

Query No. 25

Subject: Capitalisation of insurance premium in construction projects.¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’) is a central public sector enterprise incorporated with an objective to plan, promote and organise an integrated and efficient development of hydroelectric power. The Company has extended its objective to include development of power in all aspects through conventional and non-conventional sources in India and abroad. The Company’s shares are listed in BSE and NSE. The Company has adopted Indian Accounting Standards (Ind ASs) during the 1st Phase, i.e., from April 1, 2016.

2. The Company constructs Hydropower Projects and operates them on Build, Own, Operate & Maintain (BOOM) basis. Hydro power projects are capital-intensive and are funded with a mix of equity and debt, usually in the ratio of 30:70. Debt is usually long-term of 10-12 years and is sourced through corporate bonds, borrowings from domestic financial institutions and foreign borrowings. Equity is sourced through Initial Public Offer (IPO)/Follow-on Public Offer (FPO) and internal accruals.

3. The querist has stated that execution of the project is done through contractors. One of the methods of award of contract is the turnkey mode of award, where the contractor assumes responsibility for design, supervision as well as construction. Another mode of award is the package mode of award, where separate contractors are engaged for construction of different components of the project, e.g., dam, power house civil works, electromechanical, hydro mechanical works, etc., while design and supervision generally rest with the owner.

4. Electricity being a regulated product, tariff for each power station is determined by the Central Electricity Regulatory Commission (CERC) based on the CERC Tariff Regulations issued for a period of five years at a time. The currently applicable tariff period is 2019-20 to 2024-25, i.e., 2019-24. Tariff is fixed by the CERC based on the capital cost incurred for the power station. Tariff regulations provide for recovery of costs incurred on running and maintenance of the power station, depreciation of property, plant and equipment (PPE), interest on loans and borrowings for construction of the plant and interest on working capital, plus a specified rate of return on equity invested in the plant.

Insurance cover for hydro projects during construction

5. Construction of hydro-power projects is carried out in remote mountainous terrain and during the construction phase, the project assets, namely dam, power house, water conductor systems etc. are susceptible to natural disasters like floods, earthquakes, landslides and non-natural events like terrorism, etc.

6. The querist has stated that to mitigate such loss of property and lives, insurance cover by way of Engineering All Risk (EAR) and Contractors All Risk (CAR) insurance policies are obtained during the construction stage. These policies are obtained in the joint names of the owner (the Company) as well as the contractor and indemnify for the loss of assets under construction due to natural disasters as well as provide cover for terrorism loss. (A copy each

¹ Opinion finalised by the Committee on 23.12.2021.

of sample CAR and EAR policies has been separately supplied by the querist for the perusal of the Committee).

7. The querist has further stated that as per contract conditions, it is the responsibility of the contractor to obtain the EAR/CAR Policy. Accordingly, the cost of obtaining such policy is inbuilt by the contractor in the bid-price for the work. In case the contractor is unable to obtain such policy, the same is obtained by the Company and premium so paid is recovered from the on-account payments made to the Contractor. The premium paid for the CAR/EAR policies is not separately identifiable since it forms part of the bid price and is thus automatically capitalised and forms part of capital cost. Where payment of premium is made by the Company, the same is first booked to 'Amount Recoverable' and thereafter capitalised in the project component (dam/power house, etc.) while releasing payment to contractor for work done for which the policy has been obtained.

8. The quantum for which cover is obtained is the value of works awarded to the contractor, which may increase in future due to increase in value of works executed, mainly on account of price-escalation, change in quantum of works due to changes in design or as per actual site conditions, increase in completion period, etc. On the happening of a loss-event, indemnification is made by the Insurance company on replacement cost, i.e., once the loss is restored.

9. Other than CAR/EAR Policy, other insurance policies obtained are for insurance of construction equipment, vehicles and other miscellaneous assets. In the case of miscellaneous assets, generally an umbrella policy is obtained, which provides cover for perils like theft, fire and other general perils. The premium so paid is capitalised under 'Expenditure Attributable to Construction' and thereafter, allocated over the major project components on completion of the project and start of commercial production.

