

## Query No. 23

**Subject: Treatment of acquisition cost under the applicable financial reporting framework and capitalisation of borrowing cost in relation thereto.<sup>1</sup>**

### A. Facts of the Case

1. A public limited company (hereinafter referred to as ‘the Company’) is a wholly owned subsidiary of a listed government company and is in the business of oil and gas exploration and production (E&P) and other hydrocarbon related activities outside India.

2. The Company operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. Globally, E&P business is carried out by way of joint arrangements or investments in form of subsidiaries/associates. The Company has adopted Indian Accounting Standards (Ind ASs) w.e.f. 1st April, 2016 (Transition Date, 1st April, 2015). The functional currency of the Company is assessed as US Dollar (USD) in accordance with the provisions of Ind AS. The Company presents its financial statements in its presentation currency which is Indian Rupee (INR) as per the requirements of Companies Act, 2013.

3. The querist has stated that in the financial year (F.Y.) 2013-14, the Company acquired 10% Participating Interest (PI) in an overseas E&P project (Project X) which was in development stage. The Company accounted for its joint share of 10% of the value of assets and liabilities in the operation of project X on the date of transfer. The difference between the purchase consideration and net book value of assets less liabilities relating to the 10% PI in joint venture was accounted for as acquisition cost for acquiring mineral rights, capitalised under capital work in progress (CWIP) in accordance with paragraph 7 of Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013), issued by the Institute of Chartered Accountants of India (ICAI), which provides that acquisition cost covers all costs incurred to purchase, lease or otherwise acquire a property or mineral rights, proved or unproved and inter-alia includes consideration for farm-in arrangements and paragraph 18 read with paragraphs 46 and 47 of the Guidance Note provides that such acquisition cost is to be treated as capital work in progress (CWIP) or intangible assets under development when incurred. In accordance with the above-mentioned provisions of paragraph 18 read with paragraphs 46 and 47, the Company capitalised the acquisition cost as intangible assets under development in its financial statements. The querist has separately informed that 10% Participating Interest (PI) in Project X was acquired for a purchase consideration of INR 105,000 million and as at acquisition date, there were following assets in Project X:

<b>Assets</b>	<b>Indicative Amount in INR million</b>
Capital Work in Progress (CWIP):	2,964
Exploratory Wells in Progress (EWIP):	7,026
Other PPE	2,600
Loans & Advances	2,400
<b>Total Assets</b>	<b>14,990</b>

Accordingly, the Company capitalised the above assets in its books as at acquisition date and also recognised excess amount of purchase consideration over the assets acquired i.e. INR 90,010 million (viz. INR 105,000 million – 14,990 million) as acquisition cost for acquiring

<sup>1</sup> Opinion finalised by the Committee on 23.12.2021.

mineral rights under capital work in progress (CWIP) in accordance with paragraph 7 of Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013). Subsequently, upon transition to Ind AS (transition date 01.04.2015) and issuance of Guidance Note on Accounting for Oil and Gas Producing Activities (Ind AS), the said acquisition cost for acquiring mineral rights was accounted for as 'Intangible Assets under Development'.

4. The querist has further stated that the Company had financed the purchase consideration for acquisition of 10% PI in Project X by way of external borrowings (including subsequent refinancing thereof). Since the said oil and gas project X was under development, the directly associated borrowing costs were capitalised to the qualifying assets of the project X including the acquisition cost in line with the Accounting Standard (AS) 16, 'Borrowing Costs'. Since the nature of acquisition cost is that of one time expenditure for acquiring the mineral rights, there have been no further additions to the acquisition cost except the borrowing costs capitalised thereto. The querist has further informed that the borrowing costs incurred on the said borrowings for respective financial years have been capitalised with the proportionate costs of three qualifying assets, viz., CWIP, EWIP and acquisition cost for acquiring mineral rights (Intangible Assets under Development) in the ratio of 2.96%, 7.03% and 90.01% respectively.

