

Opinion

EAC/1393/09

Querist: CA. R. Bhatnagar, Indian Oil Corporation Ltd., Mumbai.

Subject: Treatment of capital expenditure on assets not owned by the company.

A. Facts of the Case

1. A public sector undertaking registered under the Companies Act, 1956, is engaged in refining and marketing of petroleum products.

2. The querist has stated that sometimes when a new project, for example, setting up of a new refinery is undertaken by the company, it has to incur expenditure on the construction/development of certain assets, like electricity transmission lines, railway siding, roads, culverts, bridges, etc., in order to facilitate construction of project and subsequently to facilitate its operations. The ownership of such assets (hereinafter referred to as 'enabling assets') as well as the land on which these assets are situated does not vest with the company. The existing accounting policy of the company with respect to such 'enabling assets' is as under:

“Capital expenditure on items like electricity transmission lines, railway siding, roads, culverts, * etc. the ownership of which is not with the company are charged off to revenue. Such expenditure incurred during construction period of projects is accounted as unallocated capital expenditure and is charged to revenue in the year of capitalisation of such projects.”

(* “Oil Jetty” may be added in the year 2009-10.)

According to the querist, the 'unallocated capital expenditure' is presented in the balance sheet as capital work-in-progress (CWIP).

3. The querist has further stated that the existing accounting policy is being followed based on the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), expressed on the treatment of such expenditure as contained in Volume IX, Query No.1.32 and Volume XII, Query No.1.3 of the Compendium of Opinions. In both the opinions, EAC has referred to paragraph 10 of the Guidance Note on Treatment of Expenditure during Construction Period¹. The conclusion of the said opinions, as per the querist, is as under:

- (a) Fixed assets which, though having been built on land not belonging to the company, but are owned by the company, should form part of the relevant head of fixed assets belonging to the company and treated accordingly.
- (b) Regarding fixed assets created on land not belonging to the company, which are also not owned by the company, the expenditure incurred on the construction of such assets should be classified as 'Capital Expenditure' in the balance sheet indicating appropriately, the nature of the expenditure including the fact that the assets are not owned by the company. Also, after the commencement of commercial operations, the same should be written off to the profit and loss account.

Both the above opinions, in the view of the querist, clearly state that till the commencement of commercial operations, such expenses should be classified as capital expenditure and after the commencement of commercial operations, the same should be written off to the profit and loss account. Accordingly, as per the querist, the company is uniformly following the above accounting policy since 1999-2000.

¹ The Guidance Note on Treatment of Expenditure during Construction Period has since been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision taken at its 280th meeting held on August 7-9, 2008.

4. According to the querist, the statutory auditors of the company hold the opinion that the existing accounting treatment of such enabling assets followed by the company does not appear to be correct. The views of the statutory auditors regarding treatment of expenditure of such nature are stated by the querist as under:

S. No.	Nature of expenditure	Accounting treatment
1.	Fixed assets created on land not belonging to the company but the fixed assets are owned by the company.	Capital expenditure shall form part of the fixed assets belonging to the company and treated accordingly.
2.	(a) Fixed assets created on land where neither the assets, nor the land, belongs to the company, or (b) The expenditure is incurred by way of payment to the government / private agencies for construction of bridge, roads, etc. and the company uses such enabling assets etc. for the purpose of completing its own project and subsequently for operational purposes. Such enabling assets are available for general public use also.	(a) Expenditure to be debited to CWIP till the enabling asset is ready for use. (b) On completion of the enabling asset, the same to be capitalised. (c) Such capital expenditure to be reflected as “Capital expenditure on assets not owned by the company”. (d) Such capital expenditure to be amortised over the period of its utility but not exceeding 5 years. (e) Amount amortised to be treated as expenditure during construction period

		till the completion of the project for which the enabling asset was originally created. After the completion of the project, the amortised amount is to be charged to the profit and loss account every year for the balance period of its utility.
3.	(a) Upgrading, widening of certain portions / stretches of the road, culverts etc. on land not owned by the company to enable the movement of heavy construction equipment during the course of putting up of project.	To be accounted for as incidental expenditure during construction period.
	(b) Upgrading, widening, renovating, repairing, re-laying of certain portion / stretches of the road, culverts etc. after the completion of the project to enable the movement of vehicles / employees / general public.	To be charged to profit and loss account in the year of incurrence.

5. The querist has stated that after the withdrawal of the Guidance Note on Treatment of Expenditure during Construction Period, no direct reference to expenses of

such nature is found either in Accounting Standard (AS) 10, 'Accounting for Fixed Assets', or in Accounting Standard (AS) 26, 'Intangible Assets'. However, to understand the accounting treatment of enabling assets, the querist has drawn attention to the following definitions:

Definition of Asset:

Paragraph 49(a) of the Framework for the Preparation and Presentation of Financial Statements, issued by ICAI, defines an asset as under:

“An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise (emphasis supplied by the querist).”

