NANGIA & CO LLP
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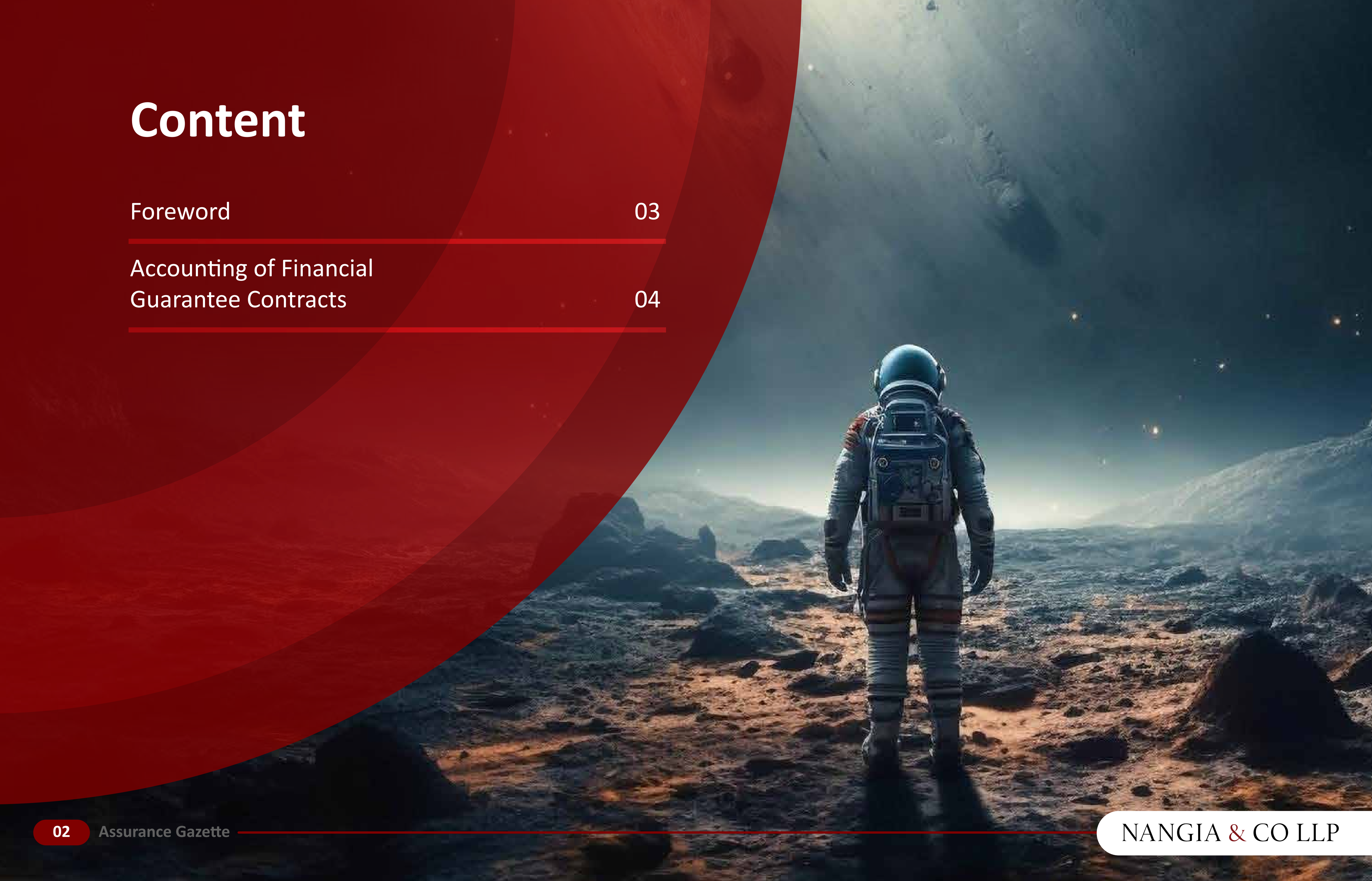