After the acquisition of Project X, the development activities are being undertaken for the project. As a result of these development activities, there have been further additions to the costs of CWIP and EWIP. Accordingly, there have been following additions till 31.12.2019 to the assets as a result of further development activities and capitalisation of borrowing costs (in respect of qualifying assets):

**(Indicative Amount in INR million)**

<b>Details</b>	<b>Whether qualifying assets</b>	<b>Value as on 28.02.2014</b>	<b>Additional expenditure capitalised</b>	<b>Borrowing cost capitalised</b>	<b>Total cost till 31.12.2019</b>
CWIP – Onshore and Offshore	Yes	2,964.00	7,850.00	143.66	10,957.66
EWIP – Wells	Yes	7,026.00	3,050.00	340.40	10,416.40
Other PPE – Computers	No	1,000.00	700.00	-	1,700.00
Other PPE – F&F	No	700.00	350.00	-	1,050.00
Other PPE – Transportation Equipment	No	900.00	560.00	-	1,460.00
Loans & Advances	No	2,400.00	1,050.00	-	3,450.00
Acquisition Cost for acquiring mineral rights (Intangible Asset under development)	Yes	90,010.00	-	4,360.92	94,370.92
<b>Total</b>		<b>105,000.00</b>	<b>13,560.00</b>	<b>4,844.98</b>	<b>123,404.98</b>

5. The querist has also informed that during F.Y. 2019-20, the Company transferred its 10% PI in respect of Project X to its wholly owned Indian subsidiary company Y w.e.f. 01.01.2020. In view of the transfer of business between entities under common control, the

transaction was accounted for as per the provisions of Appendix C, 'Business Combinations of Entities under Common Control' to Ind AS 103, 'Business Combinations'. Accordingly, all the assets (including 'acquisition cost' as well as exploratory wells in progress (EWIP) capitalised as intangible asset under development and CWIP) and liabilities of the Company in respect of its PI in Project X as on 01.01.2020 were accounted for in the books of subsidiary company Y at the carrying value appearing in the books of the Company as on the date of transfer. Purchase consideration of the transfer of the 10% PI in Project X was settled by the subsidiary company partly by way of a loan amount from the holding company and balance amount by way of equity shares of the subsidiary company. The said loan to subsidiary was provided on back-to-back interest basis, i.e., the interest expense of the Company incurred on the borrowings made for acquiring Project X (as mentioned in paragraph 4 above) from the market lenders was, in turn, charged to the subsidiary Y.

Post such acquisition of business in respect of 10% PI in Project X w.e.f. 01.01.2020, the subsidiary company continued with the same accounting treatment in its financial statements in respect of the acquisition cost as was being done by the parent company before such transfer. Accordingly, the subsidiary company has capitalised the acquisition cost as Intangible Assets under Development along with related borrowing cost incurred on the loan from parent company since the oil and gas asset was under development. The querist has further informed that the following additions have been made in the respective assets by the subsidiary company till 31.03.2021:

**(Indicative Amount in INR million)**

<b>Details</b>	<b>Opening Balance as on 01.01.2020</b>	<b>Additional expenditure capitalised till 31.03.2021</b>	<b>Borrowing cost capitalised</b>	<b>Total cost till 31.03.2021</b>
CWIP - Onshore and Offshore	10,957.66	2,600.00	28.32	13,585.98
EWIP - Wells	10,416.40	500.00	67.10	10,983.50
Other PPE - Computers	1,700.00	200.00	-	1,900.00
Other PPE - F&F	1,050.00	100.00	-	1,150.00
Other PPE - Transportation Equipment	1,460.00	160.00	-	1,620.00
Loans & Advances	3,450.00	300.00	-	3,750.00
Acquisition Cost for acquiring mineral rights (Intangible Asset under development)	94,370.92	-	859.58	95,230.30
<b>Total</b>	<b>123,404.98</b>	<b>3,860.00</b>	<b>955.00</b>	<b>128,219.98</b>

6. During the course of statutory audit of the subsidiary company for F.Y. 2020-21, the statutory auditors raised an issue of separate treatment of acquisition cost in financial statements and for taxation purposes. It may be noted that in the tax books, the subsidiary company claims depreciation on the acquisition cost treating it as an intangible asset, being a business or commercial right akin to a license and eligible for claim of depreciation, as allowed under Income-tax Act, 1961 and rules made thereunder. The auditors have questioned

as to why the subsidiary company is treating the acquisition cost as ‘Intangible Assets under Development’, i.e., assets under construction in the financial statements while at the same time, claiming depreciation on acquisition cost under income-tax before the tax authorities. Statutory auditors raised the observation that depreciation as claimed by the Company for the purpose of income-tax is available only in respect of assets which by themselves are complete, put to use and are not in a state of construction or creation. They emphasised that if the subsidiary company is treating the acquisition cost as an asset already put to use and claiming depreciation thereon for income-tax purposes, why is the Company treating the same asset, i.e., acquisition cost representing expenditure for acquiring the mineral rights as an asset under construction in financial statements. The auditors also observed that no further addition in the expenditure for the acquisition cost has happened since the acquisition of project X by the Company and subsequently by the subsidiary company.

