

Query No. 2

Subject: (i) *Accounting treatment of interest cost arising on fair valuation of interest free subordinate debt provided by the Government of India (GoI), Government of National Capital Territory of Delhi (GNCTD) and other government agencies for construction of metro projects, and*

(ii) *Accounting treatment of interest income earned on temporary investment of aforementioned interest free subordinate debt funds in flexi deposits till their utilisation in the project.*¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) is a joint venture company with equal equity participation from the Government of India (GoI) and Government of National Capital Territory of Delhi (GNCTD) and has been entrusted with the responsibility of construction and operation of the rail-based Mass Rapid Transit System (MRTS) for Delhi/NCR areas (hereinafter referred to as ‘the Project’).

2. The project financing is done in the form of equity, grants, loan from Japan International Cooperation Agency (JICA) through GoI, interest free subordinate debts from GoI, GNCTD and other government agencies, as part of funding pattern for execution of metro projects.

3. The interest free subordinate debts are provided for the specific purpose of financing of land, rehabilitation & resettlement, central taxes and state taxes, which are repayable in 5 equal instalments after completion of the repayment period of JICA loan of relevant phases i.e. after 30 years. The Company has completed Phase-I, II, III; and Phase-IV work is going on.

4. The querist has stated that earlier, the Expert Advisory Committee, on a reference made by the Company, had opined that the Company should measure the fair value of the interest free subordinate debts using valuation technique in line with the provisions of Indian Accounting Standard (Ind AS) 113, ‘Fair Value Measurement’.

Accounting treatment being followed by the Company

5. During finalisation of annual accounts for the financial year (F.Y.) 2023-24, the Company has measured the subordinate debts at fair value by adopting G-sec rate as applicable for the remaining tenure of such debts prevailing on the date of its sanction or date of transition to Ind AS, whichever is later. The difference between the carrying value and the fair value is recognised as government grant and the same is to be amortised over the remaining useful life of projects for which such debts are obtained.

6. The querist has further stated that the interest expense on subordinate debts calculated using effective interest method as described in Ind AS 109, ‘Financial Instruments’ has been accounted for as under:

- In respect of subordinate debts received for execution of Phases I, II & III of MRTS project, which are completed and fully operational, the interest cost resulting from fair valuation has been charged to the statement of profit and loss.

¹ Opinion finalised by the Committee on 16.4.2025.

- In respect of subordinate debts received for execution of Phase-IV of MRTS project, which is under construction, the interest cost resulting from fair valuation has been booked under the head ‘Capital Work-in progress’ (CWIP) and will be capitalised as part of the cost of asset as per accounting policy of the Company, as it is directly attributable to Phase-IV project.
- Interest income earned on temporary deployment of subordinate debt funds has been accounted for in the statement of profit and loss in accordance with the earlier EAC opinion published as Query No. 44 of Volume XXXIV of the Compendium of Opinions. Relevant extracts are reproduced below:

“... Interest income from investment of surplus equity funds and interest free subordinate debt should be recognised in the statement of profit and loss...”

Provisional Comment issued by the Comptroller and Auditor General of India (C&AG) during Supplementary Audit

7. During supplementary audit of financial statements of the Company for the financial year (F.Y.) 2023-24, the office of Comptroller and Auditor General of India (C&AG) issued a provisional comment, which along with the management reply thereon, is reproduced below:

C&AG provisional comment	Management reply
<p><i>“Assets - Non-Current Assets – Capital Work in Progress - ₹ 8,10,400.99 lakh (Note No. 1.3)</i></p> <p>The above includes finance cost of ₹ 1,621.49 lakh which is notional in nature as the same has been calculated due to fair valuation of subordinate debt. The subordinate debts are extended interest free by the Government of India, Government of NCT of Delhi and other Governments, however interest was provided in order to arrive at the fair value in accordance with the EAC opinion of the ICAI.</p> <p>As per paragraph 12 of Ind AS 23, to the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment</p>	<p>The core principle for accounting treatment of borrowing costs is prescribed in paragraph 1 of Ind AS 23, ‘Borrowing Costs’, which is reproduced below:</p> <p>Core principle</p> <p>Paragraph 1: Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.</p> <p>Borrowing costs eligible for capitalisation are elaborated in paragraphs 8-15 of Ind AS 23 in terms of which borrowing costs directly attributable to construction of a qualifying asset shall be capitalised.</p> <p>Specific guidance for interest expense calculated on fair valuation of subordinate debts has been given in paragraph 6(a) of Ind AS 23, which is reproduced below: -</p>

