

Query No. 22

Subject: Accounting treatment for upfront/advance payment made towards Hooking-Up Charges as a part for laying City Gas Distribution Network.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) limited by shares and domiciled in India, was incorporated on 23rd December 1998 under the erstwhile Companies Act, 1956. The Company is listed on the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE).

2. The Company is in the business of city gas distribution. As a part of its operations for laying down city gas distribution network, the Company enters into hooking up Agreements with Natural Gas Providers.

3. The querist has stated that for procurement of natural gas from various suppliers, the Company enters into several hooking up Agreements with transporters for hooking up of its various geographical areas with their trunk line for gas supply. The hooking up facilities (identified asset) were created by transporter upon receipt of upfront payment from shipper (i.e., the Company in the extant case). These facilities were created in accordance with operating requirements of shipper, like availability of facilities, volume, pressure, temperature etc. As mentioned above, design of asset in a way predetermines how and for what purpose the asset will be used throughout the period of use. Further, the transporter does not hold any substantive substitution right, as such assets were created for exclusive use of shipper which also possess right to control and direct use of identified asset. (A copy of Hooking-Up Agreement entered into by the Company has been supplied separately by the querist for the perusal of the Committee.)

Hooking-Up Agreement Terms

4. Under the Hooking-Up Agreement, the Company desired transporters to create necessary facilities at the hooking up point for measurement and pressure regulation of gas to be transported from transporter pipeline to shipper pipeline through hooking-up point. As per hooking-up Agreement, following modalities were decided:

- (i) Transporter will construct, install, test, calibrate and commission metering facility, gas monitoring equipment, pressure regulators, filters, telemetry and all hooking-up facilities in accordance with the requirement of operating conditions of the Company;
- (ii) Hooking-up facilities shall be designed to handle a defined maximum volume [Million Metric Standard Cubic Meter (MMSCM) of gas per day];
- (iii) Gas will be delivered by transporters at pressure (e.g. 26kg/cm² to 32kg/cm²) defined by shipper at hooking-up point;
- (iv) Gas temperature shall also be defined as per the Company’s requirement;
- (v) Transporter shall develop metering facilities as per the requirements of shipper (the Company) at a defined flow rate (Standard Cubic Meters Per Day (SCMD)) or lower as per the requirements of the Company and ramp-up the metering

¹ Opinion finalised by the Committee on 13.12.2022.

facility on shipper's (Company's) direction based on increased volume plan of the Company.

Foregoing modalities of the Agreement embodies the fact that the hooking-up facilities (identified asset) were created by the transporter upon receipt of upfront payment from the Company. These facilities were created in accordance with the operating requirements of shipper (the Company) like availability of facilities, volume, pressure, temperature etc. As mentioned above, design of asset in a way predetermines how and for what purpose the asset will be used throughout the period of use. Further, the transporter does not hold any substantive substitution right as, such assets were created for exclusive use of the Company, which also possesses right to control and direct use of identified asset.

Accounting treatment

5. The querist has stated that prior to introduction of Indian Accounting Standard (Ind AS) 116, 'Leases', the Company used to classify these hooking-up payments as 'Prepaid Expenses' under the heading of 'Other Non-Current Assets' and amortising the same in the Statement of Profit and Loss based on the life of the Agreement.

CAG Observation during accounts audit of Financial Year (F.Y.) 2019-20

6. During the Comptroller and Auditor General of India (CAG) audit for the financial year (F.Y.) 2019-20, the CAG opined that the aforesaid treatment of hooking-up payments under the heading of 'Other Non-Current Assets' is incorrect as the Company gets a right to use of the underlying assets, and accordingly, the Company should reflect the same under the heading 'Right to Use' assets in the Statement of Financial Position in accordance with Ind AS 116 'Leases'.