Audit observation by the office of the C&AG and reply thereto

10. During supplementary audit of the financial statements of the Company for the financial year (F.Y.) 2020-21, the office of the Comptroller and Auditor General (C&AG) had raised two audit queries regarding capitalisation of insurance premium paid by the Company for obtaining CAR/EAR policy on behalf of the contractor for one of the project components. The C&AG has based its observation on a recent opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of the India (ICAI) wherein the EAC has opined as under:

"... an insurance policy is normally taken to protect/safeguard against the loss that may arise in unforeseen future and may not be ordinarily essential for or will contribute to construction activity as such. Therefore, it cannot be considered as directly attributable to construction/acquisition of the project. In the extant case also, the Committee notes that the marine-cum-insurance policy has been taken to ensure that all the possible risks from supply/installation of goods/equipment till their complete erection are covered. Accordingly, considering the facts provided by the querist and considering the nature of directly attributable costs as per paragraphs 16 and 17 of Ind AS 16 reproduced above, the Committee is of the view that in the extant case, the expenses on account of project insurance cannot be considered as directly attributable costs and should accordingly be recognised in the statement of profit and loss."

(Emphasis supplied by the querist.)

11. Based on the above opinion, the office of the C&AG has stated in its audit queries that premium paid for obtaining CAR/EAR policy is of revenue nature and accordingly, should not be capitalised.

12. The synopsis of reply by the management to the C&AG on the above-mentioned observations is as under:

Hydroelectric projects are subject to various risks during construction phase, which include geological risks due to earthquakes, landslides, floods, etc. Further, in the case of vehicles and construction equipment, obtaining insurance policy is an essential precondition for operating the asset.

Further to the above, it is submitted that paragraph 9 of Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' provides as under:

“This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity’s specific circumstances...”

Paragraph 16 of Ind AS 16 provides as under:

“The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) ...”

The basic principle to be applied while capitalising an item of cost to an item of PPE is that it should be directly attributable to the construction of the asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of a fixed asset for bringing it to its working condition are those costs that would have been avoided if the construction had not been made. These are the expenditures without the incurrence of which, the construction of project could not have taken place and the asset could not be brought to its working condition.

The principle of avoidance as the basis of identifying directly attributable cost for the purpose of capitalisation is provided in Ind AS 16 and Ind AS 23, 'Borrowing Costs'.

Paragraph 22 of Ind AS 16, *inter alia* provides that “Ind AS 23, *Borrowing Costs*, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.”

Paragraph 10 of Ind AS 23 provides 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. ...”

The querist has also stated that in multiple earlier opinions of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) (Opinion

dated 22.01.2010, published as Query No. 34 of Volume XXIX of the Compendium of Opinions, Opinion dated 11.05.2010 published as Query No. 8 of Volume XXX of the Compendium of Opinions, etc.) the EAC had opined that “The costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are those costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by Accounting Standard (AS) 16, ‘Borrowing Costs’.”

Further, another opinion of the EAC of the ICAI dated 20.01.2003 (published as Query No. 20 of Volume XXII of the Compendium of Opinions) states as under:

“Costs that may be attributable to construction projects in general and can be allocated to specific projects include:

- (a) insurance;
- (b) ...”

The querist has further referred to paragraph 17 of Ind AS 16 which provides as under:

“Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- (f) professional fees.”

It is pertinent to mention that paragraph 17 of Ind AS 16 gives merely examples of attributable expenses and not an exhaustive list.

Accordingly, it was submitted to the C&AG that capitalisation of expenditure on insurance is appropriate being directly attributable to the construction of the project for bringing it to the location and condition required by the management of the Company.

13. Based on the reply submitted on the above lines, it was agreed that a query shall be referred to the EAC of the ICAI for its opinion during F.Y. 2021-22.

Further points for consideration of the Expert Advisory Committee:

14. Paragraph 7 of Ind AS 16 provides that **“The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:**

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably.”

