

Query No. 24

Subject: Accounting treatment of borrowing costs incurred by parent company in respect of borrowings made for acquisition of investments in subsidiary company.¹

A. Facts of the Case

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

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.

3. The querist has informed that during the financial year (F.Y.) 2013-14, the Company acquired 60% shares in an overseas company (subsidiary company X) which was having 10% participating interest (PI) in an overseas discovered oil and gas project under development (Project-A). Total purchase consideration for the acquisition of 60% shares was USD 1502.82 million. At the time of acquisition, net assets of the subsidiary company X, proportionate to the Company’s holdings, were USD 195.68 million and accordingly a goodwill of USD 1307.14 million (USD 1502.82 million – USD 195.68 million) was recognised in the consolidated financial statements of the Company. The purchase consideration for the acquisition was financed partly by market borrowings and partly by internal accruals. As noted above, at the time of acquisition of the shares in subsidiary company X, the subsidiary company was holding 10% PI in an oil and gas asset under development with assets under construction in the form of Capital Work in Progress (CWIP) of USD 69.37 million and Exploratory Wells in Progress (EWIP) of USD 173.80 million. The said in-progress oil and gas assets were under development as at 31.03.2021.

4. In the standalone financial statements of the Company, the acquisition of 60% shares in subsidiary company X was accounted as investment in the subsidiary company X. The Company also recognised liabilities in respect of the borrowings made from the market to finance the acquisition. The associated borrowing costs are charged off as expenditure in the standalone Statement of Profit and Loss for the respective financial years.

In the consolidated financial statements of the Company, the subsidiary company X is consolidated following the provisions of Ind AS 110, ‘Consolidated Financial Statements’, inter alia combining like items of assets, liabilities, equity, income, expenses and cash flows of the Company with those of its subsidiary company X. Hence, in the consolidated financial statements, the assets under construction (CWIP and EWIP) of the subsidiary company X are combined with like items as per line by line consolidation method. Similarly, the borrowings costs charged off as expense in the standalone financial statements are also combined with like items of expenditure and, therefore, are treated as expense in the consolidated financial statements as well.

¹ Opinion finalised by the Committee on 23.12.2021.

5. The querist has further informed that, during the course of supplementary audit of F.Y. 2020-21, Comptroller and Auditor and General (C&AG auditors) referred to Question 22 of Educational Material on Ind AS 110, Consolidated Financial Statements, issued by the erstwhile Ind AS Implementation Group of the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) which is reproduced below:

“Question 22

AB Limited obtains a term loan from PQR Bank. The loan has been raised by AB Limited specifically for the purpose of making a further equity investment in BC Limited, its wholly-owned subsidiary, which is in need of funds for construction of an asset. The said asset meets the definition of a qualifying asset under Ind AS 23, *Borrowing Costs* and is not excluded from the scope of Ind AS 23. Since, equity investment made by AB Limited using the proceeds of the borrowing does not qualify as a qualifying asset from its perspective; it expenses the associated borrowing costs in its stand-alone financial statements. On the other hand, since the proceeds of borrowing made by AB Limited have been provided by AB Limited to BC Limited as an equity investment and not as a loan, BC Limited does not have any associated borrowing costs from the perspective of its stand-alone financial statements.

How should AB Limited deal with the borrowing costs associated with the term loan in its consolidated financial statements?”

The response of the above question as provided in the Educational Material, after analysing the various provisions of Ind AS 23, ‘Borrowing Costs’, states that the interest payment on loan taken by the holding company for equity investment in its wholly owned subsidiary company and the funds obtained by the subsidiary company are utilised for construction of qualifying assets in subsidiary company. Therefore, holding company must capitalise the borrowing cost incurred in relation to the construction of the qualifying asset in its consolidated financial statements.

6. As per the querist, drawing an analogy from the above case study given in the Educational Material, C&AG auditors observed as follows:

“As per Education Material on Ind AS 110, it was clarified that interest payment on loan taken by the holding company for equity investment in its wholly owned subsidiary company and loan was for construction of an asset in subsidiary company. The said asset meets the definition of a qualifying asset under Ind AS 23 and therefore, from the perspective of the consolidated financial statements, the reporting entity (i.e. the group) has raised a loan from an external party and has used the proceeds of the loan to finance the construction of a qualifying asset. Hence, to the extent the borrowing costs associated with the loan are directly attributable to the construction of the qualifying asset, same should be included in the cost of the asset in the consolidated financial statements of holding company.”

On the basis of above observations, audit was of the opinion that though the Company is correct in charging off the borrowing costs relating to the borrowings made for acquisition of the shares in the subsidiary company X as expenditure in the standalone financial statements, however, in the consolidated financial statements, the Company should have capitalised such borrowing costs with the cost of related assets under construction of the subsidiary company.

