

Query No. 19

Subject: *Accounting treatment of expenditure incurred on the assets not owned by the Company.*¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’) is a company registered under the provisions of the Companies Act, 2013 in 2016. The Company is a Special Purpose Vehicle (SPV) for implementing Smart City Project of the Ministry of Urban Development (MoUD). The capital of the Company is contributed, subscribed and paid-up by the State Municipal Council.

2. The Company is responsible for monitoring and evaluation of completion and progress of the work/activities carried out by the State Municipal Council according to the time frame with regard to the project.

3. The querist has informed that the State Municipal Council has been appointed and engaged as the implementing agency to execute the Smart City Projects on the deposit work basis. Accordingly, a Memorandum of Agreement has been entered between the Company and State Municipal Council on July 18, 2018 for smooth working of both the entities. The Company has been given the limited time frame for the execution of the project by the Government of India (GoI).

4. The querist has further informed that the works to be executed by the Company in the project are development of new drainage system, facilities for general public, utility diversions, environmental protection, road diversions/restoration/signages, renovation work of drainage system and rehabilitation and resettlement etc.; and redevelopment of State Municipal Council area.

5. As per the querist, the funds of the Company are given as a grant and cost of execution of the project has to be met out from those funds and part of these funds received has been capitalised as equity capital of the Company.

6. The Company received the fund from Government of India and State Municipal Council as under:

At the start - Government of India - Rs. 196 crore and State Municipal Council – Rs. 200 crore aggregating to Rs. 396 crore. Out of Rs. 396 crore, the Company issued the share capital of Rs. 250 crore, out of which Rs. 194 crore was from Government of India and Rs. 56 crore was from the State Municipal Council.

7. All the works so executed under the project neither shall yield any revenue nor shall form part of assets of the Company. The works so completed and executed in part shall form the assets of the other entity, i.e., State Municipal Council. All development works shall not yield any revenue in future and none of the assets developed or created are controlled or owned by the Company.

¹ Opinion finalised by the Committee on 27.10.2021.

8. The querist has stated that in the financial year (F.Y.) 2017-18, the Company has executed part of the main project as sub-projects worth Rs. 27.27 crore through two executing agencies (Rs. 21.29 crore for smart city development expenses and Rs. 5.98 crore for A Ltd. project). The expenses so incurred were charged as operating and other expenses by the management of the Company since the expenses were incurred towards the main object of development works in the area of State Municipal Council. Further, any asset so generated or to be generated as part of the project shall not belong to, or be owned or controlled by the Company or booked under the Company's assets. (A copy of Guidelines applicable to the Smart City Mission as applicable for projects execution and related compliances and Memorandum of Agreement between the Company and the State Municipal Council have been supplied separately by the querist for the perusal of the Committee.)

9. The querist has also made specific reference to the following extracts from the Smart City Mission Guidelines, wherein the structure of such SPV is defined:

“Annexure 5: Structure and Functions of SPV

1. Structure of the SPV

The City level SPV will be established as a Limited Company under the Companies Act, 2013 and will be promoted by the State /UT and the ULB jointly, both having 50:50 equity shareholding. This shareholding pattern has to be maintained at all times. The private sector or financial institutions could be considered for taking equity stake in the SPV, provided the State/UT and ULB share are equal to each other, and the State/UT and ULB together have majority shareholding and control of the SPV (e.g. State/UT:ULB:Private sector shareholding can be in the ratio 40:40:20 or 30:30:40. Ratios such as 35:45:20 or 40:30:30 are not permitted since State/UT and ULB shares are not equal. Ratios such as 20:20:60 are also not permitted since the State/UT and ULB together do not have majority shareholding). In addition to equity, the State/UT can provide its contribution to the Smart Cities Mission as grant to fulfil the State Government responsibility for ensuring availability of funds for the mission and for ensuring the financial sustainability of the SPV.

2. Raising and utilization of funds by the Company (SPV)

The funds given by the Central Government to the SPV will be in the shape of tied grants and kept in a separate Grant Fund. These funds will be utilized only for the purposes given in the Mission Statement and Guidelines and subject to the conditions laid down by the Central Government. The ULBs may, through the State Government, request MoUD to permit utilization of GoI grants as ULB's equity contribution to the SPV, subject to the following conditions:

- i. The State Government has made adequate contribution to the SPV out of their own funds.
- ii. The approval will be limited to the GoI grants that have already been released. Since future instalments of Smart City funds are subject to performance and are not guaranteed, the ULB will not be permitted to earmark future instalments to meet its equity contribution.

- iii. The utilization of the GoI grants as equity contributions will not alter the relative shareholding of the State Government and the ULB, which will remain equal as per Mission guidelines.
- iv. It is clarified that the Government of India contribution to Smart Cities is strictly in the form of grant and the ULB is exercising its own discretion in utilizing these funds as its equity contribution to the SPV.

The SPV will also access funds from other sources such as debt, user charges, taxes, surcharges, etc.”

10. The Comptroller and Auditor General (CAG) conducted the supplementary audit of the Company for F.Y. 2017-18 and issued a half margin stating that as the expenditure incurred by the Company is out of capital contribution shown under the liability side of the balance sheet, the incurring of expenditure for the projects under the expenditure side of Profit and Loss Account is against the matching concept of accounting principles.

