

RE-EXPOSURE DRAFT

**TECHNICAL GUIDE ON ACCOUNTING FOR SPECIAL
ECONOMIC ZONES (SEZ) DEVELOPMENT ACTIVITIES**

(LAST DATE FOR COMMENTS: JANUARY 5, 2009)



**Research Committee
The Institute of Chartered Accountants of India
NEW DELHI**

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The following is the Re-exposure Draft of the Technical Guide on Accounting for Special Economic Zones (SEZ) Development Activities, issued by the Research Committee of the Institute of Chartered Accountants of India, for comments. The draft of the Technical Guide was exposed on the website in the month of June 2009 also. Based on the comments received on earlier exposure of the draft, peculiarities of the sector and expected accounting practices in the Country, the draft has been revised and is being issued as Re-exposure Draft. The Committee invites comments on any aspect of this Re-exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

*Comments should be submitted in writing to the Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than **January 5, 2009**. Comments can also be sent by e-mail at research@icai.org*

DRAFT
TECHNICAL GUIDE ON ACCOUNTING FOR SPECIAL ECONOMIC ZONE
(SEZ) DEVELOPMENT ACTIVITIES (REVISED)

INTRODUCTION

1. A Special Economic Zone (SEZ) is a geographical region that has economic laws more liberal than a country's prevailing economic laws. The category 'SEZ' covers a broad range of specific zone types, including Free Trade Zones (FTZ), Export Processing Zones (EPZ), Free Zones (FZ), Industrial Estates (IE), Free Ports, Urban Enterprise Zones and others. The Special Economic Zone Policy was announced by the Government of India (GoI) in April, 2000. The policy intended to make SEZs an engine of economic growth supported by quality infrastructure and complemented by an attractive fiscal package, both at the Centre and the State levels, with the minimum possible regulations. The Government of India promulgated the Special Economic Zone Act 2005 (hereinafter referred to as 'SEZ Act 2005') and the Special Economic Zone Rules 2006 (hereinafter referred to as 'SEZ Rules 2006') to implement the Special Economic Zone policy announced in April 2000.

OBJECTIVE

2. The objective of this Technical Guide is to provide guidance to SEZ Developers and Co-developers (hereinafter the term 'Developer' includes 'Co-developer' also) on accounting treatment of various SEZ development activities in their financial statements. The Technical Guide has been prepared with a view to explain, inter alia, the application of the relevant Accounting Standards in respect of transactions generally entered into by an SEZ Developer.

DEFINITIONS

3. For the purpose of this Technical Guide, the following terms are used with the meanings specified:

“Special Economic Zone” means the special economic zone notified under the proviso to sub-section (4) of section 3 and sub-section (1) of section 4 of the SEZ Act

2005 (including free trade and warehousing zone) and includes an existing special economic zone.

“Developer” means a person who, or a State Government, which has been granted by the Central Government a letter of approval under sub-section (10) of section 3 of SEZ Act 2005 and includes an Authority and a Co-Developer;

“Authority” means a Special Economic Zone Authority constituted under sub-section (1) of section 31 of the SEZ Act, 2005.

“Co-Developer” means a person who, or a State Government, which has been granted by the Central Government a letter of approval under sub-section (12) of section 3 of SEZ Act 2005;

PRINCIPAL ACTIVITIES PERFORMED BY SEZ DEVELOPER

Activities performed prior to notification of SEZ

4. At this stage, the Developer performs activities which are necessary to incorporate the entity often termed as ‘pre-incorporation activities’.

5. After incorporation, the entity has to acquire land before the SEZ can be notified by the relevant authority. Land can be purchased on outright basis or can be acquired on lease. As per Rule 7(1) of SEZ Rules 2006, land taken on lease for more than 20 years by a Developer can be considered for the purpose of notification of SEZ. An existing entity may also acquire land or offer the existing land for setting up of SEZ.

Activities performed after notification as SEZ

SEZ development and construction stage

6. During this stage, major types of activities performed are discussed in the following paragraphs.

Land development

7. Land development activities include land zoning, planning, soil testing, lay out designing, fencing, leveling and grading of land.

