Creation of an Intangible Asset (License) on Account of Pre-operational Expenditure

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is the wholly owned subsidiary company of ABC India Limited and is the largest maintenance repair and overhaul (MRO) set up in India that can serve as a one-stop-shop for all aviation engineering requirements.

2. In accordance with the Cabinet approved Turn Around Plan / Financial Restructuring Plan (TAP/FRP) for ABC India Ltd., the entire engineering activities of ABC India Limited were hived off to the Company.

3. It was agreed to give effect to above hiving off of engineering services, all equipment, tools, machinery etc. and also, the personnel of the engineering services would be transferred to the Company. The immovable properties connected with the engineering services e.g. hangars, workshops, buildings, offices etc. had not been transferred to the Company but ABC India Limited has provided requisite right to the Company to use such hangars, workshops etc. However, it was also agreed that necessary / requisite licenses, approvals, accreditations from regulatory authority would be obtained by the Company.

4. The Company would operate as an independent Maintenance, Repairs and Overhaul facility (MRO) to provide maintenance, repairs, overhaul and test of aircraft engines and components. The Company would be providing MRO services to ABC India Ltd. and its group of companies and also to other Indian and foreign airlines.

5. Considering the proposed scope of activities of the Company, MRO capability for overhaul, repair and test of engines, APUs, components including structural repair, landing gear repair etc. is required to be established at different major bases all over India. To carry on work as MRO providing services to various types of aircrafts, such facilities have to be established in accordance with regulations of Director General of Civil Aviation, India (DGCA) particularly keeping in view the 'Business Plan' of the new entity. After establishment of entire facility at various bases in India, the MRO operator has to demonstrate its capabilities for carrying on the activities to the DGCA India.

6. The DGCA India after inspection of facilities and being satisfied that the MRO operator has the requisite capabilities in place, grants license 'CAR 145' to provide maintenance, repairs, overhaul and test of aircraft, engines and components as defined in its scope of approval. For obtaining DGCA License 'CAR 145', it is essential to submit the Business Plan of the applicant company and to demonstrate to DGCA that all necessary requirements/facilities for carrying on MRO activities are in place and available.

7. Only on all compliance with all requirements and setting up of all facilities as per DGCA specifications, DGCA carries out inspection and grants the License 'CAR 145'. 'CAR 145' is the most essential requirement for MRO operation as no activities can be undertaken without obtaining the License from DGCA.

8. The querist has informed that the major facilities required for MRO would include:

   (i) Various structures/facilities e.g. hangars, workshop, building and associated offices at various important bases in India, as per Business Plan submitted by the Company.

   (ii) Equipment, tools and material used for maintenance of aircraft and

   (iii) Requisite personnel i.e., aircraft maintenance engineers, technicians and other support staff.

As such, MRO is a capital intensive industry and at present, the returns are low and there is a long payback period.

9. The entire facility (physical and technical personnel) set up and available, commensurate with the 'Business Plan' presented to DGCA is a pre-requisite for issue of license. After rigorous inspection of all facilities by DGCA, License CAR 145 is granted by DGCA.

10. The Company submitted its 1st application to DGCA for approval in December 2013. The application was resubmitted in February 2014 followed by presentation to the DGCA in June 2014. Modifications were made in accordance with discussion with DGCA and application was resubmitted in July 2014. After inspection of MRO facilities, personnel, equipment & tools and records at all bases in India, DGCA granted approval to MRO facilities of the Company w.e.f. 1st January, 2015.

11. Simultaneously with application to DGCA for the License, transfer of requisite assets, particularly specialised facilities meeting requirements of DGCA for planned work was made on 1st April, 2014. However the requisite, sufficient and qualified personnel and payroll was transferred to the Company only on 1st October, 2014 when the entire process of obtaining approval of DGCA was at a very advanced stage. The business of the Company was finally set up on 1st January, 2015 on receipt of DGCA License – CAR 145 and the Company could commence its business activities w.e.f. 1st January, 2015.

12. During the period up to 1st January, 2015 before the business of the Company was set up, following expenses were incurred:

(₹ in crores)

Hangars, Workshops, Buildings	
Rent, Rates & Taxes	5.24
Electricity & Water	9.26
Maintenance of Equipment	3.18
Personnel Expenses Aircraft	
Maintenance Engineers, Technical Officers	
Salary to Technicians/Engineers	248.19
Travelling & other expenses	4.33
Miscellaneous & Others	1.19
	₹ 271.39

The querist has stated that during the period upto 1st January, 2015, i.e., before the business of the Company was set up, the above referred expenses of ₹ 271.39 Crore, incurred on cost of manpower, rent & related expenses on hangar-workshop facilities, maintenance of equipment, etc. were incurred only to comply with stringent requirements of DGCA for issuing 'License' (without which the Company could not do any MRO work and bring its asset to commercial use) and are directly attributable to it considering as pre-requisite to obtain such license; and were capitalised as cost of License under 'Intangible Assets' for its intended use to work as an MRO in F.Y. 2014-15. Had the cost of manpower been considered from the date of intended transfer in February 2013, the Company would have to incur huge cost without its commercial use.

13. According to the querist, the main conditions for capitalising an internally generated asset as per Accounting Standard (AS) 26, 'Intangible Assets' corresponding to International Accounting Standard (IAS) 38, 'Intangible Assets' as intangible asset are:

    i. Asset will generate future economic benefits;

    ii. The intangible asset is available for use;

    iii. Ability to measure the expenditure attributable to obtain the intangible asset.

Since all these conditions were satisfied in the relevant case and DGCA License would be an asset enabling the Company to receive economic benefits in future, all the expenses incurred for obtaining such License were considered to be directly attributable to obtaining the License.