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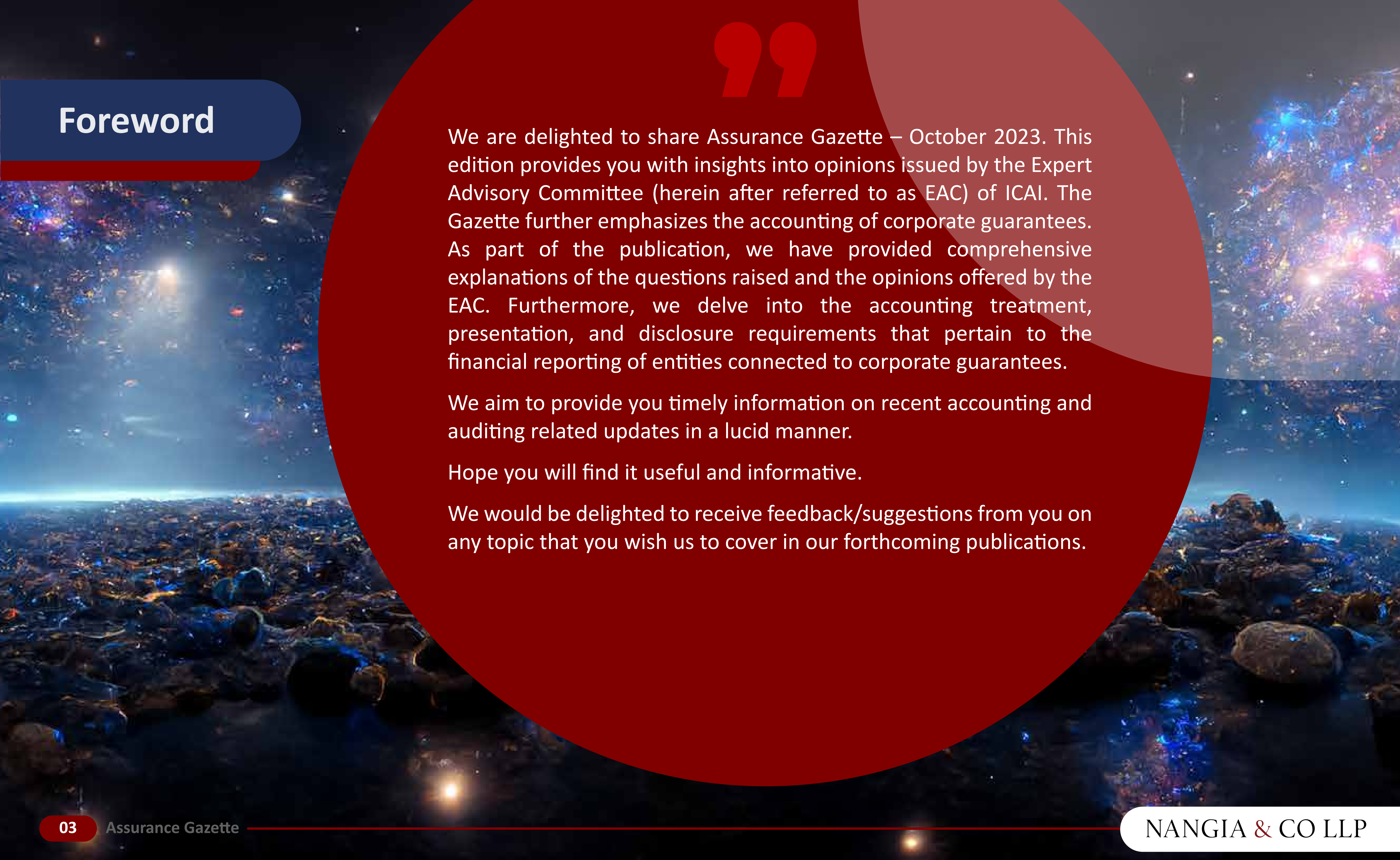

Foreword

We are delighted to share Assurance Gazette – October 2023. This edition provides you with insights into opinions issued by the Expert Advisory Committee (herein after referred to as EAC) of ICAI. The Gazette further emphasizes the accounting of corporate guarantees. As part of the publication, we have provided comprehensive explanations of the questions raised and the opinions offered by the EAC. Furthermore, we delve into the accounting treatment, presentation, and disclosure requirements that pertain to the financial reporting of entities connected to corporate guarantees.

We aim to provide you timely information on recent accounting and auditing related updates in a lucid manner.

Hope you will find it useful and informative.

We would be delighted to receive feedback/suggestions from you on any topic that you wish us to cover in our forthcoming publications.