Infrastructure development/construction

8. These facilities are core and integral part of the entire SEZ development activity. The Developer has obligation not only to establish such facilities but also to operate and maintain them after these are ready to use to provide the benefit of such facilities on regular/continuous basis to the SEZ units. These facilities are owned by the Developer who ordinarily operates these as Operation and Maintenance (O&M) facilities on which running costs would be incurred and these services would be available on chargeable fee basis. Infrastructure development/construction includes the following:

- (a) ***Infrastructure Utilities:*** This category includes water treatment plant, water distribution system, power back up, power transmission and distribution system, drainage system, sewerage and effluent treatment system, sanitation facilities, telecom system, city gas distribution, solid waste management, fire prevention etc.
- (b) ***Public Utility and Social Infrastructure:*** This category includes the building of schools, colleges, community level multipurpose parks, local shopping centre, socio-cultural centre, informal bazaar, polyclinic, nursing home, child

welfare, maternity centre, community hall/banquet hall, recreation club, sports complex/indoor stadium, socio-cultural centre, security offices etc.

- (c) ***Transportation Infrastructure:*** This category includes construction of network of roads, helipad, airport, port including jetties, storage tanks and inter-connecting pipelines for liquids and gases, metro, monorail, inland container depots or container freight stations, warehouses, etc. Efficient transportation network is developed to serve the zone internally as well as to provide adequate connectivity to the external transport networks.

Development/construction of residential and commercial units

9. SEZ Developer constructs residential and commercial units (buildings) according to the master plan and Guidelines of Ministry of Commerce considering the processing and non-processing area requirements. This would ordinarily include the following:

- (i) Shopping arcade/retail space/multiplex.
- (ii) Housing/service apartments.
- (iii) Clinics & medical centers/hospitals
- (iv) Schools/other educational institutions
- (v) Business/convention centres
- (vi) Office space/commercial space
- (vii) Factory sheds
- (viii) Office space for customs and security staff
- (ix) Playground
- (x) Boundary wall

Resettlement and Rehabilitation (R&R)

10. SEZ Developer has to perform activities for social welfare of people affected by the acquisition of land for development of SEZ. National policy on R&R and concerned State

Government's notified policy prescribe various R&R obligations of the SEZ Developer. Under these policies, generally, the Developer undertakes to perform R&R programmes, e.g., health programmes, employment programmes, social infrastructure and community development programmes. Apart from these measures, SEZ developer has to provide compensation to the affected families for the disruption caused to their normal lives and for the loss of job opportunities which might happen due to displacement during the development stages of the project. The SEZ Developer is also under obligation to undertake community development and capacity building programmes and also to execute the village infrastructure development activities such as roads, water and drainage system, sewerage system etc. R&R may thus include the following:

- (i) Education improvement programmes
- (ii) Health programmes
- (iii) Employment programmes
- (iv) Social Infrastructure and Community Development Programmes in villages
- (v) Compensation as lump-sum or annuity payment as per the policy of the government to land-sellers
- (vi) Setting up of Industrial Training Institute (ITI)
- (vii) Expenses on village infrastructure development such as roads, water and sewerage systems, drainage systems etc.

Activities performed after completion of SEZ development and construction stage

11. On completion of the SEZ development and construction stage, the Developer generally incurs expenditure on infrastructural facilities owned by the Developer in the form of maintenance and running of such facilities.

12. The Developer generally earns revenue from leasing or sale of the residential and commercial/industrial/residential buildings to various units. The Developer may also lease land from which he may earn revenue.

ACCOUNTING FOR EXPENDITURE INCURRED ON SEZ ACTIVITIES

Expenditure on activities performed prior to notification of the SEZ

13. The pre-incorporation expenses such as legal expenses in the incorporation of the entity, share issue expenses etc. should be charged to the statement of profit and loss in the period in which these are incurred, unless required to be treated otherwise by any Accounting Standard, e.g., Accounting Standard (AS) 31, *Financial Instruments: Presentation*, recommends that share issue expenses should be recognised directly in the reserves and not in the statement of profit and loss.