Change in accounting treatment from 01st April 2020

7. Based upon discussion with CAG auditors and statutory auditors of the Company for the F.Y. 2019-20, the Company agreed to reclassify the said prepayments prospectively from 01st April 2020. Accordingly, the carrying amount of hooking-up prepayments as was reflected under the heading 'Other Non-Current Assets' was reclassified to 'Right-To-Use Assets' in the Statement of Financial Position in accordance with Ind AS 116 'Leases'.

CAG Observation during audit of accounts for F.Y. 2020-21

8. During the audit of accounts for F.Y. 2020-21, another team of CAG opined that the change in accounting treatment done by the Company is incorrect as '*the Company only has a right to use the hooking-up facility as created by the transporter for it at its City Gas Station and not the actual asset with it in its physical form*'. Accordingly, they advised the Company to reclassify such prepayments as 'Intangible Assets' under Ind AS 38.

9. Due to difference in opinions raised by different CAG teams, the Company assured CAG that it will seek an opinion from the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for the appropriate accounting treatment of aforementioned payments towards hooking-up charges and till the time the matter is decided by the EAC, the Company will treat such items as 'Right-To-Use Assets' as per the provisions of Ind AS 116 'Leases'.

B. Query

10. On the basis of the above, opinion of the Expert Advisory Committee has been sought by the querist so as to determine the appropriate accounting treatment for classification of prepayments towards hooking-up facilities as to whether:

- (i) to account for such prepayments as 'Right To Use Asset' as per Ind AS 116 'Leases'; or
- (ii) to account for such prepayments as 'Intangible Asset' under Ind AS 38; or
- (iii) to account for such prepayments as 'Other Non-Current Asset'; or
- (iv) any other accounting treatment as the EAC may consider appropriate in the case.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to the classification of advance payment made towards hooking-up facilities for laying city gas distribution network. 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, detailed aspects of accounting for such advance payments, accounting for any other charges paid for laying city gas distribution network, determination of term of lease/right, measurement of any lease or right-to-use asset/obligation arising from the hooking-up Agreement, appropriateness of accounting as per previous GAAP and accounting treatment in earlier years before financial year 2020-21, accounting for any other asset(s) and cost incurred for creating facilities downstream of the hooking-up point, application of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', accounting in the books of transporter, accounting for operating charges to transporter, etc. Further, the Committee has expressed its opinion purely from the accounting perspective and not from the perspective of legal interpretation of hooking-up Agreement, gas supply Agreement etc. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

12. With regard to the classification of payments for hooking-up facilities, the first and foremost issue that needs to be examined is which standard should be considered and applied first. In this regard, the Committee notes that paragraph 9 of Ind AS 116, 'Leases', states, "At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. ...". From this, the Committee is of the view that the Company should first examine whether the contract in the extant case is or contains a lease as per the requirements of Ind AS 116. It is only when the contract in the extant case is not and does not contain a lease, the Company should consider the requirements of other Ind ASs including Ind AS 38, 'Intangible Assets'. In this regard, the Committee further notes that paragraphs 3 and 4 of Ind AS 116 provide the scope exceptions to the Standard as follows:

- "3 An entity shall apply this Standard to all leases, including leases of *right-of-use assets* in a *sublease*, except for:
- (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
 - (b) leases of biological assets within the scope of Ind AS 41, *Agriculture*, held by a lessee;

- (c) service concession arrangements within the scope of Appendix D, *Service Concession Arrangements*, of Ind AS 115, *Revenue from Contracts with Customer*;
 - (d) licences of intellectual property granted by a lessor within the scope of Ind AS 115, *Revenue from Contracts with Customers*; and
 - (e) rights held by a lessee under licensing agreements within the scope of Ind AS 38, *Intangible Assets*, for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
- 4 A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3 (e).”

From the above, the Committee is of the view that the exceptions given in paragraph 3 (a) to (e) of Ind AS 116 are not applicable in the extant case. The contract with the transporter in the extant case provides to the Company, rights to the hooking-up facilities (such as, metering facility, gas monitoring equipment, pressure regulators, filters, telemetry, etc.), which are tangible and not intangible in nature. Therefore, paragraph 4 of Ind AS 116 is also not applicable. Accordingly, if the contract in the extant case is or contains a lease, the Company should apply the requirements of Ind AS 116.