7. The statutory auditors of subsidiary company also raised the issue on capitalisation of interest on acquisition cost with the perspective that Ind AS permits capitalisation of interest on assets purchased out of borrowed funds till the date of completion of the asset or till the date when the asset is available for use. In the opinion of statutory auditors, since no further addition was being made on acquisition cost and the subsidiary company is treating it as an asset already put to use for income-tax purposes, borrowing cost pertaining to the same should be charged off to the Statement of Profit and Loss instead of capitalising the same. Further, the subsidiary company claims interest paid on such borrowings as an expense before the tax authorities. The statutory auditors further reiterated that if an asset is presented before one authority as asset in use, it would require the same treatment in the financial statements also.

*Company’s perspective:*

8. The subsidiary company has accounted for the acquisition cost in respect of Project X as intangible assets under development in accordance with the requirements of the Guidance Note on Accounting for Oil and Gas Producing Activities (under Ind AS) whereas the treatment of the acquisition cost for income-tax purposes is as per the provisions of Income-tax Act, 1961. Hence, separate treatments of acquisition cost by the subsidiary company in financial statements and for tax computation emanate due to different intents and provisions governing these separate requirements of Ind AS and Guidance Note on one side and income-tax provisions on the other. Accordingly, there is no requirement of alignment of one with the other for the same item of asset/expenditure. Since the provisions in financial reporting framework (Ind AS and Guidance Note) and income tax rules are different for acquisition cost, the Company has undertaken different treatments in compliance of the requirements of the respective framework.

9. The querist wishes to bring to the notice of the Expert Advisory Committee that paragraph 9 of Ind AS 106, ‘Exploration for and Evaluation of Mineral Resources’ states that “An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources. The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):

- (a) acquisition of rights to explore;

...”

10. Further, the Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable) issued by the ICAI defines 'Acquisition Activities' in paragraph 7 as the "Activities carried out by an E&P entity towards the acquisition of right(s) to explore, develop and produce oil and gas, constitute acquisition activities..." It also states that "...The rights for exploration, development or production may also be acquired by entering into a farm-in arrangement (transfer of part of oil & gas interest between parties)."

11. It further defines acquisition cost in paragraph 8 as, "Acquisition costs cover all costs incurred to purchase, lease or otherwise acquire a property or mineral right proved or unproved."

12. The Guidance Note provides accounting treatment of acquisition costs in paragraphs 18 and 22 as follows. Paragraph 18 of the Guidance Note states that "An entity should capitalise acquisition costs as an intangible asset or tangible asset, based on its nature. For example, acquisition cost incurred to obtain right to explore should be capitalised as intangible asset being in the nature of commercial right."

13. Paragraph 22 of the Guidance Note provides that when a well is ready to commence commercial production, the capitalised costs referred to in above paragraphs (i.e. cost mentioned in paragraphs 18 to 21 of the Guidance Note which also includes acquisition costs) corresponding to proved developed oil and gas reserves should be reclassified as 'completed wells/producing wells' from 'capital work-in-progress/intangible asset under development' to the gross block of assets. *With respect to acquisition costs, the entire cost should be capitalised from 'capital work-in-progress/intangible asset under development' to the gross block of assets.* (Emphasis supplied by the querist.)

14. Hence, as per the provisions of Guidance Note mentioned in forgoing paragraphs, the acquisition cost should be initially capitalised as an asset under construction i.e. as capital work in progress or intangible asset under development, as the case may be and such acquisition cost will be capitalised to the gross block of assets only when a well is ready to commence commercial production, i.e., proved developed oil and gas reserves are established. Till such establishment of proved developed reserves, the acquisition cost should continue to form part of assets under construction as 'Capital Work in Progress' or 'Intangible Assets under Development' as the case may be.