<p>of those borrowings. <i>As interest on subordinate debts (which are interest free) is not actually incurred, the capitalisation of the interest was in contravention of Ind AS 23.</i></p>	<p>Paragraph 6: “Borrowing costs may include:</p> <p>(a) interest expense calculated using the effective interest method as described in Ind AS 109, <i>Financial Instruments</i>;</p> <p>...”</p> <p>Effective interest method as described in Ind AS 109, ‘Financial Instruments’ is reproduced below:</p> <p>“The method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.”</p> <p>It is clear from above that the interest expense calculated by the Company on account of fair valuation of subordinate debts, using effective interest method as per Ind AS 109 is part of the borrowing costs in terms of paragraph 6(a) and same is eligible for capitalisation for cost booked during construction period of project, as it is directly attributable to construction of a qualifying asset as per provisions of Ind AS 23.</p> <p>This accounting treatment is also in line with the Educational Material on Ind AS 23, ‘Borrowing Costs’, issued by the ICAI, wherein similar issue has been addressed in question No. 17, which is reproduced below:</p> <p>“Question 17</p> <p>S Ltd. (subsidiary co.) obtained an interest-free loan from P Ltd. (parent co.) and used it for the construction of a qualifying asset. P Ltd. arranged for the said money by obtaining loan from a bank. S Ltd. is required to repay back the loan to P Ltd. after 3 years. S Ltd. initially recognised this loan as a financial liability at fair value in accordance with Ind AS 109, <i>Financial Instruments</i>. S Ltd. has recognised the difference between the fair value of the loan (as per Ind AS 109) and the funds received from P Ltd. as ‘equity’ contribution from P Ltd. in its separate financial statements. Whether S Ltd. can capitalise the interest accrued</p>
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<p>In addition, the Company has earned interest on subordinate debt by investing the fund on temporary basis as flexi deposit which is accounted as other income. Thus, the income earned by investing the subordinate debt should have been adjusted with borrowing cost while charging to CWIP as per paragraph 12 of Ind AS 23. However, audit was unable to ascertain the exact amount of the income earned by investing the subordinate debt as the subordinate</p>	<p>determined using the effective interest rate method as borrowing costs as per Ind AS 23?</p> <p>Response</p> <p>Paragraph 6 of Ind AS 23 provides that:</p> <p>“6 Borrowing costs may include:</p> <p>(a) interest expense calculated using the effective interest method as described in Ind AS 109, <i>Financial Instruments</i>;</p> <p>(b) ...</p> <p>In the given case, the loan liability will be subsequently measured at amortised cost, with interest accrued using the effective interest rate method as per Ind AS 109. In accordance with paragraph 6(a) of Ind AS 23, the interest determined using the effective interest method is an element of the borrowing costs and should be considered for determining the costs eligible for capitalisation in separate financial statements of S Ltd.”</p> <p>Hence, in view of specific provision in respect of accounting treatment of interest cost on fair valuation of subordinate debts as given in paragraph 6(a) and principles laid down in paragraphs 8 to 15 of Ind AS 23 relating to borrowing costs eligible for capitalisation, the interest cost calculated on account of fair valuation of subordinate debts during the construction period, which is directly attributable to Phase-IV project, is eligible for capitalisation in accordance with provisions of Ind AS 23.</p> <p>The accounting treatment of interest income on subordinate debt is in line with the opinion of Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), in Query No. 44 of volume XXXIV of Compendium of Opinions, which is reproduced below:</p> <p>“Opinion</p> <p>...Interest income from investment of surplus equity funds and interest free subordinate debt should be recognised in the statement of profit and loss and interest earned from investment of loan from JICA during</p>
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<p>debt and equity is maintained in the same bank account.</p> <p>Thus, inclusion of financial cost of ₹ 1621.49 lakh has resulted in overstatement of capital work in progress, other equity by ₹ 1621.49 lakh & understatement of finance cost (expenses) by the same amount”.</p>	<p>construction period should be adjusted against the borrowing cost to be capitalised in the cost of asset/project concerned...”</p> <p>Further, Ministry of Housing & Urban Affairs (MoHUA), erstwhile Ministry of Urban Development, vide letter dated 8th August, 2016, has also instructed that the interest earned on short term investment of funds received by metro rail companies towards equity and interest free subordinate debt shall be recognised in the statement of profit and loss.</p> <p>Hence, in compliance of the opinion of the EAC of ICAI, and the instructions of MoHUA, interest income on temporary deployment of subordinate debt funds has been correctly accounted for in the statement of profit and loss.</p> <p>As regards calculation of interest earned on subordinate debt funds during F.Y. 2023-24, the same is worked out at ₹106.90 lakhs on pro-rata basis, which is not material.</p> <p>Hence, as explained in above paragraphs, the booking of interest cost of ₹1,621.49 lakhs, calculated using effective interest method as per Ind AS 109 on subordinate debts received for Phase-IV project under construction, under the head ‘Capital Work in Progress’ in accordance with paragraph 6(a) of Ind AS 23 and educational material on Ind AS 23, is in order and there is no overstatement of CWIP and other equity and no understatement of finance costs (expenses).</p> <p>However, it is assured that the complete issue will be referred to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for its opinion during current F.Y. 2024-25.</p> <p>In view of above, Audit is requested to drop the provisional comment.</p>
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Points for consideration of the Committee

