

Query No. 29

Subject: *Recognition of interest on mobilisation advance against project contracts under Ind AS Framework.*¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’) is a public sector enterprise under the administrative control of the Ministry of Mines, Government of India and is engaged in mining of Bauxite, manufacturing of Alumina and Aluminium, generation of power at Captive Power Plant for use in Smelter, and selling of Alumina and Aluminium both in domestic and international markets. Besides, the Company is also engaged in generation of wind power with setting up of wind power plants at distinct locations in the Country. The Company has the following four production units:

- a. Fully mechanised Open Cast Bauxite Mine having excavation capacity of 68,25,000 tonnes per annum;
- b. Aluminium Refinery having production capacity of 22,75,000 tonnes per annum;
- c. Captive Power Plant having power generation capacity of 1200 megawatt (MW); and
- d. Aluminium Smelter Plant of 460,000 tonnes capacity per annum.

In addition, there are 4 Wind Power plants of about 50MW each located in the different states.

2. Mines Division, which is located uphill, serves feed-stock to the alumina refinery located 16 km downhill. Apart from domestic and export sale of alumina, the refinery unit provides alumina to the Company's smelter plant which is about 600 km away by specially designed alumina wagons by rail transport. For production of 1 metric tonne (MT) of aluminium at smelter, about 13,600 kilowatt-hour (kwh) of power is required, which is met by captive power plant situated at 4 km away from the smelter plant. Calcined alumina and thermal power are two important inputs for producing aluminium. The production process starting from bauxite mines to alumina refinery to aluminium smelter and captive power plant is fully integrated.

3. The querist has stated that sale of calcined alumina and aluminium metal is the mainstream of revenue for the Company. Its product profile includes hydrate, calcined alumina, ingots, billets, wire rod and rolled products. In pursuit of increasing the capacity of its alumina refinery from 2.275 metric tonne per year (MTPY) to 3.275 MTPY of Alumina, the Company has undertaken major expansion project of ₹ 6321.20 crore. The expenditure incurred so far for the project has been fully funded from surplus cash reserve of the Company (Equity). The Company has not borrowed any fund for financing of the project.

Accounting for interest on mobilisation advance followed by the Company:

4. The querist has further stated that up to 31.03.2022, the Company has expensed ₹1483.09 crore towards the project work against which no fund has been borrowed. All the amount incurred till 31.03.2022 is out of the Company's own internally generated funds without any borrowing element. The Company has awarded various contracts for execution of the Project and in order to quick start-up of the Project, there is an optional clause for availing interest bearing mobilisation advance upto 15% of the contract value. As per the contract clause, “in case the vendor needs mobilisation advance, the same shall be as follows:

¹ Opinion finalised by the Committee on 10.2.2023.

15% of Order value shall be released as interest bearing recoverable advance, to be paid in two installments (10% and 5%) against Advance Bank Guarantee (ABG) for 110% of advance amount. The interest rate for such advance shall be variable. For the financial year 2021-22, the interest rate is 8% which is worked out based on Marginal Cost of Funds based Lending Rate (MCLR) of State Bank of India (SBI) as on April, 2021 for one year tenor plus 1%. For subsequent financial years, the interest rate for the balance amount of mobilisation advance will be MCLR (1-year tenor) of SBI declared in the month of April of that financial year plus 1%.”

With the above mentioned conditions, some vendors have opted for mobilisation advance and the Company is recovering interest from vendor’s running bills against supply of goods/services. The interest recovered and accrued on mobilisation advance are recognised as interest income of the Company and credited to the Statement of Profit and Loss.

Observation of Audit:

5. The statutory auditors of the Company are of the view that “the interest recovered and accrued on mobilisation advance should be adjusted against the project cost rather than recognising as interest income as the same is inextricably linked to construction and acquisition of fixed assets and has a direct nexus to the project.”

Views of the Management:

6. The Company is financing its expansion project from its own cash reserves created out of profits accrued during the earlier years and does not have any borrowings. Generally, such cash reserve is invested in the form of Fixed Term Deposits/ Mutual Funds and incomes from these are credited to the Statement of Profit and Loss. Mobilisation advance is being paid to the contractors out of such cash reserves by liquidating the investment in bank/mutual funds as and when required. Prior to giving such mobilisation advance, the surplus amount accrued through internal reserves was invested in the bank as Term Deposit Receipt (TDR) / Mutual Fund (MF) and interest earned on it was being recognised as part of the Statement of Profit and Loss. It is only a change in the pattern of investment. The investment base is changed from bank deposits/ Mutual Funds to contractor in the form of interest-bearing mobilisation advance. Had there been no project, such internal reserve would have earned interest through investment elsewhere. By giving the advance, there is sacrifice of interest income on the surplus funds. Hence, the earnings of interest income on advance to contractors have been treated as interest income and credited to the Statement of Profit and Loss.

