

Query No. 45

Subject: Accounting treatment of additional capitalisation arisen due to arbitration award.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’), a Maharatna Public Sector Undertaking (PSU), is the leading steel-making Company in India having five Integrated Steel Plants and three Special Steel Plants. The Company produces both basic and special steels for domestic construction, engineering, power, railways, automotive and defence industries as well as for sale in export markets.

2. At one of the integrated steel plant of the Company, an order was placed with consortium of T Ltd. and DCBV in 2008 for setting up a 1x4060 Cu Mtr blast furnace on turnkey basis at a contract value of (EURO 73,982,760 + INR 1217,00,00,000/-). The duration of project was 30 months from the date of contract and the scheduled date of commissioning was 1st April 2011 which was delayed and actual commissioning took place on 17th October 2014.

3. The querist has stated that the delay was attributable to the contractor and the Company demanded liquidated damages for delay as per terms of the contract. The price variation was paid to the contractor for the scheduled period only as the price variation is not payable for the period where the delay is on account of the contractor.

4. The contractor did not accept the delay. Rather, they had raised various claims on account of extra work, price variation, prolongation cost and interest etc. which could not be mutually resolved. The consortium members invoked arbitration under International Chamber of Commerce (ICC) in three cases as listed below and the arbitral award was against the Company in all the three cases. The arbitration award amount was INR 710.99 crore + interest till date of payment.

Sl. No.	Details of disputes	Court of Arbitration	Award Amount (INR In crore)
1.	Dispute and claims arising out of blast furnace (Pkg-10) Main Package. Claimant – T Ltd./DCBV	ICC arbitration Oct’2016. ICC Tribunal: Three members panel. Date of Award: 16.05.2018.	635.95 + Interest
2.	Dispute on FAC. Claimant – T Ltd./DCBV	ICC arbitration Feb’2018. ICC Tribunal: Three members panel. Date of Award: 20.11.2019.	46.34 + Interest
3.	Dispute on IP rights/proprietary drawing. Claimant – DCBV	ICC arbitration Dec’2017. ICC – Sole Arbitrator. Date of Award: 15.10.2019.	28.69 + Interest

¹ Opinion finalised by the Committee on 27.12.2023.

5. The arbitral awards were challenged by the Company in the Hon'ble Delhi High Court in 2018 and 2019. Meanwhile, a Committee of senior officials was constituted for a mutual commercial settlement. The Committee held multiple rounds of discussions with the consortium of T Ltd./DCBV. The final offer by T Ltd./DCBV was a lump sum amount of INR 628.32 crore (INR 470.31 crore + EURO 18,567,148) plus income tax on foreign services, which was considered acceptable. At this point in February 2022, the award amount including interest and offer by contractor for settlement was as under:

Award amount – Basic award INR 710.99 cr + Interest INR 274.73 cr = INR 985.72 cr

Offer given by the contractor for settlement = INR 628.32 cr + Income Tax

After approval of the competent authority in February 2022, a settlement agreement was signed with M/s T Ltd./DCBV in March 2022 and payment of INR 637.35 crore (including income tax on foreign services) was made to M/s T Ltd./DCBV under the following heads:

a) Prolongation cost including interest -	INR 353.41 Cr
b) Balance Amount (as per contract) -	INR 142.95 Cr
c) Extra Price variation claim -	INR 119.39 Cr
d) Extra civil work -	INR 10.63 Cr
e) Additional Design Engineering cost -	INR 10.97 Cr
TOTAL	INR 637.35 Cr

6. *Accounting Treatment:*

- (a) After arbitration was invoked by the contractor, the claim amount of INR 962.51 crore was shown under contingent liability until the same was confirmed in March 2022.
- (b) On payment in March 2022, prolongation cost including interest for INR 353.41 crore was charged to revenue in the Statement of Profit and Loss.
- (c) Items (b to e) amounting to INR 283.94 crore were capitalised. Liability for INR 153.71 crore was already existing in the books on capitalisation of the asset in 2014. Balance amount of INR 130.23 crore was capitalised w.e.f. March 2022 prospectively.

7. *Observation of Comptroller and Auditor General of India (CAG)*

The resident audit (government audit) observed that INR 130.23 crore which has been capitalised in March 2022 pertains to payments towards extra work and price escalation amount. The above works have already been completed before commissioning of the original asset, i.e., 17th October, 2014. The Company was getting benefits out of it since commissioning and the amount was capitalised in the financial statements during the year 2021-22 out of the mutual settlement. Therefore, the depreciation against the capital addition made in the year 2021-22 out of an amicable settlement agreement should have been charged

from the date of initial capitalisation (i.e. since 1st September 2014) instead of from the date of addition.

8. *Basis of additional capitalisation w.e.f. March 2022*

The additional capitalisation is on account of extra price variation, extra civil work and additional design engineering which has been paid to the contractors due to arbitration award given in their favour. The asset was capitalised on 01-09-2014 without considering the aforesaid claims of the contractor because the same was not contractually payable and the claim of the contractor was put to legal scrutiny through various redressal forums. Since the liability arises because of arbitrator's award and not because of provision of contract, the same was capitalised prospectively in accordance with paragraph 5 (a) of the Appendix A, 'Changes in Existing Decommissioning, Restoration and Similar Liabilities' to Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment', which states that:

“5 If the related asset is measured using the cost model:

- (a) subject to (b), changes in the liability shall be added to, or deducted from, the cost of the related asset in the current period.
- (b) the amount deducted from the cost of the asset shall not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

...”

As per paragraph 37 of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors:

“To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.”