Accounting of Financial Guarantee Contracts

Accounting for financial guarantee contracts in India is a critical aspect of financial reporting, as it involves the recognition, measurement, presentation, and disclosure of these contracts in a company's financial statements. This article provides a detailed overview of how financial guarantee contracts are accounted for in India, including relevant accounting standards, recognition criteria, measurement, presentation, and disclosure requirements.

Introduction to Financial Guarantee Contracts

Financial guarantee contracts are legally binding agreements where one party (the guarantor) promises to make specified payments to the beneficiary if the debtor fails to meet its financial obligations. Financial guarantee contracts are commonly used in various financial transactions, such as loans, bonds, and trade credit arrangements.

Accounting Standards in India

The accounting treatment of financial guarantee contracts in India is governed by the Indian Accounting Standards (Ind AS), which are converged with the International Financial Reporting Standards (IFRS). Ind AS 109, "Financial Instruments," and Ind AS 107, "Financial Instruments: Disclosures," are the primary accounting standards that provide guidance on the recognition, measurement, and disclosure of financial guarantee contracts.

Recognition of Financial Guarantee Contracts

Recognition refers to including financial guarantee contracts in a company's financial statements. Financial guarantee contracts are recognized when the following conditions are met:

- **Existence of a Guarantee:** There must be a legally enforceable guarantee in place.
- **Probability of Outflow:** It is probable that the guarantor will have to make payments under the guarantee when the specified triggering event occurs.
- **Reliable Measurement:** The obligation can be reliably measured. This means that the potential outflow of resources can be estimated with sufficient reliability.

Measurement of Financial Guarantee Contracts

Once recognized, financial guarantee contracts are measured at the higher of two amounts:

- **Initial Measurement:** The amount initially recognized as the **fair value** of the guarantee (usually the guarantee fee or premium received), less any transaction costs directly attributable to the issuance of the guarantee.
- **Subsequent Measurement:** The liability recognized is subsequently measured at the **higher** of the following:
  a. The amount determined under the expected credit loss (ECL) model, as per Ind AS 109. This model estimates the expected credit losses over the life of the guarantee.
  b. The amount initially recognized, less any amortization of the premium received on the guarantee.

Presentation of Financial Guarantee Contracts

Financial guarantee contracts are presented in a company's balance sheet as a liability, typically under **"Provisions" or "Financial Liabilities."** The accounting entries for financial guarantee contracts involve recognizing the liability initially and then updating it based on changes in expected credit losses.

Disclosure Requirements

Indian Accounting Standards mandate comprehensive disclosures related to financial guarantee contracts in the notes to the financial statements. These disclosures should provide users of the financial statements with a clear understanding of the nature and extent of the guarantees, including:

- The nature and terms of the guarantee contracts, including any conditions and contingencies.
- The maximum potential amount of future payments under the guarantees.
- Any collateral held as security for the guarantees.
- Changes in the carrying amount of the guarantee liability during the reporting period.
- The risk management policies and strategies employed for managing financial guarantee contracts.

Nangia's Take

Accounting for financial guarantee contracts in India follows the principles outlined in Indian Accounting Standards, specifically Ind AS 109 and Ind AS 107. It involves the recognition of guarantees based on the probability of outflows and reliable measurement, measurement at the higher of initial recognition or expected credit loss, presentation as a liability in the balance sheet, and comprehensive disclosure in the financial statements. Accurate accounting and disclosure of financial guarantee contracts are essential to provide transparency to investors and stakeholders and ensure compliance with regulatory requirements. Companies must carefully adhere to these accounting standards to maintain the integrity and reliability of their financial reporting.

The Expert Advisory Committee of ICAI is a vital body that assists the Institute in various matters related to the accounting profession, financial reporting, auditing, and other relevant areas. Its primary role is to provide expert advice and guidance on technical matters to ensure that the standards, guidelines, and practices followed by chartered accountants are in line with international best practices and regulatory requirements. EAC provides opinions on entity specifi c issues referred to it by the members of the institute across all industries as well as by regulatory and government bodies.

