

Query No. 7

Subject: *Capitalisation of borrowing cost during lockdown period.*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. 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.

3. Tariff is fixed by the CERC based on the Capital Cost incurred for the Power Station. Tariff Regulations provides for recovery of costs incurred on running & maintenance of the Power Station, depreciation of Property, Plant & Equipment, interest on loans & borrowings for construction of the Plant and interest on working capital, plus a specified rate of return on equity invested in the Plant.

4. *Half-Margin raised by the office of the C&AG:*

During supplementary audit of accounts for the financial year (F.Y.) 2019-20, the office of the C&AG had raised an issue regarding capitalisation of borrowing cost during lockdown period due to Covid-19 at one of its under-construction power projects. The half-margin (HM) raised in this regard is quoted hereunder:

Profit & Loss Account for the year 2019-20

Note No.27 Finance Cost

Transferred to expenditure attributable to construction Rs.661.79 crore

(A) As per Ind AS 23, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. Other borrowing costs are recognised in profit or loss (P/L) as incurred. Further, Paragraph 20 of the above Ind AS stipulates that an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

¹ Opinion finalised by the Committee on 6.5.2021.

Due to outbreak of Covid-19 pandemic, Ministry of Home Affairs vide order dated 24th March 2020 imposed nationwide lockdown for a period of 21 days to prevent the spread of Covid-19 in India and subsequently vide order dated 15th April 2020 and 1st May 2020 extended the lockdown period across the country till 3rd May 2020 and 17th May 2020 respectively. All the construction activities were on hold during this lockdown period and no work was allowed at construction sites.

During the review of records, it was noticed that two projects of the Company, i.e., Parbati-II HEP and Subansiri Lower HEP are under construction and borrowing costs of Rs. 411.76 crore for Parbati-II HEP and Rs. 227.96 crore (October 2019 to March 2020) for Subansiri Lower HEP respectively were capitalised for the financial year 2019-20 upto 31 March 2020. As the construction work was completely halt at these projects during the lockdown period as per the orders issued by the Govt. of India, therefore, the borrowing cost of Rs. 16.61 crore capitalised for the period from 25 March 2020 to 31 March 2020 should have been transferred to rate regulated assets account. This has resulted in overstatement of Capitalisation of borrowing cost and understatement of rate regulated assets account to the tune of Rs.16.61 crore.

- (B) Similarly, Corporate Office/Regional Office expenses attributable to construction capitalized for the period from 25 March 2020 to 31 March 2020 in respect of above under construction projects should also be transferred to rate regulated assets account.

Facts and figures may please be confirmed and reply to HM be furnished to Audit within three days.

5. Reply of the Company's Management to the half-margin is reproduced hereunder:
Reply to points (A) & (B) are as under:

Relevant extracts from Ind AS 23- Borrowing Costs are quoted below:

Para 20: An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

Para 21: An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work.

Hydroelectric projects are long gestation projects which typically take between 5-10 years to complete. Since these projects involve use of diverse resources like manpower, material, construction equipment, etc., project construction activities may be stalled from time to time due to various factors, like labour unrest, geological surprises, strikes, natural calamities, etc. The determining factors as to whether capitalisation of borrowing cost should be suspended are whether:

- a) Active development of the qualifying asset has been suspended at the instance of the entity,
- b) Whether the period of suspension is an extended one, and
- c) Whether technical and administrative work were also suspended during the period of suspension of active development of the qualifying asset.

In the current situation, the temporary suspension of active development was due to an order by the Government of India and not at the instance of the Company. Further, the period of suspension as applicable to F.Y. 2019-20 is for a period of 8 days only, which is neither an extended period, nor material in the context of a hydroelectric project. As far as technical and administrative work is concerned, the Company had implemented work from home during the lockdown period including systems like e-office and access to ERP through secure VPN. Further, these Projects are located in remote areas where technical and administrative staff including Head of Project reside at project townships. Accordingly, there was no cessation of technical and administrative work at the Projects during the lockdown period.

Further to the above, the following works were being executed at Subansiri Lower Project throughout the lockdown period:

- a) Emergency works of Power House, HRT/ST, Stores and dewatering works at different work sites were being executed throughout the lockdown period.
- b) Completion works of Bailey Bridge providing access & connection to the work site at Right Bank were being executed.
- c) In addition to above, all associate services of Finance/HR/IT services/Medical services linked to construction activity were working round the clock.
- d) All preparatory and office works/documents works- directly related to construction works as well as award of contract for LOT SSL-6 were being carried out.

In view of above, it is submitted that borrowing cost and Corporate Office/Regional Office expenses attributable to construction qualify for capitalisation during the lockdown period from 25th March to 31st March, 2020.

In view of above, the HM may please be dropped.

6. The above reply was considered, but the HM was not dropped. Subsequently, management had to give an assurance that borrowing cost capitalised as CWIP during the period of lockdown during F.Y. 2019-20 shall be recognised as Regulatory Deferral Accounts (Debit) balances during the F.Y. 2020-21.