8. In terms of the core principle given in paragraph 1 of Ind AS 23, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

As per paragraph 6(a) of Ind AS 23, the borrowing costs may include interest expense calculated using the effective interest method as described in Ind AS 109, 'Financial Instruments'.

As per paragraph 12 of Ind AS 23, to the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

The earlier opinion of EAC, published as Query No. 44 of Volume XXXIV of Compendium of Opinions, regarding accounting treatment of interest income from temporary investment of subordinate debt funds, is based on the following consideration made by the Committee:

“12. Accordingly, in respect of a loan where *no* such *borrowing costs* as per AS 16 would arise, as *in the case of interest free subordinate loan* in the extant case, the *interest income* out of investment of such borrowed funds *cannot be adjusted against the borrowing costs* to be capitalised in the cost of the asset and the same shall have to be recognized in the statement of profit and loss.”

(Emphasis supplied by the querist.)

Later on, the EAC, in its recent opinion (dated 24.04.2024) to the Company has opined that interest free subordinate debts should be measured at fair value using valuation technique as per the requirements of Ind AS 113, as a consequence of which, notional interest cost on subordinate debts has arisen.

The C&AG office issued provisional comment on the Company's accounts for F.Y. 2023-24 that the finance cost of Rs. 1,621.49 lakhs is notional in nature as the same has been calculated due to fair valuation of subordinate debts and provided in order to arrive at the fair value in accordance with the recent EAC opinion to the Company.

B. Query

9. 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) on the following issues:

- (i) Whether accounting treatment followed by the Company in respect of notional interest cost arising due to fair valuation of subordinate debts, as explained in paragraph 7 above, is correct.
- (ii) Whether accounting treatment followed by the Company in respect of actual interest income earned on temporary investment of subordinate debt funds, as explained in paragraph 7 above, is correct.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised in the query relate to the accounting for interest arising on fair valuation of interest free subordinate debt provided by the Government of India (GoI), Government of National Capital Territory of Delhi (GNCTD) and other government agencies for construction of Phase IV of metro project; and accounting for interest income earned on temporary investment of interest free subordinate debt funds in flexi deposits till their utilisation in the project. Therefore, the Committee has examined these issues

only and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for funds received in the form of equity, grants, loan from JICA through GoI, accounting for the expenditure for which funds have been utilised viz. financing of land, rehabilitation & resettlement expense, central taxes and state taxes etc., accounting for repayment of JICA loan of relevant phases, determination/measurement of fair value of interest free subordinate debt, accounting for the portion of interest free subordinate debt which has been recognised as government grant including amortisation of government grant, accounting for interest cost incurred during Phase I, II and III and accounting for interest cost on borrowings taken for projects, construction of which have been completed, whether interest earned on subordinate debt funds during F.Y. 2023-24 on pro-rata basis is 'material' or not as per Ind ASs, etc. For the opinion expressed hereinafter, it is presumed that interest earned from investment of surplus subordinate debt is 'material' as per Ind AS and the interest free subordinate debts are specific borrowed funds as per the requirements of Ind AS 23. Further, the Committee has examined the query only from accounting perspective and not from any other perspective, such as, legal interpretation of various legal enactments, for example, Ministry of Housing & Urban Affairs (MoHUA) letter dated 8th August, 2016, Income-tax Act, etc. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended or revised from time to time.

At the outset, the Committee wishes to point out that an earlier EAC opinion (Query No. 44 of Volume 34 of Compendium of Opinions) has been referred to by the querist in the Facts of the Case. In this regard, it may be mentioned that the Committee's opinions are based on the specific facts provided to it and considering the then applicable requirements of Standards. Therefore, these may not necessarily apply in scenarios/situations with different facts and under different applicable accounting framework. The referred earlier opinion was from Accounting Standards (AS) perspective and the extant query raised is from Indian Accounting Standards (Ind AS) perspective. Accordingly, the Committee has independently examined the issues referred by the querist in the facts and circumstances of the extant case and the extent to which the earlier opinion is applicable or relevant has not been examined by the Committee.