Following are some of the important EAC opinions issued in recent months:

Query 1

Recognition of interest on mobilisation advance against project contracts under Ind AS Framework

Background

A Company is a public sector enterprise under the administrative control of the Ministry of Mines, Government of India and is engaged in mining of Bauxite, manufacturing of Alumina and Aluminium, generation of power at Captive Power Plant for use in Smelter and selling of Alumina and Aluminium both in domestic and international markets.

The Company has awarded various contracts for execution of the Project and in order to quick startup of the Project, there is an optional clause for availing interest-bearing mobilisation advance upto fixed percentage of the contract value. Some vendors have opted for mobilisation advance and the Company is recovering interest from vendor's running bills against supply of goods/services. The interest recovered and accrued on mobilisation

advance are recognised as interest income of the Company and credited to the Statement of Profit and Loss. All the amount incurred by the Company's is out of own internally generated funds without any borrowing element.

Observation in audit/Query

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

Views of the management

The Company stated that paragraph 21 of Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' prescribes that "Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. …" Even if, the contracts would not have such interest-bearing advance clause, the vendor would execute the contract from its own source/ bank fund etc. Hence, such mobilisation advance payment/ interest income thereof may not be directly attributable to the cost of asset acquired.

Further, Ind AS 23, 'Borrowing Costs' mandates to add the borrowing costs net of income, if any. However, as there is no borrowing cost element in the project cost of the Company, any adjustment of interest on mobilisation advance sourced from internal reserve will reduce the natural project cost. Furthermore, according to the Company, adjustment of interest income against mobilisation advance not funded through borrowing, in the project

cost may lead to understatement of income and understatement of cost of 'Property, Plant and Equipment (PPE)'. It may lead to non-uniformity in the recognition of PPE from contract to contract depending on option of such mobilisation advance availed by the contractors.

EAC opinion

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

Query 2

Accounting treatment of export incentives

Background

The Company was receiving following two types of export incentives:

a. **Incentive by way of duty credit scrips under RoDTEP Scheme (prior to 1.1.2021 known as Merchandise Exports from India Scheme (MEIS)):** These duty scrips are due at the time of realisation of foreign currency against the export. Duty credit scrips can be used by the Company for payment of import duty, or it is also tradeable in the market, value of which varies from 80% to 95% of value of scrips depending upon the demand and supply of duty credit scrips in the market. This incentive is due on realisation of export proceeds and after completing administrative formalities with the concerned department. Accordingly, income is booked on receipt of duty credit scrips based on estimated market value which varies from 80% to 95% of value of duty credit scrips.

b. **Duty Drawback incentive:** In this scheme, the Company gets the cash incentive which varies from 1.5% to 2.0% of FOB value depending upon the HSN code under which exported material is covered. Duty drawback incentive is due at time of export of goods and the amount of eligible duty drawback is endorsed by the custom authority on the shipping bill. Accordingly, revenue on account of duty drawback as export incentive is being recognised at the time of export.

The Company is recognising both the above export incentives as ‘other operating income’, since export incentive is directly linked with the revenue from operations (export segment) of the Company.

Observation in audit/Query

1. Paragraph 20 of Ind AS-20 on Accounting for Government Grants and Disclosure of Government Assistance states that the Grants related to income are sometimes presented as a credit in the statement of profit and loss, either separately or under a general heading such as ‘Other income’; alternatively, they are deducted in reporting the related expense.
2. Paragraph 39 of Ind AS-20 states that the accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements shall be disclosed. During audit, it was observed that the significant accounting policy on Export Incentives disclosed the method of presentation adopted in the financial statement. Hence, the disclosure made is deficient to that extent.

EAC opinion

The benefits of incentive/ duty draw back are ‘government grants’ as per the provisions of Ind AS 20. The presentation of the income from government grant as ‘other operating revenue’ in the extant case is not inappropriate. Also, as discussed in paragraph 13 above, the disclosure requirements as per Ind AS 20 should be complied with by the Company with regard to incentives in the extant case.

