Accounting for Equipments Owned by an Enterprise Installed with Another Enterprise for use by the latter.

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company is a Government of India enterprise engaged in the business of transmission of power generated by central public sector generating companies to different State Electricity Boards.

2. The company has ventured into a state-of-art project, 'Unified Load Despatch Centres' (ULDC). The ULDC are highly sophisticated and are being implemented for the first time in India. The scheme is complex in nature and international consultants of repute were engaged to assist in all phases of work as per the advice of the World Bank. The benefits of the scheme are as given below:

(i) Supervision, monitoring and control of power system on real-time basis.
(ii) Optimal operation of power system (i.e., generation and associated resources).
(iii) Minimisation and faster restoration of grid disturbance.
(iv) Improvement in the quality of supply through better control of frequency, voltage and other parameters.

3. The querist has stated that for effective implementation of the scheme it was necessary that equipments are installed in the facilities owned by the company as well as the facilities owned/operated by the State Electricity Boards. There is complexity involved in the project execution due to the state-of-art technology and paucity of funds and, therefore, the State Electricity Boards entrusted the responsibility to the company to install and implement the scheme in their units.

4. In the MOU between the company and the various State Electricity Boards, it was agreed that "the recovery of cost/charges in respect of equipment/system supplied/erected by the company in the jurisdiction of various Constituents other than Central Generating Companies shall also be recovered on fixed monthly basis apportioned to the cost incurred by company in respect of Load Despatch and Communication facilities provided for each Constituent". Presently, the ownership of equipment vests with the company and "the ownership of equipments installed at SLDC/Sub-LDCs Sub-stations and Power Stations shall be transferred to respective constituents on payment of book value to querist after full recovery of investment of the company including interest." Accordingly, levelised tariff for recovery of cost incurred by the company has been agreed to by the Regulatory Authority in principle considering life of the equipment as 15 years. For example, cost incurred by the querist in northern region is Rs. 311.93 crore and levelised tariff being allowed for 15 years is Rs. 44.37 crore per year.

5. The equipments installed are in the physical possession of the State Electricity Boards and the benefits of the system are also being drawn by them. The operational and maintenance expenditures in respect of the same are being incurred by the concerned State Electricity Boards.

6. The company has considered this as a finance lease in terms of Accounting Standard (AS) 19, 'Leases', issued by the Institute of Chartered Accountants of India. The following accounting treatment is proposed for this transaction:

(a) Cost incurred on installation of ULDCs would be shown as amount recoverable from the State Electricity Boards.
(b) The levelised tariff to be recovered in 15 years would be apportioned between the cost and interest income. Cost recovered would be reduced from the amount recoverable and interest income would be recognised as income. A sample calculation for apportioning the cost and interest income is given in the table:
(c) Since the cost incurred is being accounted for as amount recoverable no depreciation would be charged in the books of account of the company. The same would be claimed by the concerned State Electricity Boards.
(d) Interest incurred for the borrowed loans for implementation of the above scheme would be charged to the profit and loss account.

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 Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 21 volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

ULDC FINANCE LEASE					
					(Rs. in Lakh)
Year	Opening Balance	Installment	Repayment of Principal	Interest	Closing Balance
(a)	(b)	(c) = (d) + (e)	(d)	(e)	(f) = (b) - (d)
1	31193.05	4437.98	876.92	3561.06	30316.13
2	30316.13	4437.98	977.04	3460.94	29339.09
3	29339.09	4437.98	1088.57	3349.41	28250.52
4	28250.52	4437.98	1212.85	3225.13	27037.67
5	27037.67	4437.98	1351.30	3086.68	25686.37
6	25686.37	4437.98	1505.58	2932.40	24180.79
7	24180.79	4437.98	1677.45	2760.53	22503.34
8	22503.34	4437.98	1868.96	2569.02	20634.38
9	20634.38	4437.98	2082.32	2355.66	18552.06
10	18552.06	4437.98	2320.04	2117.94	16232.02
11	16232.02	4437.98	2584.90	1853.08	13647.12
12	13647.12	4437.98	2879.99	1557.99	10767.13
13	10767.13	4437.98	3208.78	1229.20	7558.35
14	7558.35	4437.98	3575.11	862.87	3983.24
15	3983.24	4437.98	3983.24	454.74	0.00

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Whether considering the above transaction as a finance lease in terms of AS 19 is correct.

(b) Whether the above accounting treatment is as per the requirements of AS 19.

C. Points considered by the Committee

8. The Committee notes the following definition of 'finance lease' as given in Accounting Standard (AS) 19, 'Leases', issued by the Institute of Chartered Accountants of India:

> ***"A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset."***

9. The Committee also notes paragraph 8 of AS 19 which explains as below:

> "8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:
> (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
> ...."

10. The Committee notes from the facts of the case that the equipment is in the physical possession of the State Electricity Boards and the operational and maintenance expenditures are incurred by them. Further, all the benefits of the system are also being drawn by them. The Committee also notes that the ownership of the assets would be transferred to the State Electricity Boards at the end of the lease term, i.e., 15 years which is the useful life for the purpose of determination of the tariff. Further, such a transfer would be made at the book value which, if depreciation is charged considering the useful life of 15 years, would be a nominal amount. The Committee is of the view that under the given facts and circumstances of the case, it appears that the lease would be considered as a finance lease as per AS 19.

11. The Committee notes paragraphs 26 and 28 of AS 19 which deal with accounting treatment of leases in the financial statements of lessors as below:

> ***"26. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease."***

> ***"28. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease."***

12. The Committee also notes that as per paragraph 27 of AS 19, "..... the lease payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease, and finance income to reimburse and reward the lessor for its investment and services". Thus, the accounting treatment proposed by the company is correct if the cost of the equipments represents the net investment in the lease within the meaning of AS 19 and subject to the other requirements of AS 19, e.g., the disclosure requirements.

D. Opinion

13. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7:

(a) Under the given facts and circumstances of the case, it would be correct to treat the transaction in question as finance lease, subject to complying with other requirements of AS 19.

(b) The accounting treatment of finance lease proposed by the company in paragraph 6 is correct if the cost of equipments represents the net investment in the lease within the meaning of AS 19 and subject to the other requirements of AS 19, such as, disclosure requirements.

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