11. The Committee notes that the querist had earlier referred another query to EAC, containing, inter alia, an issue with regard to accounting for interest-free subordinate debts. In that case, the Committee had opined that the subordinate loan bearing nil interest rate at its initial recognition should be measured at its fair value, minus directly attributable transaction costs (if any) and fair value of the liability (subordinate debts) should be measured as per the requirements of Ind AS 113, 'Fair Value Measurement'. In the extant case, the Committee has proceeded on the premise that the Company has applied this opinion appropriately.

12. The Committee further notes the following requirements of Ind AS 109:

“4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:

- (a) ***financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be subsequently measured at fair value.***
- (b) **financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement**

approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities.

- (c) *financial guarantee contracts*. After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:
 - (i) the amount of the *loss allowance* determined in accordance with Section 5.5 and
 - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115.
- (d) commitments to provide a loan at a below-market interest rate. An issuer of such a commitment shall (unless paragraph 4.2.1(a) applies) subsequently measure it at the higher of:
 - (i) the amount of the loss allowance determined in accordance with Section 5.5 and
 - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115.
- (e) contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. Such contingent consideration shall subsequently be measured at fair value with changes recognised in profit or loss.

Option to designate a financial liability at fair value through profit or loss

4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:

- (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or
- (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in Ind AS 24 *Related Party Disclosures*), for example, the entity’s board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).”

“amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance .”
“effective interest method	The method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability . When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses . The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs , and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).”

From the above, the Committee notes that paragraph 4.2.1 of Ind AS 109, inter alia, requires an entity to classify all financial liabilities as subsequently measured at amortised cost except for when paragraphs 4.2.1 and 4.2.2 require otherwise. Since the requirements of paragraphs 4.2.1 and 4.2.2 to measure the financial liability at other than amortised cost are not apparently applicable in the extant case, the Company should subsequently measure financial liability for funds received (interest free subordinate loan) at amortised cost, which requires the use of effective interest method and to calculate interest on such financial liability using effective interest method as per the above-reproduced requirements of Ind AS 109.

The Committee also wishes to clarify that interest *accrued* in the financial statements as per effective interest rate, is due to accounting as per applicable Ind AS and should not be considered as notional interest.

13. In this context, the Committee further notes the requirements of Ind AS 23, ‘Borrowing Costs’ as follows:

“Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.”

- “6 Borrowing costs may include:
- (a) interest expense calculated using the effective interest method as described in Ind AS 109, *Financial Instruments*;
- ...”

“A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.”

“Recognition

8 An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.”

“12 To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

13 The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.”

From the above, the Committee notes that Ind AS 23 specifies that borrowing costs include interest expense calculated using the effective interest method as described in Ind AS 109, ‘Financial Instruments’. Further, as per the requirements of Ind AS 23, the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are to be capitalised and other borrowing costs are recognised as an expense. In the extant case, the Committee notes that funds are borrowed and used for the metro project, which usually takes a substantial period of time to get ready for its intended use and thus, it can be said that the project is a qualifying asset as per the requirements of Ind AS 23. Therefore, the borrowing cost/interest expense calculated using the effective interest method on interest free subordinate loan in the extant case should be capitalised as per the above-mentioned requirements of Ind AS 23.

14. With regard to accounting for interest income earned on temporary investment of subordinate debt funds, the Committee notes that Ind AS 23 requires that the borrowing cost (on specific borrowed funds) to be capitalised is to be adjusted with the income earned from temporary investment of such borrowed funds while the project is in the stage of construction. Accordingly, in the extant case, the interest earned on temporary investment of the interest free subordinate debt funds in flexi deposits till their utilisation in the project during the construction period should be adjusted against the borrowing costs calculated using the effective interest

method as discussed above and which is to be capitalised in the cost of the project as per the requirements of Ind AS 23.

D. Opinion

15. On the basis of the above and subject to statements and presumptions in paragraphs 10 and 11 above, the Committee is of the following opinion on the issues raised in paragraph 9 above:

- (i) Accounting treatment followed by the Company in respect of interest cost viz. capitalising the same as capital work-in progress is appropriate, as discussed in paragraphs 12 and 13 above.
- (ii) Accounting treatment followed by the Company in respect of interest income earned on temporary investment of subordinate debt funds in the statement of profit and loss is not appropriate; the same is to be set-off against the borrowing costs to be capitalised as per the principles of Ind AS 23, as discussed in paragraph 14 above.