Query 3

Accounting treatment of subsequent expenditure as per Ind AS 16, ‘Property, Plant and Equipment’

Background

The Company is mainly engaged in mining, production and marketing of raw coal required for power, cement and other sectors. The Company also operates coal washeries to reduce the ash contents of coal and improves its heating value so that cooking washed coal required for steel and another sector may also be produced. The Company is operating washery plant. The said washery plant is commissioned in June 1986. The initial design capacity of the said washery is 3 million tonne per year (MTY). In washery plant, the capacity of plant is determined on the basis of the capacity of raw coal fed to the said plant for washing. As per the technical evaluation, the useful life of coal washery plant is determined as 15 years. The washery plant has completed its useful life in the financial year (FY) 2001-02 and the said plant is still in the operation solely on account of regular maintenance activities carried out by the Company. However, the capacity utilisation of said washery plant was very poor. There was also increase in breakdown hours. If a new washery plant of capacity of 3 MTY is constructed presently, it may have total cost estimation of around Rs. 300 crores.

A contract value of Rs. 42.92 crore including GST was awarded to contractor. The work awarded inter alia includes Design and Engineering, supply and fabrication along with strengthening of existing civil and structural works, erection, commissioning, trial run, performance guarantee test and operation and maintenance for 4 years under defect liability period. Till date, the total executed works out of the awarded contract value of Rs. 42.92 crore is around Rs. 28.10 crore. The Company has recognised the incurred cost of Rs. 28.10 crore in the Statement of Profit and Loss considering the following aspects of the transaction:

As the replacement activities undertaken related to a particular section of an item of PPE (Property Plant and Equipment) i.e., say improvement in particular section of washing section / fine coal section / coal handling and dispatch section, hence, the probability of future economic benefits associated with the item as whole (i.e., an asset) could not be established. Moreover, as such, the said expenditure is not related to PPE as a whole. Hence, the reliable estimation of the enhancement of further useful life of whole PPE could also not be technically established.

Further, the Company followed Component accounting and followed the following policy:

"Threshold value of the asset requiring componentisation to be Rs. 10 crore and above as any assets below Rs. 10 crore will not have any material effect on the financial statements. While considering the threshold value in percentage of cost component to the total cost of the asset, the Company considered that the component having value not less than 20% of the total cost of the asset will be treated as significant and eligible for component accounting, if other conditions are fulfilled." As such, according to the Company, none of the items of contractor's BOQ qualifies for recognition as PPE.

The Company has also stated that washery has lived its rated life 20 years back and there is no reliable estimation that the said repair will enhance the life of the washery. The activity of repairing is undertaken basically to improve the operation of the washery, because even if the said repair improves the capacity even by 10%, then the actual expenses of Rs. 42.92 crore would be recovered in a very short span of time. Based on the past data, it is expected that the said expenditure would be recovered with in a period of 6 to 9 months post repair.

Query 4

In view of above, the Company had sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issues:

i. Whether the accounting treatment extended by the Company for replacement activities and restoration of selected structural, civil and other support system with an aim to improve the operational efficiency and reduction in maintenance / breakdown hours after the useful life of the washery is as per the applicable provisions of Ind AS 16, 'Property, Plant and Equipment' (i.e. the said expenses to be charged as expenses in the Statement of Profit and Loss as and when incurred).

ii. If not, then, how the said expenditure is to be accounted for and what should be the basis for determination of useful life in the given case for provision of depreciation.

Points considered by the Committee

The Committee pointed out that though the querist has mentioned that the expenditure incurred on individual system/part/ component is insignificant as compared to the overall cost of new washery, from accounting perspective, the matter requiring consideration is 'materiality' as defined under Ind AS 1, 'Presentation of Financial Statements'.

Points considered by the Committee

The Committee pointed out that though the querist has mentioned that the expenditure incurred on individual system/part/ component is insignificant as compared to the overall cost of new washery, from accounting perspective, the matter requiring consideration is 'materiality' as defined under Ind AS 1, 'Presentation of Financial Statements'.

The Committee was of the view that determination of what is 'material' involves significant judgement considering the nature and/ or magnitude/size of the information, assessed not only individually, but also in combination with other information and which could reasonably be expected to influence decisions of primary users of general purpose financial statements. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an entity's financial statements. Consequently, to determine what could be material in a particular situation requires judgement, in the specific facts and circumstances, considering the requirements of Ind AS 1.