The Company operates in a regulated industry where capital cost of the project on completion forms the basis of tariff fixation. Since CERC allows insurance expenditure incurred during construction period as a part of capital cost for tariff fixation, future economic benefits on the above-mentioned expenditure shall flow to the Company on start of commercial operation.

15. Before start of active construction of a hydro power project, certain approvals from various Government Ministries and agencies are required to be obtained, including from the Ministry of Environment, Forest & Climate Change, Central Electricity Authority, Central Water Commission, Project Investment Board, etc. with the final investment approval being that of the Cabinet Committee on Economic Affairs (CCEA). Insurance premium on CAR Policy is allowed as a part of sanctioned cost by the CCEA as may be seen from the CCEA Sanction letters of Teesta Stage-VI and Rangit Stage-IV Projects currently under construction by the Company.

16. The ‘Guidelines for Preparation of Project Estimates for River Valley Projects’ issued by the Central Water Commission (CWC) is the basis of framing the cost estimate of any hydro power project. The said Guidelines provide for inclusion of insurance premium paid for transportation of equipment/project components as well as Construction Insurance in Project cost.

17. The logic that an item of expenditure incurred to protect/safeguard against the loss that may arise in unforeseen future and may not be ordinarily essential for or will contribute to construction activity as such should not be capitalised, may not hold true. Hydro power projects typically involve thousands of crores of rupees and many activities are undertaken which are intended to protect against loss of life and/or the constructed structures. Examples include deployment of security at site, deployment of fire tenders, etc. all of which are intended to guard against an undesirable event that may or may not occur. Providing of gumboots and helmets to construction workers intended to prevent loss of life in the case of an accident, construction of a retaining wall at the onset of monsoons to prevent flooding of site, are again events that may or may not occur. Accordingly, the basic test of whether insurance premium (whether on account of CAR/EAR Policy, transportation, umbrella policy or vehicle insurance) should be capitalised or not should be based on the principle of avoidance of costs as also deliberated by the EAC in its earlier opinions (stated at paragraph 12 above).

18. The impact of natural disasters can be seen in the recent case of Tapovan Vishnugadh Project in Uttarakhand where an unprecedented surge of water led to massive destruction of project components as well as loss of many lives. Accordingly, in the case of hydro power projects, obtaining insurance cover for project assets is not a matter of abundant precaution, but rather an absolute necessity, besides being a legal necessity in some cases as well e.g., in the case of vehicles, construction equipment etc. Further, obtaining of CAR/EAR Policy for

hydro-projects under construction is a universal practice, being followed by all hydro power companies.

19. Further to the above, insurance coverage of projects under construction is a pre-condition for obtaining project-based funding. In this connection, a standard condition forming part of the loan agreement of a World Bank funded hydro-power project is quoted hereunder:

“The Borrower and the Project Implementing Entity shall make adequate provision for the insurance of any goods required for their Respective Parts of the Project and to be financed out of the proceeds of the loan, against hazards incident to the acquisition, transportation and delivery of the goods to the place of their use or installation. Any indemnity for such insurance shall be payable in a freely usable Currency to replace or repair such goods.”

In case such coverage is not obtained, either project-based funding would not be available from banks/financial institutions, or else be available at a higher rate than that would be the case for an insured project, which would result in a significant increase in project cost.

Not obtaining insurance coverage for high value hydro-power projects shall also have an adverse impact on the credit-rating of the Company which shall consequently have an adverse effect on the rate at which the Company is able to access finance for project construction.

B. Query

20. In view of the above submissions, the querist has sought the opinion of the Expert Advisory Committee as to whether the premium paid for insurance coverage of assets under construction and other property, plant and equipment of a hydro-electric project under construction qualifies for capitalisation.