Further, it is noted that Notes to the financial statements of the Company disclose that where the historical cost of a depreciable asset undergoes a change, the depreciation on the revised unamortised depreciable amount is provided over the residual useful life of the asset. Accordingly, depreciation on the addition to the asset has been charged on prospective basis.

According to the querist, the accounting treatment of INR 130.23 crore in the Company's books of account complies with the requirements of Ind AS 16, Ind AS 8 and prevailing accounting policy of the Company.

B. Query

9. The opinion of the Expert Advisory Committee of the Institute of Chartered Accountant of India is sought on the following issues:

- (i) Whether the contention of C&AG that INR 130.23 crore should be depreciated retrospectively, i.e., from the original date of capitalisation, or

- (ii) The accounting treatment of additional capitalisation and depreciation followed by the Company, is in accordance with the requirements of Ind AS 16, Ind AS 8 and prevailing accounting policy of the Company.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to accounting for additional capitalisation on account of extra price variation claim, extra civil work, and additional design engineering cost; and depreciation thereof. 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, any other expense incurred by the Company in relation to the project, accounting as per Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets', including appropriateness of liability/provision created in 2014 and disclosure as contingent liability after invoking of arbitration by the contractor till the claim amount was confirmed in March 2022, accounting for prolongation cost (including interest), accounting for foreign exchange variation (if any), appropriateness of the Company's accounting policy, etc. The Committee also wishes to point out that since the query pertains to financial year (F.Y.) 2021-22, the opinion expressed hereinafter is in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Accounting Standards) Rules, 2015, applicable for the F.Y. 2021-22. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the legal perspective, such as legal interpretation of various agreements/contracts entered into by the Company, arbitration award, etc.

11. At the outset, the Committee notes from the Facts of the Case that one of the integrated steel plants of the Company placed an order for blast furnace for which actual commissioning took place in 2014. As the project was delayed, the Company demanded for liquidated damages, however, the contractor did not accept the delay and raised various claims on the Company on account of extra work, price variation, prolongation cost and interest etc. In 2022, a settlement agreement was signed and amount of INR 283.94 crore (excluding prolongation cost) was determined as compensation for various elements including balance amount (as per contract), extra price variation claim, extra civil work, and additional design engineering cost. A liability for INR 153.71 crore was already provided for in respect of above elements in the books on capitalisation of the asset in 2014 and balance amount of INR 130.23 crore was capitalised w.e.f. March 2022 prospectively.

12. In this context, the Committee examines the following requirements of Ind AS 16, Property, Plant and Equipment:

“7 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.”

“10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. ...”

“15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Elements of cost

- 16 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 initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.”

The Committee notes from the above-reproduced requirements of Ind AS 16 that only those costs/expenditure that are directly attributable to bringing the item of PPE to the location and condition necessary for it to be capable of operating in the manner intended by management should be capitalised as part of the cost of PPE. Since the additional cost incurred towards additional design engineering cost, extra civil work, price variation claims etc. has been contended by both the management and the C&AG auditor to be capitalised as part of the cost of the steel plant/blast furnace in the extant case, the Committee presumes that the same is a directly attributable cost as per the requirements of Ind AS 16 and accordingly, can be capitalised as part of cost of plant. The Committee also presumes that all these items of costs pertain to pre-capitalisation period of the plant/asset (i.e. prior to commissioning of the plant on 17th October 2014 in the extant case); In other words, these do not include any new item of cost which might have arisen after capitalisation of asset.

The Committee further notes that as per requirements of paragraph 15 of Ind AS 16, an item of PPE shall be measured at recognition *at cost*. The Committee also notes that in the extant case, the cost of the plant includes an element of an estimate of INR 153.71 crore towards extra price variation claim, extra civil work, and additional design engineering cost at the time of capitalisation of the asset (Plant) in 2014, actual cost of which got crystallised in 2022 at a higher amount and therefore, the same is a change in estimate of the cost of PPE, which should be accounted for as a change in accounting estimates in accordance with the following requirements of Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors:

“²A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and accordingly, are not corrections of errors.”

² This paragraph has been subsequently substituted vide Notification No. G.S.R. 242(E) dated 31st March, 2023 which came into force with effect from April 1, 2023.

“36 The effect of change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in:

(a) the period of the change, if the change affects that period only; or

(b) the period of the change and future periods, if the change affects both.

37 To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.”

From the above, the Committee notes that change in estimate due to adjustment of the carrying amount of an asset should be recognised prospectively by adjusting the carrying amount of the related asset in the period of the change. Thus, in the extant case, the additional amount incurred towards the cost of asset due to change in the initial estimate of the cost of the asset arising because of the settlement of the provision/liability towards design engineering cost, extra civil work, price variation claims etc., should be capitalised with the cost of the PPE/asset(s) prospectively. Further, the depreciation on the amount capitalised subsequently due to change in estimate should be charged prospectively. However, the resulting carrying amount of such asset should be reviewed for impairment as per the requirements of Ind AS 36, ‘Impairment of Assets’.

Accordingly, the accounting treatment of additional capitalisation and depreciation followed by the Company is in accordance with the requirements of Ind AS 16 and Ind AS 8.

D. Opinion

13. On the basis of the above and subject to presumptions made in paragraph 12 above, the Committee is of the following opinion on the issues raised in paragraph 9 above:

- (i) The addition to the asset of INR 130.23 crore should be depreciated prospectively as discussed in paragraph 12 above.
- (ii) The accounting treatment of additional capitalisation and depreciation followed by the Company is in accordance with the requirement of Ind AS 16 and Ind AS 8, as discussed in paragraph 12 above.
