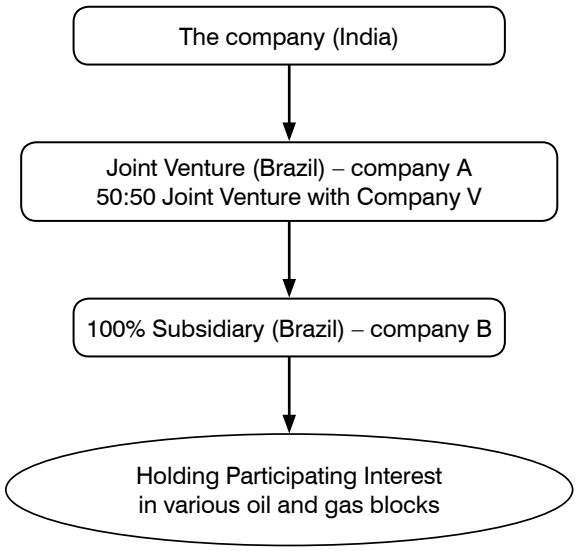
Accounting treatment of success fee paid to financial advisors.

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 government company (hereinafter referred to as 'the company') registered under the Companies Act, 1956, is a wholly owned subsidiary of a listed government company. The shares of the company are not listed with any stock exchange.

2. The company is engaged in activities relating to exploration and production of oil and gas. The company follows the 'Full Cost' method of accounting for its oil and natural gas exploration and production activities. The company is holding participating interest (PI) in various oil and gas blocks. The company along with another company (company V) has acquired through joint venture company – company A, shares in company B which holds the PI in oil and gas blocks in Brazil. The structure of the Group in respect of acquisitions of participating interest is as under:



3. The steps followed for this acquisition, as stated by the querist, are as under:
   - On 22nd December, 2005, the holding company of 'the company' entered into MOU with company V for cooperation in oil and gas exploration in India and worldwide.
   - On 6th June, 2007, proposal came from a foreign company, M/s E Corporation (which was holding the shares of company B) for divesture of deep-water offshore exploration portfolio of assets in Brazil.
   - On 13th June, 2007, Joint Study and Bid Participation Agreement (JSBPA) was signed between the company and company V, with the following terms and conditions:
     - Participating Interest shall be through a joint venture 50:50 partnership.
     - Bidding companies shall jointly appoint an investment bank, management consultant and/or a petroleum expert (collectively referred to as consultants/financial advisors).
     - Costs for these consultants shall be shared equally by the two Indian parties.
     - The payment will be released from India.
   - On 14th June, 2007, appointment of financial advisors was made whose scope of work was defined as under:
     - Carry out detailed financial due diligence.
     - Develop a detailed financial model and other methodologies to determine the transaction value.
     - Analyse various risks associated with the projects.
     - Valuation of company/project.
     - Assisting in appointment of technical, legal and taxation consultants.
     - Listing out various financial options available to the company.
     - Preparing the bidding strategy to acquire the proposed equity interest or participating interest by the seller.
   - The fees payable was as under:
     - A drop dead fee of US $ 2,50,000 if for any reason, the transaction does not consummate.
     - A success fee of 0.70% of the bid price, payable on successful closure of the transaction.

     The querist has pointed out that the Fixed Drop Dead Fee, however, shall not be payable if engagement is commenced but the financial advisors are unable to continue or complete the transaction for reasons attributable to them. Notwithstanding this, payment of Fixed Drop Dead Fee shall become due and payable only after 90 days from the date of the signing of the agreement with them.
   - On 27th July, 2007, the financial advisors submitted the report along with presentation and the same was deliberated upon by the company and company 'V'. On 30th July, 2007, after the internal deliberations, the strategy meeting between the company and company 'V' for acquiring company B was held, wherein it was decided to bid for 3 basins out of 4 held by company B. Accordingly, bid letter was submitted on 30th July, 2007.

The querist has pointed out that the bidding could have been possible even without relying on financial advisors' report.

- Later, negotiations took place with E Corporation and during the meeting, it clarified its intention that it wishes to exit from the Brazil project and therefore, offered the 4th basin at a nominal price of US $1.
- After negotiations/discussions, application was made to Agencia Nacional do Petroleo Gas Natural Biocombustiveis (ANP) - Government of Brazil for granting permission.
- On 7th December, 2007, a local Special Purpose Vehicle (SPV), viz., A Ltd. (50:50 Joint Venture) was incorporated with one thousand Rials as share capital. Later, on 18th March, 2008, the share capital was increased to Rials 2.09 million to meet ANP's requirement.
- On 29th July, 2008, ANP granted conditional approval subject to fulfilling conditions related to performance guarantees and to have local SPV with one million Brazilian Rials as share capital, etc.
- After a lot of follow-ups, on 12th September, 2008, ANP granted approval for the acquisition.
- On 18th September, 2008, the payment for acquisition was made to E Corporation and subsequently acquired its subsidiary company B.
- The merger of company B and company A is also under process. The assets at present are existing in the books of company B.
- On 15th July, 2009, an amount of ₹2,40,95,418.00 (being 0.7% of bid price of USD 82.5 million converted into Indian Rupee (INR) @ 47.055) after TDS was paid to the financial advisors against the bill of financial due diligence.