C. Points considered by the Committee

21. The Committee notes that the basic issue raised in the query relates to the accounting treatment of insurance premium paid for insurance coverage of assets under construction and other property, plant and equipment of a hydro-electric project under construction under CAR and EAR insurance policies. 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 treatment of various elements involved in the determination of tariff by CERC, accounting for expenditure incurred on deployment of security at site, deployment of fire tenders, providing of gumboots and helmets to construction workers, construction of a retaining wall at the onset of monsoons to prevent flooding of site, etc., accounting for premium paid on insurance policies other than CAR and EAR etc. Further, the opinion, expressed hereinafter, is purely from accounting perspective and not from the legal perspective, such as, interpretation of CERC Tariff Regulations, CWC Guidelines for preparation of project estimates for river valley projects, insurance policies, various approvals/communications 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.

22. The Committee notes the following paragraphs of Ind AS 16, ‘Property, Plant and Equipment’, notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as the ‘Rules’), which state as follows:

“16 The cost of an item of property, plant and equipment comprises:

...

- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

...

17 Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)²; and
- (f) professional fees.”

From the above, the Committee notes that the expenses that are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management should only be capitalised. The Committee also notes from the examples of directly attributable costs as given in paragraph 17 of Ind AS 16 that these include only such items/expenditure which arise directly from the construction or acquisition of the item of property, plant and equipment or which are directly related to construction activities. In other words, had these expenses not been incurred, construction activity would not have proceeded/completed and the item of PPE could not be brought to the location and condition necessary for it to be capable of operating in the manner intended by management.

The Committee is of the view that whether an expenditure is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management requires an exercise of judgement and the Company has to determine as to whether the expenditure has been incurred for bringing the item of PPE in the operating condition and location as envisaged by the above-reproduced requirements of Ind AS 16. The Committee is further of the view that insurance expenses may form part of the cost of the PPE only if these are of the nature of directly attributable expenses, i.e., without which the item of PPE cannot be brought to the location and condition necessary for it to be capable of operating in the manner intended by management.

² This paragraph has been subsequently revised through Companies (Indian Accounting Standards) Amendment Rules, 2022, notified vide Notification No. G.S.R 255(E) dated 23rd March, 2022 which came into force with effect from April 1, 2022.

The Committee notes that in the extant case, to mitigate the loss of property and lives due to any natural disaster like floods, earthquake, landslides and non-natural events like terrorism, during the construction stage, the Company has obtained insurance cover by way of EAR and CAR insurance policies. The Committee further notes that as per contract conditions with contractor, it is the responsibility of the contractor to obtain the EAR/CAR policy. Accordingly, the cost of obtaining such policy is inbuilt by the contractor in the bid-price for the work. In case the contractor is unable to obtain such policy, the same is obtained by the Company and premium so paid is recovered from the on-account payments made to the Contractor.

However, the Committee also notes that these policies are obtained in the joint names of the Company as well as the contractor and both the parties are joint insured as per the policies. Therefore, the Committee is of the view that it cannot be considered that either of the party took the policy on behalf of other irrespective of payment of premium mechanism by either of the parties or recovery of premium against each other. The Committee is of the view that accounting for an item of expenditure depends on its nature, viz., whether it is directly attributable to acquisition or creation of an asset or not (as discussed above); rather than how the expenditure is incurred, viz., through contractor or directly.

As regards the nature of insurance expenses in the extant case, the Committee notes from the facts of the case that the insurance premium has been included as a part of the approved or allowable expenditure under various approvals (including that from CCEA and CWC); and is an inbuilt element of the project cost and not an optional expenditure. From this, it appears that in the extant case, the incurrance of insurance expense is essential or a pre-condition for obtaining such approvals, without which construction activity cannot be commenced and the project/concerned asset(s) cannot be brought to the location and condition necessary for it to be capable of operating in the manner intended by management, as discussed above.

Accordingly, the Committee is of the view that in the extant case, the insurance expenses can be considered as directly attributable expenditure to bringing the project/asset(s) to the location and condition necessary for it/them to be capable of operating in the manner intended by the management and therefore, can be capitalised with the cost of an item of PPE.

D. Opinion

23. On the basis of the above, the Committee is of the opinion that that in the extant case, the insurance expenses can be capitalised with the cost of an item of PPE, as discussed in paragraph 22 above.