15. In line with the provisions of Ind AS 106 and Guidance Note on Accounting for Oil and Gas Producing Activities (Ind AS), the Company's accounting policy for accounting of acquisition cost states as follows:

**"Acquisition cost**

Acquisition costs cover all costs incurred to purchase, lease or otherwise acquire a property or mineral right proved or unproved in case of acquiring participating interest in an oil and gas assets and are accounted as follows:-

**Exploration and development stage**

Acquisition cost relating to projects under exploration or development are initially accounted as Intangible Assets under development or Capital work in progress - Oil and gas assets respectively.

Such costs are capitalized by transferring to oil and gas assets when a well in field/project is ready to commence commercial production. In case of abandonment/relinquishment, such costs are written off.”

16. Thus, as per the querist, it is evident from the aforementioned provisions of Ind AS 106 and the Guidance Note that acquisition cost is not capitalised as a complete asset in itself without the related oil wells and facilities. Acquisition cost is initially capitalised as asset under construction and subsequently capitalised to the gross block of underlying assets of the oil and gas project/field upon commencement of commercial production, i.e., establishment of proved developed reserves. Therefore, until the commencement of commercial production, acquisition cost will continue to form part of assets under construction under capital work in progress/intangible assets under development. Since Project X is under development, the related acquisition cost has been accounted for as intangible assets under development in line with the requirements of Ind AS and the Guidance Note.

17. The accounting treatment of acquisition cost is independent from the treatment thereof for income tax computation purposes. An asset can have different treatment for accounting purpose and for the purpose of income tax computation, more so, in oil and gas exploration and exploitation and there may be different treatment of the same item including exploration well cost and acquisition cost etc. in financial accounting and for taxation purposes. This view is also supported by Ind AS 12, ‘Income Taxes’ which defines the tax base of an asset or liability as *the amount attributed to that asset or liability for tax purposes*. It also provides for the treatment of tax consequences of temporary differences between the carrying amount of an asset or liability in the balance sheet and its tax base.

18. For income tax purposes, acquisition cost is treated as an ‘intangible asset’ (being a business or commercial right akin to a license), i.e., a complete asset in itself, put to use and eligible for claim of depreciation under clause (ii) of sub-section (1) of Section 32 of the Income-tax Act. However, the treatment of acquisition cost as an asset complete in itself and put to use for business for taxation purposes does not have any bearing on the accounting treatment of acquisition cost as an asset under construction under capital work in progress/intangible asset under development. Both the treatments of same item, i.e., acquisition cost are different and independent of each other. Therefore, it is incorrect to assume that since the acquisition cost is treated as a complete asset, put to use in business for the purposes of income tax computation, it cannot be treated as capital work in progress/intangible asset under development in the financial statements.

19. *Capitalisation of borrowing cost relating to acquisition cost for Project X:* Development of oil and gas assets and establishment of commercial production therefrom takes substantial time. During development period, the acquisition cost forms part of capital work in progress/intangible asset under development and is subsequently capitalised to the gross block of underlying oil and gas assets when the development is complete with establishment of proved developed reserves and the well is ready for commercial production. Therefore, in essence, acquisition cost forms part of oil and gas assets in progress and upon commencing of commercial production, is capitalised as oil and gas assets along with other in-progress assets e.g. development wells in progress, under-construction production facilities, etc.

In terms of paragraph 8 of Ind AS 23, ‘Borrowing Costs’, **“An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset....”**. Further, Ind AS 23 defines the qualifying asset as an asset that necessarily takes a substantial period of time to get

ready for its intended use or sale. Paragraph 7 of Ind AS 23 clarifies that depending on the circumstances, intangible assets may also be qualifying assets. The acquisition cost in respect of Project X meets the criteria of qualifying asset as per the requirements of Ind AS 23.

20. Further, the querist also wishes to bring to the notice of the Committee that the subsidiary company is undertaking such development activities in respect of Project X that are necessary to prepare the in-progress oil and gas assets for the intended use (viz. production of hydrocarbons). Therefore, the subsidiary company also fulfils all the three conditions of paragraph 17 of Ind AS 23, viz.:

- The Company has incurred expenditures for the asset;
- It is also incurring the borrowing costs; and
- It is undertaking the activities that are necessary to prepare the asset for its intended use.

The fact that there is no additional expenditure incurred for acquisition cost subsequent to acquisition of Project X, as noted by the auditors, is not relevant for an asset to be a qualifying asset. Acquisition cost is a one-time expenditure incurred at the time of acquisition of PI. It remains part of intangible asset under development till the beginning of commercial production. The provisions of Ind AS 23 do not mandate incurring of subsequent expenditure in respect of a particular component of in-progress assets. The requirement of Ind AS is that the development activities necessary to prepare the asset for its intended use are being undertaken.