4. The querist has stated that the above-mentioned success fee has been treated as revenue expenditure in the books of the company for the following reasons:
   (a) The underlying assets (PI) are not in the books of the company. The value of equity shares together with share premium subscribed by the company in company A are shown as investment in the books of the company. The PI in Brazilian blocks is in the books of company B. Hence, it is felt that the expenditure on success fee incurred in relation to PI cannot be capitalised in the books of the company.
   (b) The expenditure on account of success fee is incurred at the bidding process stage before the formation/incorporation of company A (whose 100% subsidiary held the PI in Brazilian blocks). The success fee has relation to bidding process for PI and has no relation to the acquisition of equity shares in company A.
   (c) Though the advisory services of the financial advisors have helped the bidding process, the bidding could have been possible even without these services, i.e., it need not necessarily be an integral part of the acquisition. Hence, as per the querist, relying on one of the recent opinions issued by the Expert Advisory Committee (published as query No. 19 of Volume XXVI of the Compendium of Opinions) on the subject 'Capitalisation of certain expenses related to acquisition of an investment', the success fee has been treated as revenue expenditure. The querist has reproduced the following portion of the opinion for reference:

> "The cost of acquisition should include only those direct charges which are incurred 'on' acquisition of investment, i.e., the expenses, without the incurrence of which, the transaction could not have taken place such as share transfer fees, stamp duty, registration fees and duties and levies by regulatory agencies and stock exchanges. The expenses incurred 'before' acquisition, even though directly attributable to acquisition should not be added to the cost of acquisition of shares as these do not represent the worth of shares acquired."

5. As per the querist, the government auditors while reviewing the accounts had examined the above treatment given by the company and have decided that this matter be taken up with the Expert Advisory Committee of the Institute of Chartered Accountants of India for specific opinion on the matter.

B. Query

6. Considering the above facts, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
   (i) Whether the accounting treatment followed by the company is correct.
   (ii) If no, then what is the correct accounting treatment.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting treatment of fee, i.e., Fixed Drop Dead Fee and success fee, paid by the company to financial advisors in connection with acquisition of investment in the subsidiary company B which held the participating interest in oil and gas blocks. 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, accounting in the books of the holding company, company A, company V or company B with respect to any expenditure in connection with the acquisition of shares or participating interest, etc.

8. The Committee notes from the Facts of the Case that the company in the instant case has incurred the expenditure on fee to financial advisors for

a commercial advantage which is to be availed through its joint venture company A, in whose books, the investment in company B would appear. The Committee examines whether this expenditure can be added to the cost of investment in the joint venture company A as appearing in the books of the company. In this context, the Committee notes paragraphs 28, 29 and 32 of Accounting Standard (AS) 13, 'Accounting for Investments', which provide as follows:

> ***"28. The cost of an investment should include acquisition charges such as brokerage, fees and duties.***
>
> ***29. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident."***
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> ***"32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually."***

From the above, the Committee is of the view that in the present case, the expenditure on fee paid to financial advisors, cannot be included in the 'cost of investment' at the time of initial recognition. Such expenditure also does not become part of the carrying amount of the investment in the shares of company A as the investment is to be carried at cost with only diminution being recognised under certain circumstances.

9. The Committee now examines whether the expenditure on fee to financial advisors can be capitalised as a separate asset. The Committee notes that the term 'asset' has been defined in the Framework for the Preparation and Presentation of Financial Statements (the Framework), issued by the Institute of Chartered Accountants of India as "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)). The Committee is of the view that the expenditure on fixed drop dead fee and success fee does not result into a resource controlled by the company and accordingly, it cannot be capitalised as an asset.

10. The Committee further notes paragraph 96 of the Framework issued by the Institute of Chartered Accountants of India, which provides as follows:

> "96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

From the above, the Committee is of the view that the expenditure on fixed drop dead fee and success fee incurred by the company, which does not meet the definition of an asset as discussed in paragraph 9 above, should be expensed in the statement of profit and loss.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 6 above:
    (i) The accounting treatment followed by the company to treat the expenditure incurred on success fee as revenue expenditure is correct.
    (ii) Since the answer to (i) above is in the positive, this issue does not arise.

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 11.5.2010. 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 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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