7. *Further representation to the office of the C&AG:*

The matter was further reviewed during F.Y. 2020-21 and a representation was made to the C&AG to review their stand on the matter. The same is quoted as under:

View taken by the C&AG is based upon FAQ No. 39 of the 'ICAI Covid-19 FAQs on Ind AS' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India which provides as under:

FAQ 39

An entity is in the process of development of power generation facility which is expected to take three years for the facility to get ready for its intended use. In order to fund this huge expenditure, the entity has borrowed substantial amount of money and has been capitalising the borrowing costs as per Ind AS 23, Borrowing Costs. *In view of the reduced demands for its products over next one year and also the lockdown of its manufacturing units due to onset of global pandemic recently, the entity has suspended the active work on the development of this power generation facility since one month before the end of the current financial year. The entity has decided to keep this project in abeyance for another six months, however, it continues to incur the borrowing costs. In view of the fact that the suspension of active development of the power generation facility is caused by Act of God and Nature, can the entity continue to capitalise the borrowing costs that it continues to incur?*

Answer

Borrowing costs that are attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of that asset. All other borrowing costs should be expensed in the period incurred. Ind AS 23, Borrowing Costs, has specific requirements as to qualifying assets, borrowing costs eligible for capitalisation and their method of computation and commencement, suspension and cessation of capitalisation.

Paragraphs 20 and 21 deal with the suspension of capitalisation. In particular, paragraph 20 states that an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends the active development of the qualifying asset. Considering the entity's decision to suspend the active development of the qualifying asset for 7 months, it cannot continue to capitalise the borrowing costs during this extended period regardless of the fact that the situation is caused by factors beyond its control.

Paragraph 21 elaborates on certain situation of temporary suspension where the entities are not required to suspend the capitalisation of borrowing costs. For example, when a temporary delay is a necessary part of the process of preparing an asset for its intended use. The suspension of construction activity due to COVID-19 pandemic does not fall under this situation.

The facts in the FAQ are different from those of the Company in the following aspects:

- a) As per the FAQ, the project has been put on hold at the instance of the Company itself for a period of six months anticipating reduced demand. In the case of the Company, the stoppage of work was due to extraneous factors, namely lockdown declared by the Government of India.
- b) As per facts of the FAQ, stoppage is for a period of 6 months, apprehending reduced demand for the output. Original construction period was 3 years. Accordingly, period of stoppage is significant w.r.t. the anticipated completion time. In the case of the Company, stoppage is for a period of one month which is insignificant when compared to the construction period of hydro power projects, which generally take 6-7 years for completion. Further, considering the must-run status for Run-of-the-River (ROR) projects and scheduling to the extent possible by RLDCs in case of ROR with Pondage and Storage Projects, there is no impact

of the COVID-19 pandemic on the demand for power generated by the Company and neither does the Company anticipate any reduction in demand for power to be generated by its Projects currently under construction.

Accordingly, the facts of the FAQ do not match those prevailing in Subansiri Lower and Parbati-II Projects where physical construction was halted only during the initial lockdown period, i.e. 25th March 2020 till 24th April, 2020. As already stated in the reply to HM 17, there was no cessation in technical and administrative work at either of the projects during this period. In the case of Subansiri Lower Project, works including dewatering, completion works of Bailey Bridge, etc. were also being executed, as stated in the Management reply to the Half Margin.

It is thus apparent that in view of difference in the facts of the case, the opinion expressed by the ASB in FAQ 39 does not apply to the Company.

(Emphasis supplied by the querist.)

8. After considering the above representation, the Office of the C&AG has reiterated that the assurance given by the Company be ensured, i.e., Regulatory Deferral Account (Debit) Balance be created for borrowing cost for the lockdown period from 25th March 2020 till 24th April, 2020.

B. Query

9. Accordingly, the opinion of Expert Advisory Committee has been sought as to whether the borrowing cost incurred at the project during the lockdown period from 25th March, 2020 to 24th April, 2020 qualifies for capitalisation?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to whether the borrowing cost incurred at the project during the lockdown period from 25th March, 2020 to 24th April, 2020 qualifies for capitalisation. The Committee has therefore considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, creation of deferred regulatory balance in respect of the said borrowing cost, accounting treatment of other expenditure incurred during the said period of lockdown, considerations of materiality, etc. Further, this opinion is restricted to the financial reporting requirements under Ind AS and does not deal with the regulatory aspects of the CERC tariff regulations or any other related regulations. Furthermore, 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.

11. With regard to accounting for borrowing costs incurred during the lockdown period, the Committee notes the following paragraphs from Indian Accounting Standard (Ind AS) 23, 'Borrowing Costs':

“Suspension of capitalisation

20 An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

- 21 An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.”

From the above, the Committee notes that the Standard requires an entity to suspend capitalisation of borrowing costs during extended periods during which it suspends active development of a qualifying asset. The Standard does not indicate or define ‘extended period’ and therefore the application of the Standard requires judgment and the opinion could differ on a case to case basis based on facts.

12. The Committee notes that in the extant case, Government actions to fight the COVID-19 outbreak caused the physical development of the project to pause because project workers had to stay at home. One needs to apply judgement and consider both the length/expected length, the nature of the suspension and the period required to complete the construction of the project when evaluating whether an interruption caused by the COVID-19 outbreak is ‘temporary’ or may be considered as an ‘extended period’. In the extant case, the lockdown extends from 25th March to 17th May (i.e. not more than 2 months if events after the balance sheet date are considered).

The Committee is of the view that the suspension of construction activity may be considered ‘temporary’ and the company need not suspend capitalisation of interest considering the following:

- (a) The suspension was caused because of an external common event affecting the whole of India,
- (b) The event and therefore the suspension was not in control of the management,
- (c) As represented by the Company, the Projects are located in remote areas where technical and administrative staff including Head of Project reside at project townships. Accordingly, there was no cessation of technical and administrative work at the Projects during the lockdown period, and
- (d) The period of suspension may be considered a short duration especially when considered together with the time required to complete the project.

D. Opinion

13. On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 9 above that in the extant case, the suspension of construction activity may be considered ‘temporary’ and the company need not suspend capitalisation of interest, as discussed in paragraphs 11 and 12 above.