Land Acquisition Cost

14. Land acquisition cost includes cost incurred to purchase or otherwise acquire land. This includes the purchase price of land and other directly attributable costs incurred to acquire the land such as stamp duty, registration charges, legal fees, expenditure incurred in conducting the land due diligence, brokerage charges, legal notice in newspaper, compensation paid for structures on land, cost of site survey etc. Cost of land would also include certain R&R expenditure as discussed in paragraphs 28-30. Land acquired on lease should be accounted for as discussed in paragraph 31.

Treatment of land in the financial statements of the Developer

15. As stated in paragraph 12 above, the Developer is allowed to transfer land only on lease basis and the structures such as buildings constructed thereon to various units on sale or lease basis. The lease rentals in respect of a building may specifically or otherwise comprise lease rentals for land also.

16. Accounting Standard (AS) 19, *Leases*, classifies leases into operating leases and finance leases keeping in view the principle of substance over form as to whether substantially all the risks and rewards incidental to ownership of an asset are transferred to

the lessee by the lessor. Where such risks and rewards are transferred, a lease is termed as 'finance lease' otherwise the same is termed as an 'operating lease'. The Accounting Standard also prescribes that the asset under a finance lease is recognised in the financial statements of the lessee whereas the asset under an operating lease continues to be recognised in the financial statements of the lessor. The Standard also prescribes the measurement of various assets and liabilities in the financial statements of the lessor and the lessee. It may be mentioned that AS 19 excludes from its scope the leases of land. Accordingly, the leases of land should be accounted for as recommended in the following paragraphs.

17. The Developer should be considered to have transferred to the lessee the right-to-use land over the lease term. In other words, the lessor exchanges all, or a portion of, the leased land for the right to receive payments over the lease term and it retains the right to the leased item at the end of the lease term. Where a Developer leases out either the entire asset or a portion of the asset, the following treatment should be applied to that part of the asset which is let out on lease.

The developer should derecognise only a portion of the leased asset and recognise a receivable for its right to receive rentals at an amount equal to the net investment in the lease. Thus, where the net investment is equivalent to or more than the fair value of the land, the Developer should show land at a nominal value of Re 1. Where the aforesaid amount is less than the fair value of land, the portion representing the excess of fair value over the aforesaid amount should continued to be shown as land; it represents the portion of right-to-use of land not transferred to the lessee, but retained by the Developer. For example, where a Developer has leased out land having a fair value of Rs 1 crore in return of lease rentals whose present value is Rs 30 lakh (net investment in lease), it will continue to show land at Rs 70 lakh and receivable at Rs 30 lakh. The portion of right to use asset of Rs. 70 lakh is, in essence, a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. Accordingly, it would be appropriate to retain such portion of the asset in the books of the lessor.

18. The land and the buildings elements of a lease of land and buildings are considered

separately for the purpose of lease classification. The land element is accounted for as explained in paragraph 17 above. The buildings element is classified as a finance or operating lease in accordance with the requirements of AS 19.

19. Whenever necessary, in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and the buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

20. For a lease of land and buildings in which the amount that would initially be recognised for the land element, in accordance with paragraph 18, is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with AS 19. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.

Accounting for activities performed after notification of SEZ

Accounting for Land Development Costs

21. Land development costs of the nature stated in paragraph 7 above should be capitalised as part of the cost of land. For the purpose of AS 16, *Borrowing Costs*, land should ordinarily be considered as a qualifying asset and borrowing costs should accordingly be capitalised.

Accounting for construction of buildings and infrastructure costs

22. As mentioned earlier, the SEZ Developer would transfer various residential, commercial and industrial structures generally in the form of buildings to various units on sale or lease basis. In case of lease, while the land element should be accounted for as

recommended in paragraph 17 above, the lease of buildings element should be accounted for in accordance with the requirements of AS 19. Thus, buildings given on lease should be accounted for by the Developer as finance leases or operating leases. However, when a Developer starts developing/construction activities, he does not ordinarily have the information as to the extent of buildings that will be sold or transferred on finance lease and operating lease. Keeping in view the fact that the accounting treatment during development/construction stage would also require classification of such buildings into inventories work-in-progress (where these are to be sold or transferred on finance lease since on completion thereof significant risks and rewards of ownership will be transferred to the lessee) and as capital work-in-progress (where these are to be transferred on operating lease), the Developer should make a reasonable estimate as to the extent to which the buildings are expected to be sold or transferred on finance lease and on operating lease.