7. The querist has stated that paragraph 8 of Ind AS 23, 'Borrowing Costs' states that 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. Paragraph 10 further states that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. In case of difficulty in identifying direct relationship between particular borrowings and a qualifying asset, paragraph 11 of Ind AS 23 states inter alia that such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and *the exercise of judgement is required*. (Emphasis supplied by the querist.)

8. In the opinion of the Company, the facts as mentioned in the Question No. 22 of Educational Material on Ind AS 110 as reproduced in paragraph 5 above are very much different from the Company's case. Therefore, the accounting treatment as suggested in the response of said question of Educational Material cannot be made straightaway applicable on the Company's case. Therefore, exercise of judgement, as required in paragraph 8 of Ind AS 23, is required for identifying direct relationship between particular borrowings and a qualifying asset.

9. In the question given in Educational Material, the subsidiary company is in need of funds for construction of a qualifying asset and the holding company borrows the funds from market and provides these funds to the subsidiary company through equity investment. Therefore, the subsidiary company actually obtains the funds borrowed by the holding company and utilises the same for creation of qualifying assets. However, in the Company's case, the Company acquired the shares of the subsidiary company X in a secondary transaction, i.e., the Company acquired the shares from the previous holder of shares by paying the purchase consideration to the said holder for which the borrowings were made from the market and, therefore, the subsidiary company did not receive any funds from the Company as a result of this acquisition. Moreover, the subsidiary company was already having assets under construction in its financial statements as at the date of acquisition and therefore, in the Company's case there is no direct association of the funds borrowed by the Company for financing the purchase consideration (paid to the previous investor from which the shares in subsidiary company were acquired) and the assets held by the subsidiary company as at the time of acquisition.

10. The querist has also highlighted that the main objective of the Company, in respect of the acquisition of subsidiary company X, was to obtain the mineral rights in the form of participating rights in view of the hydrocarbon reserves of the underlying project. It is demonstrated in the Company acquiring the investment in the subsidiary company X by paying a significant proportion (around 86%) of purchase consideration towards the goodwill. Thus, the purchase consideration paid by the Company for the acquisition of investment in subsidiary X and hence the borrowings made for such acquisition were aimed at the futuristic potential of the underlying project in terms of its hydrocarbon reserves. Therefore, the assets under construction (CWIP and EWIP) are acquired by the Company, not as a primary purpose of acquisition but as an incidental takeaway of the acquisition of the participatory mineral rights in the underlying project. Accordingly, the borrowings made for such acquisition and the associated borrowing costs are not directly associated with the in-progress qualifying

assets held by the subsidiary company X at the time of acquisition. Association of the borrowing costs with these assets, if any, is only indirect, remote and secondary.

11. Without prejudice to the above, the querist has also stressed that paragraph B86 of Ind AS 110, 'Consolidated Financial Statements', in respect of accounting requirements of consolidation procedures provides as follows:

“B86 Consolidated financial statements:

- (a) *combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.*
- (b) offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (Ind AS 103 explains how to account for any related goodwill).
- (c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). ...”

(Emphasis supplied by the querist.)

Since the Company (being a parent company) recognises the borrowing costs in respect of the borrowings made for acquisition of subsidiary company X as expenses in its separate statement of profit and loss, the same, not being an intragroup transaction, is required to be consolidated on line by line basis as per paragraph B86 of Ind AS 110 as mentioned above. If the said borrowing costs are not combined as expenditure in consolidated financials on line by line basis and is instead capitalised therein, it may not be in alignment with the requirements of paragraph B86 of Ind AS 110. Similar will be the case with in-progress assets which will have a different carrying value in the separate financial statements of the Company from carrying value in consolidated financial statements as a result of the capitalisation of borrowing costs while consolidation. Therefore, the suggested accounting treatment that the borrowing costs should be treated as expenditure in separate financial statements, but in consolidated financial statements, the same should be capitalised, is not in accordance with the consolidation accounting procedure as given in Ind AS 110.

12. Moreover, it may also be highlighted that the opinion of the Expert Advisory Committee (EAC) was also obtained by the Company in respect of the same arrangement earlier in February, 2015 (which was published as Query No. 42 of Volume 34 of the Compendium of Opinions). In paragraph 8 of the EAC opinion, the query asked by the Company is that whether the following suggested accounting treatment (as provided in paragraph 7 of the EAC opinion) is appropriate or not in the light of Accounting Standard (AS) 16, 'Borrowing Costs':

“In the standalone books, the borrowing cost related to acquisition of PI through the subsidiary company would be charged off to the statement of profit and loss. However, in the consolidated financial statement of the company, the borrowing cost incurred by the company relating to acquisition of PI through the subsidiary company will be capitalised to the respective eligible assets by necessary adjustment to the statement of profit and loss.”