13. In this context, the Committee notes the following clauses from the Agreement for hooking-up facilities between the Owner (transporter) and the entity (the Company):

“3.1 OWNER’s Responsibilities:

OWNER shall design and install the metering facility, gas monitoring equipment, pressure regulators, filters, telemetry, and such other equipment (collectively, “Hooking-Up Facilities”) necessary to hook-up with the ENTITY’s Facilities at the Hooking-up Point and subject to Clause 4.1, transport a maximum of **0.260 MMSCM** of Gas per day from the DVPL-GREP Upgradation & Chainsa-Jhajjar (CJPL) *Natural Gas* pipeline into the ENTITY’s Pipeline.”

“4.2 Term:

The term of this Agreement shall be for an initial period of **Ten (10) years** commencing from the Execution Date with a mid-term review after completion of **Five (5) year** period.

Thereafter, this Agreement may be extended further under the mutual agreement of the Parties.”

“5.1 OWNER’s Obligations:

- i. Upon receipt of the Upfront / Advance Payment for Hooking-Up Charges in accordance with Clause 6.1 of this Agreement from ENTITY, OWNER will construct, install, test, calibrate, and commission the Hooking-up Facilities in accordance with the Clause 3.
- ii. OWNER shall own and operate the Hooking-up Facilities.

- iii. OWNER shall be responsible for acquiring all regulatory and statutory permits that are necessary for the construction, commissioning, operation, and maintenance of the Hooking-up Facilities.
- iv. OWNER shall perform all daily operational activities in connection with Hooking-up Facilities, including, but not limited to, operation, testing, calibration in accordance with the industry practice and maintenance necessary for the utilization of Hooking-up Facilities.
- ...
- viii. OWNER shall develop the metering facilities for a flow of 25,000 SCMD or lower as per the initial requirement of ENTITY.

However, if the ENTITY requires the metering facility for a flow more than **25,000 SCMD** at the initial stage, then OWNER shall install the same considering the requirement of ENTITY subject to Upfront/Advance Payment of corresponding Hooking-Up Charges by the ENTITY.

...

5.2 ENTITY's Obligation:

...

- ii. ENTITY shall construct, install, test calibrate, commission, own and operate the ENTITY's Facilities downstream of the Hooking-up Point. ENTITY shall be solely responsible for all costs associated with the maintenance and repair of the ENTITY's Facilities downstream of the Hooking-up Point.

..."

"6.1 HOOKING-UP CHARGES:

...

- V) It is agreed between Parties that in the event of early termination of this Agreement for any reason whatsoever prior to the expiry of the initial term as provided above, ENTITY shall not have any claim on the Hooking-up Facilities and Hooking-up Charges paid to the OWNER. Operating Charges shall not be applicable after the termination of this Agreement.

...

6.2 OPERATING CHRGES:

- i) The ENTITY shall pay to the OWNER an Operating Charges @2.5% of hooking-up Charges including subsequent Hooking-up Charges with 5% escalation on annual basis. The Operating Charges shall be collected in advance with applicable taxes.

...

- 6.3 OWNER shall install the metering facilities as per the requirement of ENTITY. The measurement aspects and related issues shall be governed by relevant clauses under GSA/GTA as applicable."

- "7.2 Parties agree and acknowledge that nothing contained in this Agreement is intended to create any obligation upon the OWNER to transport Gas to the

ENTITY. Any transportation of Gas through the Hooking-up Facilities will be performed under the terms and conditions of one or more separate written agreements between the Parties.”

“7.9 The OWNER reserves the right of installing, operating, maintaining and modifying any facilities at the Hooking-up Facility for other entities, as & when required.”

14. The Committee now examines whether the contract of hooking-up facility in the extant case can be considered as a ‘lease’ within the scope of Ind AS 116, ‘Leases’. In this regard, the Committee notes the following paragraphs from Ind AS 116:

“**Lease** A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.”