23. The cost of buildings estimated to be sold or transferred on finance lease should be arrived at in accordance with the requirements of Accounting Standard (AS) 2, *Inventories*. These inventories should be valued at the lower of cost and net realisable value.

24. Strictly, the cost of buildings to be treated as inventories work-in-progress and capital work-in-progress should be arrived at on the basis of the relevant Accounting Standards, namely, AS 2 and AS 10, *Accounting for Fixed Assets*, respectively. However, keeping in view the principles of arriving at the cost under the respective Accounting Standards, the cost in both cases would be similar, namely, it would comprise the cost of materials, labour, overheads and other directly attributable costs in bringing the buildings in their present condition. In both cases, costs would also include borrowing costs as per Accounting Standard (AS) 16, *Borrowing Costs*, since buildings would ordinarily be considered as a 'qualifying asset' for the purpose of that Standard.

25. For buildings expected to be sold or transferred on finance lease, the net realisable value should be arrived at keeping in view the definition of the term 'net realisable value' and, in case of lease, the requirements of AS 19 in this regard. AS 2 defines 'net realisable value' as follows:

“Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale”.

26. For arriving at the selling price, for the purpose of the requirements of AS 19, the selling price at the commencement of a finance lease is the fair value. If the present value of minimum lease payments expected to accrue to the Developer computed at a commercial rate of interest is lower than the fair value, the amount to be estimated as sale revenue is the present value so computed.

Accounting for cost of creating infrastructure facilities

27. The cost of infrastructure facilities should be arrived at in the same manner as that of the cost of the capital work-in-progress for residential, commercial and industrial structures discussed above.

Accounting for Costs of Rehabilitation and Resettlement (R&R)

28. As stated earlier, the Developer has the obligation to rehabilitate and resettle the persons affected by the SEZ development activities. In some cases, the SEZ Developer, besides having legal and contractual obligations to rehabilitate and resettle the affected persons, may voluntarily undertake to perform certain other R&R activities. From the accounting perspective, the following two issues arise with regard to the R&R expenditure:

- (i) The timing of the creation of the provision for R&R expenditure:
- (ii) The corresponding debit in respect of the provision, i.e., whether the same should be capitalised or recognised as an expense in the statement of profit and loss.

29. With regard to the timing of the creation of the provision, Accounting Standard (AS)

29, *Provisions, Contingent Liabilities and Contingent Assets*, requires that a provision should be recognised when

- “(a) an enterprise has a present obligation as a result of a past event;**
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and**
- (c) a reliable estimate can be made of the amount of the obligation.”**

30. In accordance with the above principles of recognition of provision as enunciated in AS 29, the provision for R & R expenditure should be created and accounted for as follows:

- (i) In respect of the R&R expenditure which arises on the acquisition of land as the lump-sum or annuity payment to be made by a Developer to the land seller, provision should be created at the time of the acquisition of the land itself. This is because the Developer has present obligation in this regard at the time of the acquisition of the land itself and the other two criteria for recognition are normally met at that point of time. The amount in respect of the provision should be capitalised as a part of the cost of the land. Similarly, provision should be created at the time of acquisition of land in respect of the other R&R expenditure with regard to which the Developer has a present obligation which cannot be avoided by the Developer by a future action. Such expenditure should also be capitalised as part of the cost of land.
- (ii) Where a Developer can avoid the future R&R expenditure by its future action, for example, in respect of purely voluntary R&R activities, the provision should be made at the time when such an activity starts and should be capitalised as a part of the cost of the asset where such asset is eligible to be recognised on the balance sheet of the Developer, provided the expenditure is directly attributable to bringing the asset to its intended working condition. In other cases such as those stated in (iii) and (iv) below, it should be recognised in the statement of profit and loss.

- (iii) Where a provision is not related to any asset to be recognised as the asset of the Developer, for example, R&R incurred with respect to those assets which will not be recognised by the Developer because he would not be the owner of these assets as these will be transferred to the local area administrators, for example, village panchayats, the same should be recognised in the statement of profit and loss when the provision in this regard is made.
- (iv) The R&R expenses, which are revenue in nature, e.g., revenue expenditure in respect of Education and Health Programmes, should be recognised in the statement of profit and loss for the period in which the criteria for making the provision in this regard are met.