11. The querist has stated that it could be gathered from the CAG half margin that in the opinion of CAG, the expenses need to be capitalised and amortised over the period of its utility based on matching concept since they are paid out of the capital of the Company.

B. Query

12. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the expenses incurred are the operating expenses of the Company or whether these should be charged to the capital of the Company without going through the Profit and Loss Account for the financial year or whether the treatment of expenses as suggested by the CAG is correct.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to recognition of expenses incurred for smart city development and A Ltd. Project. 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, classification and accounting for fund/grant/contribution received from the GoI/ULBs, accounting for share capital issued by the Company, etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from the legal perspective, such as, interpretation of Smart City Mission Guidelines, MoA between the State Municipal Council and the Company etc. The Committee has also not examined whether the State Municipal Council, while providing funds to the Company is acting in the capacity of owner or as ‘Government’ as per Accounting Standard (AS) 12, ‘Accounting for Government Grants’, as this issue has not been specifically raised by the querist.

The Committee notes from the annual reports of the Company for the financial years 2017-18 and 2018-19 that the Company is following Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006² and accordingly, the opinion expressed hereinafter is from the perspective of the Accounting Standards, notified under the

²Companies (Accounting Standards) Rules, 2021 supersedes the Companies (Accounting Standards) Rules, 2006 with effect from accounting periods commencing on or after 1.4.2021.

Companies (Accounting Standards) Rules, 2006 and not from the perspective of Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee presumes from the Facts of the Case that the Company is not acting as an agent of the Government of India/State Municipal Council; rather it is acting in the capacity of principal.

At the outset, the Committee notes from the Facts of the Case that the querist has specifically stated that the expenses mentioned above (including expenditure in respect of A Ltd. Project) were charged as operating and other expenses by the management of the Company since the expenses were incurred towards the main object of development works in the area of State Municipal Council. Further, any asset so generated or to be generated as part of the Project shall not belong to or be owned or controlled by the Company or booked under the Company's assets. Accordingly, in the absence of any other specific information/details about A Ltd. project to the contrary, the Committee presumes that from accounting perspective, A Ltd. project is similar to or part of project of smart city development and, therefore, the Committee has not examined the expenses incurred in relation to A Ltd. project separately. In case, the nature, purpose and/or other modalities of A Ltd. project is/are different, the opinion expressed hereinafter will not be relevant for the A Ltd. project.

14. With regard to recognition of the expenses incurred on smart city development and A Ltd. project, the Committee notes that Clause 6 of Memorandum of Agreement (MoA) entered between the Company and State Municipal Council states as follows:

“... the main objective of this agreement is to implement, manage and monitor arrangements made for the Smart City Development Projects for the area under “State Municipal Council” in accordance with the Smart City Mission Guidelines issued by Government of India.

...

6) Any construction/upliftment/re-modification on any asset of State Municipal Council under the Smart City Mission shall not dilute the right of State Municipal Council and it shall be the exclusive owner of that asset.”

“II. SCOPE OF SERVICES TO BE PERFORMED BY STATE MUNICIPAL COUNCIL

...

1) State Municipal Council will maintain assets created for the purpose of this Project under this Agreement. The cost for maintenance of these assets including AMCs etc. are to be borne by State Municipal Council.”

From the above, it is evident that the Company will neither get ownership rights of any assets created/modified as part of smart city development project nor maintain the same.

In this context, the Committee notes the definition of ‘asset’ from Accounting Standard (AS) 26, ‘Intangible Assets’ and paragraphs 14 and 56 thereof as follows:

“6.2 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.”

“14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.”

“56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. ...”

From the above, the Committee notes that an asset is a resource *controlled* by the enterprise and an enterprise *controls* an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. Accordingly, the Committee is of the view that it is only where the asset is controlled by the Company in the manner envisaged by paragraph 14 of AS 26, the Company should recognise asset in its financial statements in respect of the expenditure incurred. However, in the extant case, the MoA clearly states that the State Municipal Council shall be exclusive owner of and shall maintain the assets created/modified as part of smart city development project. Further, the Committee notes from the Facts of the Case that the querist has specifically stated that “all development works shall not yield any revenue in future and none of the assets developed or created are controlled or owned by the Company”.

Therefore, the Committee is of the view that in the extant case, the Company does not *control* the assets created/modified under smart city development project in the manner envisaged in the above-mentioned paragraphs of AS 26. Thus, the expenditure incurred for the smart city development and A Ltd. project should not be capitalised as an asset in the financial statements of the Company. Further, the Committee notes the following requirements of AS 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’:

“5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.”

From the above and considering the requirements of paragraph 56 of AS 26, as reproduced above, the Committee is of the view that the expenditure incurred by the Company for the smart city development and A Ltd. project should be recognised as an expense in the Statement of Profit and Loss of the Company.

D. Opinion

15. The Committee is of the opinion that the expenses incurred for the smart city development and A Ltd. project should be recognised as an expense in the Statement of Profit and Loss of the Company, as discussed in paragraph 14 above.