21. Accordingly, the borrowings costs incurred for such acquisition cost in respect of Project X are capitalised with acquisition cost in terms of paragraphs 8 and 9 of Ind AS 23 which state that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset.

22. Further, since acquisition cost is treated as a complete and put to use asset in itself as per the provisions of Income-tax Act and rules made thereunder, the associated borrowing cost (i.e. the interest expenditure on borrowings) is treated and claimed as revenue expenditure under section 37 (1) of the Income-tax Act and associated tax provisions for the purpose of income tax computation as against capitalisation thereof with acquisition cost (being a qualifying asset as intangible asset under development) in the financial statements as per Ind AS 23. It is highlighted that such different treatment of borrowing cost for tax computation is due to different provision under income tax jurisprudence.

23. In view of the above, it was submitted to the statutory auditors that the subsidiary company has correctly accounted for the acquisition cost relating to the oil and gas Project X as intangible assets under development and has correctly done the capitalisation of the borrowing cost directly attributable to the acquisition cost, being a qualifying asset. The different treatment undertaken by the subsidiary company in respect of acquisition cost and associated borrowing costs for income tax computation as per income tax provisions has no bearing on the financial accounting of the same in the financial statements, which are prepared in accordance with the provisions of Ind AS and Guidance Note.

## **B. Query**

24. In view of the above, the querist has sought the opinion of the Expert Advisory Committee (EAC) of the ICAI on the following issues:

Whether-

- (i) (a) The subsidiary company has correctly capitalised the acquisition cost as capital work in progress/intangible asset under development in its financial statements as per the applicable provisions of Ind AS and Guidance Note on Accounting of Oil and Gas Producing Activities (Ind AS) notwithstanding the fact that the acquisition cost is treated as a separate asset and considered as an asset put to use for claiming the depreciation under income tax provisions.  
  
(b) the subsidiary company can treat the acquisition cost as an under-development asset and capitalise interest on borrowings made for acquisition of such asset in its financial statements in accordance with provisions of Ind AS and Guidance Note as against different presentation before the tax authorities for the same asset treating the same as put to use and claim depreciation thereon along with associated interest on borrowing for acquisition thereof treated as an expense as per Income Tax Act and rules made thereunder.
- (ii) If the answer to the above query (i) (a) is in affirmative, whether the subsidiary company is correctly treating the said acquisition cost (capitalised as intangible asset under development till the time it is capitalised with the gross block of underlying oil and gas assets) as qualifying asset within the meaning of Ind AS 23 for the purpose of capitalising the borrowing costs.

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

25. The Committee notes that the basic issue raised in the query relates to capitalisation and classification of acquisition cost of the 'mineral rights' as 'intangible assets under development' and capitalisation of the borrowing cost incurred for acquiring the same in the separate financial statements of the subsidiary company under the Ind AS Framework. The Committee has, therefore, considered only these issues and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting treatment in the consolidated financial statements of the Company, accounting for acquisition of PI (including treatment of the difference between the purchase consideration and the value of net assets acquired as acquisition cost of mineral rights), whether the share of 10% of the value of assets and liabilities in the operation of Project X in the extant case is a joint venture or joint operation or joint arrangement, accounting as per the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006, amortisation of mineral rights, accounting treatment at the time of transition to Indian Accounting Standards (Ind ASs), accounting for transfer of PI to the Company's wholly owned subsidiary including requirements of Appendix C (Business combination of entities under common control) to Ind AS 103, 'Business Combinations', accounting for other assets and liabilities acquired in relation to Project X, accounting treatment of purchase consideration paid by subsidiary company in respect of PI (in form of equity shares and loans), applicability of Ind AS 12, 'Income Taxes', appropriateness of usage of the term, 'exploratory wells in progress (EWIP)' for development wells, etc. The Committee has also not examined that whether the assets or wells acquired by the Company or subsidiary company in the extant case are under exploration or development stage and since the querist has stated and treated them as under development stage, it has been presumed that the Company has correctly determined the classification of the assets/wells acquired as development assets. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various legal enactments, such as, Income-tax Act, 1961 or Rules made thereunder.