Accounting for land acquired on lease

31. As discussed in paragraph 17, the land obtained by a SEZ Developer (lessee) on lease should be considered as the right-to-use leased asset of the lessee. This right-to-use leased asset should be measured at the present value of minimum lease payments discounted at the lessee's incremental borrowing rate. Where the entire amount is paid by the lessee upfront, the same should be recognised as the cost of the right-to-use leased land in the balance sheet of the lessee. The land acquisition and development costs as discussed in paragraphs 14 and 21, incurred by the lessee, should be capitalised as a part of the right-to-use leased asset (land). The right-to-use leased asset (land) should be amortised in the statement of profit and loss on straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the users' benefit. This is irrespective of the fact whether the lease payments are made during or after development and construction of SEZ. Insofar as the lease obligation is concerned, the lessee should allocate the finance charge over the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period and charged to the statement of profit and loss account of each period.

ACCOUNTING FOR REVENUE IN THE FINANCIAL STATEMENTS OF SEZ DEVELOPER

Revenue from lease of land

32. As stated earlier, where a Developer leases land to the lessee, it is transferring a right-to-use asset to the lessee. Because the lessor has transferred this asset to the lessee and the lessee has obtained control of it, the lessor would recognise revenue representing its sale of the right to use the asset. Accordingly, where the entire amount is paid by the lessee upfront, revenue representing the excess of amount received from the lessee towards the transfer of right-to-use the asset is recognized. However, where the lease payments are made by the lessee over the lease term, the developer would also recognise interest income on its receivable over the leased term. The aforesaid items of revenue should be recognised in the statement of profit and loss for the period to which they relate.

33. The lease deposits received before the inception of the lease (which is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principle provisions of the lease) should be considered as ‘income received in advance’ to the extent the deposits are not refundable. The income from lease should be recognised in the statement of profit and loss only after the inception of the lease as discussed in the above paragraph.

Lease of buildings

Finance leases

34. As per the principles laid down in AS 19, a finance lease of a building by a Developer gives rise to two types of income, viz.,

- (a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

35. In case the entire amount is received from the lessee upfront at the inception of the lease there will be no finance income and the entire amount would be recognised as sale and profit/loss recognised in accordance with paragraph 34(a) above.

36. The sales revenue recorded at the commencement of a finance lease term should be the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed. The cost of sales recognised at the commencement of the lease term is the cost, or carrying amount, if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit.

37. Where a Developer quotes artificially low rates of interest in order to attract customers, the use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

38. Other requirements of AS 19 should be followed *mutatis mutandis* by the Developer.

Operating leases

39. The Developer should present the asset given under operating lease in its balance sheet under fixed assets.

40. Lease income from operating leases of buildings should be recognised in the statement of profit and loss on a straight-line basis over the lease term, unless another

systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

41. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the receipts are not on such basis, unless another systematic basis is more representative of the time pattern in which benefits derived from the use of the leased asset is diminished.

42. The depreciation on buildings should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charges should be calculated on the basis set out in AS 6, *Depreciation Accounting*.

43. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard (AS) 28, *Impairment of Assets*, that sets out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

44. The Developer should make the disclosures in his financial statements as required in paragraphs 37 and 46 of AS 19.

Agreements for sale of buildings

45. In respect of agreement for sale of buildings, revenue should be recognised in accordance with the *Guidance Note on Recognition of Revenue by Real Estate Developers*, issued by the Institute of Chartered Accountants of India.

Accounting for revenue from Operation and Maintenance (O&M) of infrastructure facilities

46. The revenue from operation and maintenance (O&M) of infrastructure facilities should be recognised on the basis of the normal principles of revenue recognition as enunciated in Accounting Standard (AS) 9, *Revenue Recognition*, with regard to revenue from rendering of services. Where charges for infrastructure facilities are in-built in the lease rental charges of land and buildings, it would be appropriate to segregate the two on the basis of their respective fair values and recognise the same in accordance with AS 9 and AS 19.