14. In the financial year (F.Y.) 2017-18, the Company has chosen to prepare financial statements as per Indian Accounting Standards (Ind ASs). As per paragraph 88 of Ind AS 38, the intangible assets can either have a definite life or indefinite life. As per paragraphs 107 and 108 of Ind AS 38, in case of assets with indefinite life, the intangible asset has to be tested for impairment.

15. The Company has tested the intangible assets for impairment and the Company is of the firm opinion that same need not to be amortised, particularly in view of rapid growth of Indian aviation sector which has increasing demand for existence of MRO in the vicinity and also, recent initiatives for development and support to MRO in India, by the Government of India under its 'Make in India' programme will further boost the revenue from MRO, apart from the capability enhancement during past four years.

16. As such, the Company has decided not to amortise the intangible assets, which is

also in line with the provisions stated in Ind AS 38/AS 26. For past four years, the issue of creation of intangible asset and amortisation of same has become a matter of debate. Also, last year, the auditors of the Company have raised a query as regards to non-recognition of any revenue during the pre-commencement period, i.e., from October to December 2014.

B. Query

17. The opinion from the Expert Advisory Committee of ICAI is sought on the following issues:

    (i) Whether the decision taken by the Company in F.Y. 2014-15 was correct to create the intangible assets as regards to salary expenses booked for engineers to the tune of ₹ 248.19 crores, on account of pre-operation expenditure incurred by the Company during the period October-December, 2014; these expenses include only salary expenses for engineers.

    (ii) While the Company has tested the intangible assets for impairment and in view of the fact that due to capability enhancement by the Company and other factors, there is no diminution in the value of assets so created, whether the decision to not amortise the assets so created, as regards to salary expenses booked for engineers as stated in above point (i) is correct.

    (iii) The Company could commence its business only from the date 1st January 2015. Though the Company has got the required license (CAR 145) on 1st January, 2015, the staff of the Company had rendered the services to the holding company – ABC India Ltd., group of companies and other customer during the period 1st October to 31st December, 2014 under the license CAR 145 of ABC India Ltd. Since the Company did not have the required license CAR 145 in its own name, the Company was not in position to bill to any party for the services so rendered during such period. Whether the decision of the Company not to bill for the services rendered by the Company during the period 1st October to 31st December, 2014, is correct.

C. Points considered by the Committee

18. The Committee notes that the basic issue raised by the querist relates to whether capitalisation of expenditure relating to salaries for engineers/technicians during the pre-operative period (October to December 2014), as cost of License under 'Intangible Assets' was appropriate. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting treatment of any other expenditure incurred by the Company on acquisition of license, such as license fee (if any) and other pre-operative expenses, such as, travelling & other personnel expenses, rent, rates & taxes, electricity & water, maintenance of equipment, and other related expenses on hangars, workshop, and buildings; accounting for right to use of hangars, workshops, etc.; appropriateness of recognising license as a separate intangible asset by the company; accounting for prior period errors (if any) due to non-compliance of the requirements of the accounting standards or Indian Accounting Standards; etc. Further, the Committee has not examined whether the salaries of engineers were recoverable or not from the holding company and whether any other asset is therefore required to be recognised by the Company for the services rendered by the employees (engineers) of the Company.

19. With regard to recognition of costs on salaries of engineers/technicians during pre-operative period as intangible asset in respect of License, the Committee notes that since the expenditure on account of salaries of engineers have been incurred during the period October to December 2014, when Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 were applicable, the Committee has hereinafter examined these Standards. In this context, considering that License has been separately acquired from the DGCA India, the Committee notes the requirements of Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006 as follows:

"Separate Acquisition

…

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost."

From the above, the Committee notes that when an intangible asset is separately acquired, only the purchase price (including any import duties and other taxes) and the expenditure which are directly attributable for making the asset ready for its intended use are included in the cost of asset.

The Committee is of the view that the cost incurred on account of salaries of engineers/technicians from October to December 2014 are the cost of holding the team of engineers till the time the License is acquired rather than the cost incurred to acquire the License as during this period, the engineers are rendering services to the holding Company or on its behest to the third party. Although these may be incurred during the period when the License is being acquired and having a team of engineers may be a pre-requisite for obtaining the License, these are neither incurred to acquire or generate the license nor are directly attributable or allocable to acquisition/generation of license. Further, these costs are required to be incurred for the whole of the business; and are in the nature of period costs, which would have been incurred irrespective of whether the Company will get the license or not and would also be continued to be incurred even after the license is obtained. Thus, these costs cannot be considered as directly attributable expenditure for acquiring the intangible asset or making the asset ready for its intended use, as per the above-reproduced requirements of AS 26. Accordingly, these costs cannot be capitalised as part of the intangible asset (License).

D. Opinion

20. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 17 above:

(i) It was not appropriate to capitalise expenditure incurred on salaries of engineers during October to December 2014, as cost of License as per the requirements of AS 26, as discussed in paragraph 19 above.

(ii) Since the expenditure incurred on salaries of engineers was not required to be capitalised as intangible asset, the question of any impairment or amortisation on such intangible asset created purely on account of salary costs does not arise.

(iii) The issue with regard to whether the decision of the Company not to bill for the services rendered by the Company during the period 1st October to 31st December, 2014, does not involve any application of accounting/auditing principles and therefore, considering the Advisory Service Rules of the Committee, the same has not been examined by the Committee.

1.	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2.	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on August 4-5, 2020. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3.	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty six volumes. A CD of Compendium of Opinions containing thirty six volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4.	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5.	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.