The Committee noted requirements of Ind AS 16 that recognition principle as laid down in the Standard is equally applicable to the costs incurred subsequently to add to, replace part of, or service an item of property, plant and equipment (PPE). Thus, any expenditure that meets the recognition criteria under paragraph 7 should be capitalised as part of the cost of PPE and if it does not, it should be recognised in the statement of profit or loss. Further, the Committee notes that as per paragraph 12 of Ind AS 16, expenditure on minor repairs and maintenance, including replacement costs of small parts and cost of day-to-day servicing of the items is to be recognised in profit or loss as and when incurred and only an expenditure that meets the conditions of recognition as per paragraph 7 of Ind AS 16, is recognised in the carrying amount of an item of property, plant and equipment.

The Committee noted that in the extant case, it is stated that the activity of repairing is undertaken basically to improve the operation of the washery and that even if the said repair improves the capacity by 10%, then the actual expenses of Rs. 42.92 crore are expected to be recovered in a period of 6 to 9 months post repair. Thus, the expenditure incurred will improve the operations of washery and will enhance its capacity. Therefore, the Committee is of the view that it will lead to future economic benefits in terms of improvement in operations and capacity of the washery plant. Further, since the cost incurred can be reliably measured, the recognition criteria under paragraph 7 of Ind AS 16 are met and hence, the Company should capitalise such expenditure as cost of the washery plant. Further, the contractor has committed to provide operation and maintenance for 4 years under defect liability period, which indicates that the improved asset will atleast be operational for 4 years after the expenses incurred on enhancement/improvement. Therefore, the Committee is of the view that an estimation of life should be made by the Company considering various factors as mentioned in paragraphs 56 and 57 of Ind AS 16, reproduced above including, technical evaluation, past experience, defect liability period, etc.

EAC opinion

The accounting treatment extended by the Company for replacement activities and restoration of selected structural, civil and other support system with an aim to improve the operational efficiency and reduction in maintenance / breakdown hours after the useful life of the washery will not be appropriate as per the requirements of Ind AS 16 'Property, Plant and Equipment', if such expenditure, in aggregate, can be considered to be 'material', as per the requirements of Ind AS 1 in the context of washery plant as a whole, as discussed in paragraphs 14 and 15 above. If the expenditure incurred is material, since it will lead to future economic benefits in terms of improvement in operations and capacity of the washery plant and the cost incurred can be reliably measured, the recognition criteria under paragraph 7 of Ind AS 16 are met; and hence, the Company should capitalise such expenditure as cost of the washery plan.

Nangia's take

EAC opinions are a great source of knowledge for professionals. It provides us guidance and advice in the matters of application and implementation of accounting and auditing principles.

Meet our Experts

Vikas Gupta
Partner - Audit & Assurance
vikas.gupta@nangia.com

Prateek Agarwal
Partner - Audit & Assurance
prateek.agarwal@nangia.com

Vikram Singh Pratap
Partner - Audit & Assurance
vikram.pratap@nangia.com

Jaspreet Singh Bedi
Partner - Audit & Assurance
jaspreet.bedi@nangia.com

With Inputs from

Avneet Singh
Director - Audit & Assurance
avneet.singh@nangia.com

Shalu Kedia
Director - Audit & Assurance
shalu.kedia@nangia.com

Sachin Gupta
Senior Associate - Audit & Assurance
sachin.gupta@nangia.com

Noida
(Delhi NCR - Corporate Office)
A-109, sector 136, Noida 201304, India
T : +91 120 259 8000

Delhi
B-27, Soami Nagar, New Delhi-110017, India
T : +91 120 2598000

Gurugram
001-005, Emaar Digital Greens Tower-A 10th Floor, Golf Course Extension Road, Sector 61, Gurgaon-122102, India
T: 0124-4301551

Mumbai
4th Floor, Iconic Tower, Urmi Estate,95 Ganpatrao Kadam Marg, Lower Parel, Mumbai - 400 013, India
T: +91 22 6173 7000

Chennai
Palladium Bayan, Level 5, 129-140, Greams Road, Thousand Lights, Chennai 600006, India
T: +91-44-46549201

Bengaluru
Prestige Obelisk, Level 4, No 3 Kasturba Road, Bengaluru - 560 001, Karnataka, India
T: +91 80 2248 4555

Pune
3rd Floor, Park Plaza, CTS 1085, Ganeshkhind Road, Next to Pune Central Mall, Shivajinagar, Pune - 411005

Dehradun
First Floor, "IDA" 46 E. C. Road, Dehradun - 248001, Uttarakhand
T: +91 135 271 6300

www.nangia.com | query@nangia.com