Treatment of loss arising on sale of under-performing assets and associated liabilities to a group company of the supplier of the assets.

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

A. Facts of the Case

1. A listed company had given a Letter of Intent (LOI) for 40 Windmills Model 250T Wind Electric Generator (WEG) of 250/80 KW on turnkey basis including land to a company dealing in wind mills (hereinafter referred to as the 'supplier'). The company had finally scaled down to 20 windmills instead of the 40 windmills for which LOI was given. These 20 windmills were installed at the site of the company. The supplier was paid in full @ ₹128 lakh per machine amounting to ₹2,560 lakh at a debt:equity ratio of 75:25. The debts were funded by two nationalised banks. The machines installed were under operations and maintenance (O&M) for two years free of charge. The supplier had also executed a bond of performance guarantee of power generation of 5 lakh units per machine annually and individually with effect from the date of commissioning, and to compensate the shortfalls in the power generation at the prevailing State Electricity Board's rate.

2. The querist has stated that right from the inception, there were several problems in the power generation, land title, encroachment thereof and services. The company intimated the supplier regarding poor revenue generation and performance in respect of the 20 Windmills. As per the querist, the supplier admitted and affirmed about the non-performance and low performance of the machines and settlement thereof, but the settlement amount was not acceptable to the company. In view of the disparity, the company served a legal notice against the supplier stating the aforesaid facts and suggested arbitration recourse to resolve the matter. There was no response to the said notice from the supplier.

3. The querist has stated that in view of the foregoing, the company invoked section 9 of the Arbitration and Conciliation Act, 1996 with prayer to set aside the money to be realised from the forthcoming public issue of the said supplier and till then maintain the machines to generate the guaranteed generation of power. When the matter came up for hearing, the supplier gave an undertaking to the Court to maintain the machines to the guaranteed level of generation and requested time to file counter with regard to the settlement of the matter.

4. After subsequent discussions between the company and the supplier, a Memorandum of Understanding (MOU) dated 10.07.08 was entered into for out-of-court settlement. The main points of the MOU (copy furnished by the querist for the perusal of the Committee) have been supplied by the querist as under:

   - ✓ Net consideration was finalised for ₹1,966 lakh for entire 20 machines as on 01.04.2008.
   - ✓ Out of the net consideration finalised at ₹1,966 lakh, ₹1,596 lakh was to be paid to the term lending bankers of the company and balance ₹370 lakh was paid to the company.
   - ✓ The supplier or its nominee will take over the loan liabilities of the company relating to 20 machines and relieve from all liabilities and obligations, whatsoever, including personal guarantee, charge on other assets of the company and its promoters and directors.
   - ✓ The supplier or its nominee will service interest/ principal to bankers in a timely manner w.e.f. 01.04.08 till the takeover of the loan and ensure that the loan accounts are maintained as standard asset.
   - ✓ In case takeover of loan does not fructify by the end of 6 months or such further extended period agreed by the parties, the supplier will pay the balance of loan outstanding with bankers, take over the assets and relieve the company from all liabilities with bankers.

5. Consequent to the MOU, the following entries were passed in the books of the company:
   - ✓ For the electricity generation on accrual basis: The amount is credited to the 'Wind mill generation account' and debited to 'Wind mill generation receivable account'.
   - ✓ For the interest accrued on term loan: The interest is debited to 'Interest account' and credited to 'Term loan account'.
   - ✓ When interest is paid by supplier to the bank: The amount is debited to 'Term loan account' and credited to supplier account.
   - ✓ For the principal repayment: The amount is debited to respective loan account and credited to supplier account.
   - ✓ Amount received from the State Electricity Board for the electricity supplied: The amount is credited to Wind mill generation receivable account.
   - ✓ Amount directly collected by the supplier from the State Electricity Board for electricity supplied: The amount is credited to 'Wind mill generation receivable account' and debited to supplier account.

6. One of the group companies of the supplier has recently got the sanction of term loan for the takeover of the assets and liabilities. When the company transfers the assets, there will be no cash flows, but the aforesaid accounts, namely, Wind mill generation receivable account, Supplier account, Term loan account and Windmill assets account (WDV) will be squared off. This process of squaring off will result in a net loss of ₹444 lakh (excess debit balance) to the company.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the said loss of ₹444 lakh arising out of the abovesaid windmill transaction can be amortised over a period of time or whether the said loss should be fully charged off in the year in which the wind mills are sold by the company.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to the manner of recognition of loss arising out of the wind mill transaction in the instant case, i.e., whether the loss should be charged to the profit and loss account of the period in which such loss is incurred or whether it should be amortised over a period of time. 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, computation of net consideration or computation of loss arising from the windmill transaction, interpretation of the terms of the MOU, propriety of journal entries passed by the company consequent to MOU, timing of recognition of loss arising from the said transaction, i.e., whether the loss could be said to have been incurred by the company before entering into the MOU, after entering into the MOU or at the time of transfer of assets and related liabilities, accounting to be done at the time MOU is entered into, compensation received, if any, for shortfall in power generation, etc. The Committee notes that there are certain discrepancies between the Facts of the Case supplied by the querist and the MOU, for example, amount to be paid to the term lending bankers as per MOU is ₹1590 lakh, whereas the amount is stated in the Facts of the Case to be ₹1596 lakh, no mention in the Facts of the Case about the interest to be paid to the company by the supplier but stated in the MOU, etc. However, the discrepancies do not have a bearing on the issue under consideration for opinion.

9. The Committee notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, inter alia, provides that "losses represent decreases in economic benefits and as such they are no different in nature from other expenses" (paragraph 78). With respect to recognition of expenses, the Committee notes that the Framework, inter alia, provides in paragraph 96 that "an expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits". From the Facts of the Case, the Committee is of the view that the loss incurred by the company does not produce any future economic benefit to the company. Accordingly, in the view of the Committee, such loss should be fully charged off to the profit and loss account when incurred.

10. In the context of the proposed amortisation of the loss by the company, the Committee notes that amortisation over a period of time is possible only when the item is recognised as an asset. The Committee notes that the term 'asset' has been defined in the Framework as follows:

    "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." (Paragraph 49(a))

From the above, the Committee is of the view that an expenditure can be recognised as an asset only if it results into a resource controlled by the entity and some future economic benefits are expected to flow to the enterprise as a result of such expenditure. Since neither of the conditions is met in the case of the loss under consideration, it cannot be recognised as an asset and, therefore, there is no question of amortisation thereof.

D. Opinion

11. On the basis of the above, subject to paragraph 8 above, the Committee is of the opinion on the issue raised by the querist in paragraph 7 above, that the loss arising out of the windmill transaction in the instant case should be fully charged off to the profit and loss account of the year in which such loss is incurred. Such loss cannot be amortised over a period of time.

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.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty eight volumes. A CD of Compendium of Opinions containing twenty eight 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.org .

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