7. The querist has also stated that paragraph 21 of Indian Accounting Standard (Ind AS) 16, ‘Property, Plant and Equipment’ prescribes that “Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. ...” Even if, the contracts would not have such interest-bearing advance clause, the vendor would execute the contract from its own source/ bank fund etc. Hence, such mobilisation advance payment/ interest income thereof may not be directly attributable to the cost of asset acquired. Further, Ind AS 23, ‘Borrowing Costs’ mandates to add the borrowing costs net of income, if any. However, as there is no borrowing cost element in the project cost of the Company, any adjustment of interest on mobilisation advance sourced from internal reserve will reduce the natural project cost. Furthermore, according to the querist, adjustment of interest income against mobilisation

advance not funded through borrowing, in the project cost may lead to understatement of income and understatement of cost of 'Property, Plant and Equipment (PPE)'. It may lead to non-uniformity in the recognition of PPE from contract to contract depending on option of such mobilisation advance availed by the contractors.

B. Query

8. In view of above, the querist has sought the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) as to whether the interest earned on mobilisation advance funded from internal cash reserve is required to be adjusted against the project cost or the existing practice of the Company to recognise such interest as interest income in the Statement of Profit and Loss can be continued.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to the recognition of interest earned on mobilisation advance funded from internal cash reserve by the Company during the construction of the Project. The Committee has, therefore, examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for mobilisation advance, timing of recognition of interest earned, accounting for sale of alumina, aluminium and calcined alumina etc., accounting for power generated from captive plant and captive consumption of alumina, accounting for investments made in TDR/MF and income earned thereon, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the legal perspective, such as, legal interpretation of various legal decisions, agreement with the contractors of the Company, etc. It is presumed from the Facts of the Case that as per the contractual terms and conditions, the interest earned on mobilisation advances is not receivable in cash. Furthermore, the Committee wishes to point out that the Indian Accounting Standards referred to in the Opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

At the outset, the Committee notes from the Facts of the Case that the Company has awarded various contracts for execution of the Project and in order to quick start-up of the Project, there is an optional clause for availing interest bearing mobilisation advance up to 15% of the contract value as per certain terms and conditions. Further, the Company is financing its expansion project from its own cash reserves created out of profits accrued during the earlier years and does not have any borrowings. Since there are no borrowing costs incurred by the Company, the question of consideration of requirements of Ind AS 23 does not arise.

10. With regard to accounting for interest income earned on mobilisation advance given to the contractors during construction of the Project, the Committee notes the following requirements of Ind AS 16, 'Property, Plant and Equipment':

- “21 Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in

the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.”

The Committee notes from the above that expenses or income arising from incidental operations before or during the construction or development of an item of property, plant and equipment (PPE), which are not necessary to bring the item of PPE to the location and condition necessary for it to be capable of operating in the manner intended by management, are recognised in the Statement of Profit and Loss. The test is not inextricable linking or direct nexus of the income to the project, but is whether it results from operations that are necessary to bring the item of PPE to the location and condition necessary for it to be capable of operating in the manner intended by the management. Thus, the key requirement to be examined is whether such operations are necessary to bring the item of PPE to the location and condition necessary for it to be capable of operating in the manner intended by management or not.

The Committee also notes that how the surplus amount was used by the Company prior to giving mobilisation advance is not relevant to determine accounting of interest income in the extant case. Therefore, whether interest was being earned on such surplus or not before it was advanced to the supplier does not affect the opinion of the Committee.

In this context, the Committee notes that in the extant case, mobilisation advance is an optional financing arrangement between the Company and the contractors, which is incidental in connection with the execution of the project, giving rise to income in the form of ‘interest’, but it cannot be considered as an activity necessary to bring the project/asset to the location and condition necessary for it to be capable of operating in the manner intended by management, because an item of PPE could be developed even in the absence of such an arrangement. Accordingly, the Committee is of the view that interest income earned on mobilisation advance funded from internal cash reserve in the extant case should not be capitalised/included in the cost of the asset/project and therefore, should be recognised in the Statement of Profit and Loss.

D. Opinion

11. On the basis of the above, the Committee is of the view that interest earned by the Company on mobilisation advance funded from internally generated funds without any borrowings in the extant case should not be adjusted against the expansion cost of the project/asset(s); rather should be recognised in the Statement of Profit and Loss, as discussed in paragraph 10 above.