While responding to the above query after duly analysing the applicable provisions, EAC responded in the opinion that:

“No, the suggested accounting treatment of capitalising the borrowing cost related to acquiring PI in the oil and gas project through the overseas subsidiary company to the respective eligible assets held by the subsidiary company in the underlying oil and gas project in the consolidated financial statements as per paragraph 7 of the EAC opinion is not appropriate.” (Emphasis supplied by the querist.)

The querist has also pointed out that the provisions of Ind AS 23 and AS 16 are similar in respect of the capitalisation of borrowing costs directly associated with the qualifying assets. Therefore, in the opinion of the Company, EAC opinion as obtained previously on the issue should still hold good.

13. In the light of foregoing, the Company is of the view that considering the specific facts of the extant case, the Company has correctly not capitalised the borrowing costs associated with the acquisition of investment in subsidiary company X in the consolidated financial statements.

B. Query

14. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether in the light of provisions of Ind AS 23 and Ind AS 110, the facts of the Company's case, Educational Material on Ind AS 110 and the previous EAC opinion on the same issue, the Company is correct in not capitalising the borrowing costs associated with the borrowings made for acquisition of shares in subsidiary X with the costs of in-progress assets held by the subsidiary company and charging off the same as expenditure in the separate as well as consolidated financial statements.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to accounting treatment of borrowing costs incurred by the Company in respect of borrowings made for acquisition of investments in subsidiary company in a secondary transaction in its separate and consolidated financial statements. 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 acquisition of investment in subsidiary company, accounting treatment in the separate financial statements of subsidiary company, determination of functional currency of the Company, etc. Further, the accounting Standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time.

At the outset, with regard to the earlier opinion issued to the querist on similar subject (as referred by the querist), the Committee wishes to point out that the earlier opinion was issued in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006² whereas the current opinion has been sought from the perspective of Indian Accounting Standards. Since the frameworks governing the two sets of Standards are different, the Committee's opinion under Accounting Standards framework may not necessarily apply under Indian Accounting Standards framework. Therefore, the earlier opinion has not been examined by the Committee.

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

16. With regard to the issue raised, the Committee notes the following paragraphs of Ind AS 23 ‘Borrowing Costs’;

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

“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.”

“Borrowing costs eligible for capitalisation

10 The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

11 It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgment is required.”

“17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.”

From the above, the Committee notes that 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, paragraph 11 of Ind AS 23 also acknowledges the fact that there should be a direct relationship between particular borrowings and a qualifying asset. In other words, the borrowings should have been directly used/utilised for acquisition/construction/production of a qualifying asset.

17. The Committee notes from the Facts of the Case that the Company acquired 60% shares in an overseas company (subsidiary company X) *which was having 10% participating*

interest (PI) in an overseas oil and gas project under development (Project-A). Total purchase consideration for the acquisition of 60% shares was financed partly by market borrowings and partly by internal accruals. Further, these shares were acquired from a third party.

From the perspective of separate financial statements of the Company, the Committee notes that funds paid by the Company were not directly used for acquisition of oil and gas project under development; rather these were used for acquisition of shares which cannot be considered as a qualifying asset (as these do not take a substantial period of time to get ready for their intended use or sale). Accordingly, borrowing costs incurred on acquisition of shares in subsidiary X cannot be capitalised in the separate financial statements of the company. Further, since from the perspective of separate financial statements, the asset capitalised is investment in shares of subsidiary and not the oil and gas project, the question of capitalisation of borrowing costs with the oil and gas project/asset under development does not arise in the separate financial statements of the Company.

With regard to the consolidated financial statements, the Committee notes that at the time of acquisition of shares in subsidiary company, subsidiary company was already holding 10 percent PI in an oil and gas asset under development with asset under construction (Project A). Since in the extant case, the Company has acquired the shares of the subsidiary company X in a secondary transaction, the subsidiary company did not receive any funds from the Company as a result of this acquisition. Thus, even from the Group perspective, the funds paid by the Company for acquisition of shares in subsidiary X were not directly used to acquire participating interest in oil and gas project (Project A) under development or for development activities on the project A. Therefore, the Committee is of the view that in the extant case, the borrowed funds cannot be considered to have been utilised for the acquisition/construction/development of a qualifying asset and there is no direct relationship between the borrowings made by the reporting entity (viz., the Group) and the expenditure incurred on acquisition/construction/development of the qualifying asset. Accordingly, the borrowing costs incurred on borrowings taken for acquiring investment in subsidiary company cannot be capitalised even in the consolidated financial statements.

D. Opinion

18. On the basis of the above, the Committee is of the opinion that the borrowing costs incurred on acquisition of shares of subsidiary company in a secondary transaction cannot be capitalised either in the separate financial statements or in the consolidated financial statements of the Company, as discussed in paragraph 17 above.