Paragraph 6 of AS 26 defines, inter alia, an asset as under:

“An asset is a resource:

- (a) controlled by an enterprise as a result of past events; and***
- (b) from which future economic benefits are expected to flow to the enterprise.”***

6. According to the querist, as is clear from the above definitions, in order to recognise the expenditure as an asset, the following two conditions must be satisfied:

- (i) The company must have *control over the asset*, and
- (ii) *Future economic benefits* must flow to the company from these assets.
(Emphasis supplied by the querist.)

7. With respect to ‘control over the asset’, the querist has stated that ‘control’ has been defined/referred as under:

- Paragraph 56 of the Framework for the Preparation and Presentation of Financial Statements issued by ICAI, states as under:

“56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may *nonetheless satisfy the definition of an asset even when there is no legal control*. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.” (Emphasis supplied by the querist.)

- Paragraph 14 of AS 26 states as under:

“14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can *restrict the access of others* to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary

condition for control since an enterprise may be able to control the future economic benefits in some other way.” (Emphasis supplied by the querist.)

The querist has stated that since in most of the cases of enabling assets, *the company cannot restrict the access of others to the benefits* arising from them, it can be concluded that the company does not have control over the assets (emphasis supplied by the querist).

8. With respect to ‘future economic benefits’, the querist has stated that future economic benefits are ensured from the enabling assets since they would facilitate operations of the company. Hence, as per the querist, even though the expenditure has been incurred for obtaining future economic benefits, the criteria for recognition as an asset are not met because the company cannot restrict the access of others to enabling assets.

9. The querist has also stated that paragraph 56 of AS 26 which deals with such expenses states, inter alia, as under:

“In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but *no intangible asset or other asset is acquired or created* that can be recognised. In these cases, the expenditure is *recognised as an expense when it is incurred.*” (Emphasis supplied by the querist.)

Therefore, the querist has stated that, in the view of the company, the accounting treatment followed by the company of treating such expenditure incurred during construction of projects as unallocated capital expenditure and charging off the same to revenue in the year of capitalisation of such projects is in order.

B. Query

10. Due to divergence of opinion between the company and the statutory auditors and keeping in view the querist's view that subsequent to the withdrawal of the 'Guidance Note on Treatment of Expenditure during Construction Period', these issues have neither been covered in any of the Accounting Standards, nor the issue has been a subject matter of any query to the Expert Advisory Committee, the querist has sought the opinion of the Committee on the following issues:

- (i) Whether the current accounting treatment of considering the expenditure incurred on 'enabling assets' as CWIP during construction period of the project and charging off the same to revenue in the year of completion of the project is correct.
- (ii) Whether the accounting treatment suggested by the auditors in paragraph 4 above is correct.
- (iii) Whether such expenditure can be charged off to revenue;
 - (a) If yes, the accounting period in which such expenditure should be charged off to revenue, i.e., whether
 - in the accounting period of incurrence of such expenditure; or
 - in the accounting period in which the enabling asset is complete and ready for use; or
 - in the accounting period of completion of the main project for which such expenditure was incurred.

- (b) If yes, what should be the treatment for such expenditure which is still lying as CWIP as on date.
- (iv) If the answer to all or any of the above queries at (i) to (iii) is in the negative, what is the suggested accounting treatment for such expenditure.

C. Points considered by the Committee

11. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to accounting for construction/development of electricity transmission lines, railway sidings, roads, etc. in order to facilitate construction of the project and subsequently to facilitate its operations and the ownership of which does not vest with the company, collectively referred to by the querist as ‘enabling assets’. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, fixed assets owned by the company but created on land not belonging to the company, etc. The Committee further notes from the Facts of the Case that the expenditure on ‘enabling assets’ includes payment to the government / private agencies for construction of the ‘enabling assets’ which will be available for general public use also. In the absence of any information to the contrary, the Committee presumes that the expenditure on ‘enabling assets’ is not adjustable against any payment to be made by the company towards future use of such assets.

12. The Committee notes that paragraphs 49 and 88 of the ‘Framework for the Preparation and Presentation of Financial Statements’, issued by the Institute of Chartered Accountants of India, give respectively, the following definition of and recognition criteria for, an asset:

“An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.”

“88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.”

From the above, the Committee notes that an expenditure incurred by an enterprise can be recognised as an asset only if it is a ‘resource controlled by the enterprise’. Therefore, the issue raised by the querist requires examination from the point of view of the type of the resource that the company controls, if any, as a result of expenditure on ‘enabling assets’. For this purpose, the Committee has examined whether the expenditure results into recognition of a tangible asset or an intangible asset.