The Committee notes from the Facts of the Case that the ‘mineral rights’ acquired by the Company are treated as an intangible asset under development. The Committee also notes from the facts that for income tax purposes, the ‘mineral rights’ have been considered as a separate completed asset in itself, which has already been put to use and depreciation is being claimed on the same. However, the Committee has not examined or opined as to whether the treatment accorded is appropriate or not from the income-tax perspective.

26. The Committee notes that the acquisition of 10% Participating Interest (PI) in an overseas E&P project (Project X) including the acquisition cost of ‘mineral rights’ (which was capitalised as ‘intangible asset under development’) had been financed by way of external borrowings. Since the said oil and gas Project X was under development, the directly associated borrowing costs were capitalised to the qualifying assets of the Project X including the acquisition cost in line with the Accounting Standard (AS) 16 (Borrowing Costs).

Subsequently, the Company transferred its 10% PI in respect of Project X to its wholly owned Indian subsidiary company ‘Y’ and acquisition cost was capitalised as ‘intangible asset under development’ in the books of the subsidiary company. The subsidiary company continued with the same accounting treatment in its financial statements in respect of the acquisition cost as was being done by the parent company before such transfer. Accordingly, the subsidiary company capitalised the acquisition cost as ‘intangible assets under development’ along with the related borrowing cost incurred on the loan from parent company since the oil and gas asset was under development.

27. With regard to the capitalisation and classification of acquisition cost in the books of subsidiary company, the Committee notes the following paragraphs of Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable), issued by the ICAI:

#### **“Classification of Activities and Related Costs**

##### **Acquisition Activities**

7. Activities carried out by an E&P entity towards the acquisition of right(s) to explore, develop and produce oil and gas, constitute acquisition activities. Once the areas of oil and gas finds are identified, the E&P entity approaches the owner who owns the rights for the exploration, development and production of the underground minerals in respect of the property or area. In order to undertake surveys and exploration activities, an E&P entity has to first obtain a Petroleum Exploration License (PEL) or Letter of Authority (LOA) in India or similar permit elsewhere, by whatever name called. For engaging in development and production activities, an entity has to obtain a Mining Lease (ML) in India. Similarly, other countries may require specific permissions/lease/license for the purpose. The rights for exploration, development or production may also be acquired by entering into a farm-in arrangement (transfer of part of oil & gas interest between parties).

##### **Acquisition Costs**

8. Acquisition costs cover all costs incurred to purchase, lease or otherwise acquire a property or mineral right proved or unproved. These include lease/signature bonus, brokers’ fees, legal costs, cost of temporary occupation of the land including crop compensation paid to farmers, consideration for farm-in arrangements and all other directly attributable costs which are incurred in acquiring these rights. These are costs

incurred in acquiring the right to explore, drill and produce oil and gas including the initial costs incurred for obtaining the PEL/LOA and ML. Annual licence fees are excluded. In case the acquisition cost pertains to more than one field, it should be apportioned to the related field on a fair and reasonable basis.”

### **“Accounting for “Acquisition”, “Exploration And Evaluation” and “Development Costs”**

18. An entity should capitalise acquisition costs as an intangible asset or tangible asset, based on its nature. For example, acquisition cost incurred to obtain right to explore should be capitalised as intangible asset being in the nature of commercial right.”

“22. When a well is ready to commence commercial production, the capitalised costs referred to in above paragraphs corresponding to proved developed oil and gas reserves should be reclassified as ‘completed wells/producing wells’ from “capital work-in-progress/intangible asset under development” to the gross block of assets. With respect to acquisition costs, the entire cost should be capitalised from “capital work-in-progress/intangible asset under development” to the gross block of assets. Normally, a well is ready to commence commercial production on establishment of proved developed oil and gas reserves.”

“53. The carrying amounts of tangible and intangible oil and gas assets should be classified separately as tangible and intangible non-current assets, capital work-in-progress and intangible assets under development, as the case may be.

54. For the purpose of paragraph 53 above, oil and gas assets should be classified as tangible and intangible, based on the nature of the asset. Determining whether the nature of oil and gas assets is tangible or intangible, should reflect whether the cost is incurred towards creation of a physical (tangible) asset that will itself be used or intangible knowledge. For example, a producing well which is used to extract reserves is classified as a tangible non-current asset. However, an exploratory well may only provide knowledge, and accordingly, is classified as intangible asset under development.”

