to the nature of activities being performed under Phase I of the Consultancy Contract in the extant case, the Committee notes that the contract, inter alia, states under the Broad Framework under the Scope of Work that the Consultant shall prepare an approach document for ERP & Data Center at the Company including selection of modules of ERP and other identified applications, *assessment of IT infrastructure required* for Data

Center, estimated cost of licensing, suggest on Premises hosting/cloud hosting, cost of hardware, recurring annual expenses on ERP/ data center maintenance & cost benefit analysis. The Committee also notes that the Contract provides for the schedule of rates for two options/models for implementation the Project, viz., On-premise data Centre and Cloud based solution and states as follows:

“1. ...

- The decision for the On-premise data Centre or Cloud based solution would be taken on the basis of cost benefit analysis to be submitted by ‘the Consultant’ during first phase of the project. In case it is decided to opt for cloud based solution, total fee shall be Rs. XX plus GST and in case it is decided to opt for On-premise Data Centre, total fee shall be Rs. YY plus GST.”

Further, the Committee notes the following clauses from the Contract between the Company and the Consultant:

“I. SCOPE OF PHASE-I: ERP Strategy & Roadmap for implementation of ERP

- (a) Consultant shall make an assessment of ‘As is Processes’, the current state of applications in various business domains, hardware infrastructure, risk and continuity, security and scalability.
- (b) Consultant shall make a detailed functional requirement specification after studying the prevailing processes for various business domains viz. Finance, Human resource, Production, Planning, Marketing, Materials, logistics. Suggest, “to be process” with incorporation of mobile based front-ends. In this regard, consultant shall have to visit the Company’s site at Ramagundam & Corporate Office at New Delhi.
- (c) Consultant shall make a requirement study indicating expected business domains to be covered under ERP and highlight the potential benefits that the Company can derive on the implementation of ERP.
- ...
- (f) Consultant shall also indicate various potential ERP systems which can be considered for implementation and identify options available to the Company which suit the prevailing business domains of the Company in particular and Fertilizer industry in general. A list of fertilizer manufacturers along with ERP system implemented by them may be provided.
- (g) Consultant shall suggest various modules of ERP which are advisable to be implemented for the Company.
- (h) Consultant shall prepare a cost breakup of implementation of an ERP system covering hardware, license, Annual technical support, implementation and support costs for a period of 3 years after warranty period.
- (i) Consultant shall also work out the cost-benefit analysis on implementation of ERP.
- (j) Consultant shall also suggest implementation of ERP at the Company with in-premises hosting model/ cloud based hosting model.”

“10. GENERAL AND COMMERCIAL TERMS AND CONDITIONS

...

- iii. **Activities of Phase-II** and subsequent activities shall be started on getting specific advice from the Company in writing. In the event it is decided not to implement ERP solution after completion of phase-I of the scope of work, contract can be short closed on mutual agreed terms and conditions for payment in r/o deliverables”.

From the above, the Committee notes that during Phase I, the Consultant is required to make assessment of ‘as is processes’, make a detailed functional requirement specification after studying prevailing processes and make a requirement study indicating expected business domains to be covered under ERP. The scope of Contract also includes to indicate various potential ERP systems which can be considered for implementation and identify options available to the Company which suit its prevailing business domains. Consultant is also required to prepare a cost break-up, to work out the cost-benefit analysis on implementation of ERP and also suggest implementation of ERP at the Company with in-premises hosting model/ cloud based hosting model. Thus, during Phase I, even the ERP system to be implemented, various modules of ERP, hosting model, etc. are yet to be decided and only study is to be made to choose the best alternative for taking the decision about the implementation of the Project. Further, the activities performed during the Phase I are in the nature of analysis and study, which appear to be similar to the kind of activities undertaken in research phase as per the examples of research activities given in paragraph 56 of Ind AS 38, reproduced above. Moreover, as per the Contract with the Consultant, in the event it is decided not to implement ERP solution after completion of Phase I of the scope of work, Contract can be short closed, which further indicates that during Phase I, the usefulness of the output under the Contract is not established as the decision to continue with further stages of the Contract will be undertaken based on the result of the Phase I and therefore, how the intangible asset (if any) developed under the Contract will generate probable future economic benefits cannot be demonstrated as per paragraph 57 of Ind AS 38, reproduced above. Thus, the activities under Phase I do not give rise to any intangible asset that will generate probable future economic benefits.

Accordingly, the Committee is of the view that the expenses incurred during Phase I of the Contract in the extant case are for research activities and should be recognised as an expense, as and when incurred.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that expenses incurred during Phase I of the Consultancy Contract fall under the category of research phase as mentioned in Ind AS 38 and should be recognised as an expense as and when incurred, as discussed in paragraphs 13 and 14 above.