13. The Committee is of the view that the above-mentioned expenditure can be considered to result into a tangible asset, only when, the company is able to control such asset(s). The Committee is of the view that an entity that controls an asset can generally deal with that asset as it pleases. For example, the entity having control of an asset can exchange it for other assets, employ it to produce goods or services, charge a price for others to use it, use it to settle liabilities, hold it, or distribute it to owners. Further, the Committee is of the view that an indicator of control of an item of fixed asset would be that the entity can restrict the access of others to the benefits derived from that asset. This view is also supported by the principles enunciated in paragraph 14 of AS 26, as reproduced in paragraph 15 below.

14. The Committee notes from the Facts of the Case that the ownership of the ‘enabling assets’ does not vest with the company. The assets are available for general public use. Although the company is entitled to use these assets for the purpose of completing its own projects and subsequently for operational purposes, it has no say on

the use of such assets by others. Thus, none of the factors mentioned in paragraph 13 above indicating control of the company is evident. Thus, ‘enabling assets’ are not resources controlled by the company and, therefore, the expenditure incurred by the company on such ‘enabling assets’ cannot be capitalised as a separate tangible asset.

15. The Committee now examines whether the above-said expenditure results into an intangible asset for the company. In this context, the Committee notes the following paragraphs from AS 26:

“An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An asset is a resource:

- (a) controlled by an enterprise as a result of past events; and***
- (b) from which future economic benefits are expected to flow to the enterprise.”***

“14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. ...”

From the above, the Committee is of the view that the expenditure incurred by the company on ‘enabling assets’ not owned by the company does not meet the definitions of the terms ‘asset’ and ‘intangible asset’ as, even though the economic benefits are expected to flow to the enterprise from such facilities, the company does not have control

over such facilities. Accordingly, such expenditure cannot also be capitalised as a separate intangible asset.

16. Now, the question arises as to whether the expenditure incurred on ‘enabling assets’ could be considered as a component of the cost of a fixed asset/project. In this context, the Committee further notes paragraphs 9.1 and 10.1 of AS 10, which are reproduced below:

“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. ...”

“10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.”

From the above, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to the cost of a fixed asset/project under construction is that it should be directly attributable to the construction of the project/fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are those costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to its

working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by Accounting Standard (AS) 16, 'Borrowing Costs'. From the above, the Committee is of the view that the expenditure incurred on 'enabling assets' cannot be considered as directly attributable cost and accordingly, the same cannot also be capitalised as a component of fixed asset.

17. The Committee further notes that paragraph 56 of AS 26 provides as below:

“56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. ...”

From the above, the Committee is of the view that the expenditure incurred on 'enabling assets' should be expensed and charged to the profit and loss account of the period in which these are incurred.

18. As far as accounting treatment given by the company in respect of such 'enabling assets' which are still lying as capital work-in-progress as on the date is concerned, the Committee notes that as per the Announcement on Clarification on Status of Accounting Standards and Guidance Notes, issued by the Institute of Chartered Accountants of India, “In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard. ...” Accordingly, the Committee is of the view that the recommendations of a Guidance Note would be applicable only to the extent these are not contrary to an Accounting Standard. Hence, the recommendations of the 'Guidance Note

on Treatment of Expenditure during Construction Period’, after AS 26 becoming applicable to the company (even before the withdrawal of the said Guidance Note) were applicable only to the extent these were not contrary to the provisions of AS 26. Therefore, since, after AS 26 became applicable to the company, the expenditure incurred on ‘enabling assets’ was not expensed by the company as per the requirements of AS 26, as discussed above, the same is an error committed in the prior years which should be rectified in the financial statements and disclosed as a ‘prior period item’ of the period in which such rectification is carried out in accordance with the requirements of Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’.

D. Opinion

19. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

- (i) No, the existing accounting treatment followed by the company of considering the expenditure incurred on ‘enabling assets’ as capital work-in-progress during construction period of the project and charging off the same to revenue in the year of completion of the project is not correct.
- (ii) No, the accounting treatment suggested by the auditors with regard to the ‘enabling assets’ is also not correct.
- (iii)(a) Yes, the expenditure incurred on enabling assets not owned by the company should be charged off to revenue in the accounting period of incurrence of such expenditure.

- (b) Expenditure on such assets not owned by the company appearing as CWIP, being an error should be rectified and disclosed as a 'prior period item' as per the requirements of AS 5 in the financial statements of the period in which such rectification is carried out as discussed in paragraph 18 above.

 - (iv) The expenditure on 'enabling assets' should be expensed by way of charge to the profit and loss account of the period in which the same is incurred.
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