“**9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.**”

“**B9** To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, *throughout the period of use*, the customer has both of the following:

- (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and
- (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

B10 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.”

“Identified asset

B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Substantive substitution rights

B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:

- (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily

available to the supplier or could be sourced by the supplier within a reasonable period of time); and

- (b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).”

“Portions of assets

- B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Right to obtain economic benefits from use

- B21 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.”

“Right to direct the use

- B24 A customer has the right to direct the use of an identified asset throughout the period of use only if either:
- (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or
 - (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.”

From the above, the Committee notes that a contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Further, to assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of

use, the customer has the (i) right to obtain substantially all of the economic benefits from use of the identified asset and (ii) right to direct the use of the identified asset.

In the extant case, the contract with owner/transporter gives to the Company, the rights to the hooking-up facilities for an initial period of 10 years in exchange of the up-front payments. Further, the hooking-up facility is explicitly specified in the contract/agreement along with the specific location, temperature, pressure, maximum volume/capacity, maximum flow, etc. and has been exclusively developed as per the Company's requirements. Furthermore, if in future, any alteration or modification is required in terms of increase in flow or volume/capacity or temperature or pressure variation, additional cost has to be incurred for the same. Therefore, it appears that the facilities at present represent substantially all of the capacity of the asset and provide the Company with the right to obtain substantially all of the economic benefits from use of the asset. The Committee also notes that any clause in the Agreement does not suggest that the owner/transporter has substitution right. Accordingly, it can be concluded that, *an identified asset exists in the extant case.*

With regard to right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use, the Committee notes that paragraph B21 of Ind AS 116 specifies that a customer can have that right, for example, by having exclusive use of the identified asset throughout the period of use. In this regard, the Committee notes that in the extant case, assets were created for exclusive use of the Company with the temperature, pressure, flow, capacity etc. defined by the Company and even if the transporter wishes to use these facilities for another entity, same have to be altered/modified to suit the needs of that entity. Thus, even though as per clause 7.9 of the Agreement, Owner has the right of installing, operating, maintaining and modifying any facilities at the Hooking-up Facility for other entities, the same would require modification/alteration as per the needs of that entity. Therefore, it can be concluded that the Company has exclusive right to use the specified hooking-up facilities throughout the period of use and therefore, the *Company has the right to obtain substantially all of the economic benefits from the use of identified asset.*

With regard to right to direct the use of the asset, the Committee notes that paragraph B24 of Ind AS 116 specifically provides that where the relevant decisions about how and for what purpose the asset is used are predetermined (as in the extant case, how and for what purpose the hooking-up facilities will be used is pre-determined), an entity has the right to direct the use of an identified asset throughout the period of use only if (i) it has the right to operate the asset *or* (ii) if it designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. In the extant case, although as per the terms of the Agreement, the Company may not have the right to operate the facilities, however, since these facilities have been specifically developed considering the requirements of the Company in terms of temperature, pressure, flow, volume etc., it can be concluded that the Company designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use. Therefore, the Committee is of the view that in the extant case, the *Company has the right to direct the use of identified asset throughout the period of use.*

On the basis of the above, the Committee is of the view that the arrangement in the extant case contains lease and the prepayments made towards hooking-up charges should be accounted for as per the requirements of Ind AS 116.

D. Opinion

15. In view of the above and subject to paragraph 11 above, the Committee is of the following opinion on issues raised in paragraph 10 above:

- (i) The arrangement in the extant case contains lease, as discussed in paragraph 14 above. Thus, the prepayments made towards hooking-up charges should be accounted for as 'right-of-use' asset per the requirements of Ind AS 116.
- (ii) Since the underlying asset in the extant case is tangible and not intangible in nature, as discussed in paragraph 12 above, Ind AS 38, 'Intangible Assets' is not applicable.
- (iii) & (iv) In view of (i) above, answers to these questions do not arise.