From the above, the Committee notes that acquisition cost covers all costs incurred to purchase, lease or otherwise acquire a property or mineral right proved or unproved. It also states that acquisition cost should be capitalised as an intangible asset or tangible asset based on its nature. In the extant case, apart from various tangible and intangible assets acquired by the Company as a result of acquisition of PI, part of the acquisition cost for PI represents expenditure incurred for acquiring the ‘mineral rights’ and the same is in the nature of ‘Intangible assets’. Since as per the requirements of the Guidance Note (paragraph 22), till the well is ready to commence production, acquisition cost of intangible assets is to be classified as intangible asset under development, the treatment made by the Company to account for and classify the mineral rights as ‘intangible asset under development’ appears to be appropriate.

Furthermore, since at the time of acquisition of the mineral rights as part of Project X by the subsidiary, the Project was still under development stage, recognition of the mineral rights as ‘intangible asset under development’ by the subsidiary company also appears to be appropriate.

28. With regard to the accounting for borrowing costs incurred in respect of acquisition of such rights, the Committee notes that as per paragraph 36 of the Guidance Note on Oil and Gas Producing Activities (for entities to whom Ind AS is applicable), capitalisation of

borrowing costs should be in accordance with Ind AS 23, 'Borrowing Costs'. Therefore, the Committee notes the following paragraphs of Ind AS 23:

**“8 An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.”**

**“A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.”**

From the above, the Committee notes that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset can only be capitalised, and a qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. Further, paragraphs 22, 24 and 25 of Ind AS 23 provide as follows:

**“22 An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.”**

**“24 When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.**

25 A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.”

From the above, the Committee notes that borrowing costs should cease to be capitalised when substantially all the activities necessary to prepare the qualifying asset for *its intended use* are complete. Therefore, in the extant case, borrowing costs directly attributable to acquisition of mineral rights should be ceased to be capitalised when the mineral rights can be considered to be ready for intended use. Thus, the Committee is of the view that to determine whether the borrowing cost directly attributable to mineral rights should be capitalised or should cease to be capitalised after acquisition thereof, the intended use of acquiring the same should be analysed. In this context, the Committee feels that the company/subsidiary company being engaged into E&P business, the intended use of acquisition of mineral rights appears to be extraction and production of minerals. Therefore, acquisition of mineral right in itself cannot be considered to prepare it to be ready for its intended use; rather it can only be ready for its intended use after the completion of development activities on other assets of Project X under construction or development. The Committee is of the view that applying paragraph 24 of Ind AS 23, an entity considers whether the mineral rights are capable of being used for their intended purpose while development/construction continues on other assets of the Project X. If mineral rights are not capable of being used for their intended purpose while development/construction continues on other assets of the Project X, the entity considers the entire project together in assessing when to cease capitalising borrowing costs. In the extant case, the Committee is of the view that the mineral rights would not be ready for

their intended use of extraction and production of minerals until substantially all the development activities on Project are complete.

Therefore, considering Project X under development as a qualifying asset and mineral rights as a part thereof, as per the requirements of Ind AS 23, borrowing costs should cease to capitalise, when all the development activities of the Project X are complete and the Company or subsidiary company is ready to produce minerals.

The Committee is of the view that this view is also consistent with the example in paragraph 25 of Ind AS 23 as in that example also, the entity does not cease capitalising borrowing costs on any part of the plant until the entire plant is complete.

Accordingly, in the extant case, borrowing costs directly attributable to mineral rights should be continued to be capitalised when the development activities of Project X are taking place.

#### **D. Opinion**

29. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 24 above:

- (i) (a) Subject to paragraph 25 above, capitalisation and classification of the acquisition cost of mineral rights as ‘intangible asset under development’ by subsidiary company appears to be appropriate, as discussed in paragraph 27 above.
- (b) Subject to paragraph 25 above, the subsidiary company can treat the acquisition cost of mineral rights as an under-development asset as discussed in paragraph 27 above. Further, the borrowing costs directly attributable to mineral rights should be continued to be capitalised when the development activities of Project X are taking place, as discussed in paragraph 28 above.
- (ii) Subject to paragraph 25 above, the subsidiary company is correctly treating the said acquisition cost (capitalised as intangible asset under development till the time it is capitalised with the gross block of underlying oil and gas assets) as qualifying asset within the meaning of Ind AS 23 for the purpose of capitalising the borrowing costs, as discussed in paragraph 28 above.