Query No. 1

Subject: Capitalisation of interest during pre-operative period in Cable and Telecommunication Industry.[1]

A. Facts of the Case

1. A closely held public limited company is engaged in the business of providing cable TV (both analog and digital services) and broad band internet service in the State of Orissa and its neighbouring states, like West Bengal, Andhra Pradesh and Chhattisgarh. The company is registered under the Companies Act, 1956. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956. The company plans to expand its operations to different states of India in near future.

2. The company has a three-tier organisation structure consisting of stations, regional headquarters and corporate office. The stations are grouped under different regions and report to the corporate office through the regional headquarters. The regional headquarters provide various services to the projects under construction and the operating stations under their jurisdiction.

3. The company is undertaking the following process for a location in project stage:

(a) Make selection of potential sites where the company operations are to be taken up. Bring approval of right of way from the local authority to lay cable in that locality. Then the company sets up an office and installs the network operating centre from where the services are to be provided to its customers.

(b) Immediate arrangement is made to have full contents from different broadcasters on payment to provide the services to the customers. Arrangement of intercity connectivity from available sources is also made for providing the broadband services from the company's control room. Once the facilities are available, company starts laying the cables and creates new passing which enable the company to provide cable and data connection to its customers. It also deploys necessary manpower to run the operations and provide services to its customers. All the above arrangements have an initial cost for the new location.

4. According to the querist, passings are created in phases in different areas one after another depending upon the market demand and also the environmental situation. Normally, there is a time lag between the availability of the first pay channel and connecting the first customer. It is not practically possible to arrange for all the pay

[1] Opinion finalised by the Expert Advisory Committee on 16.03.2011.

channels at a specific time. Irrespective of whether the customer is connected or not, the pay channel liability starts from the day the company gets the decoder box to receive the signals. A customer will also not be interested to avail a connection when all the channels are not available in the network.

5. The querist has stated that there are also initial operational hurdles in new locations and the business moves very slowly and considering its nature of activities, it takes time to consolidate the business. Getting a sizeable number of customers takes a pretty long time. This time period varies from 6 months to 2 years depending upon the market where the operations have been started by the company.

6. The company, as per its business plan, mixed the funding requirement of both equity and debt to meet the capital expenditure including the pre-operational expenses at new locations and expansion and up-gradation in its existing locations. The nature of the activities is such that the same materials are used both for capital expenditure and the repair and maintenance activities. It is also difficult to bifurcate the loan and equity amount that is spent to purchase fixed assets for different locations. The total assets requirement of all locations is pooled and then loan is arranged for the entire lot. The querist has stated that it is difficult to identify direct relationship between the loan and the capital item purchased as per paragraph 8 of Accounting Standard (AS) 16, 'Borrowing Costs'.

7. The querist has further stated that based on the provisions of paragraph 8 of AS 16, the interest cost on debt taken for new locations and up-gradation of the existing operations is being charged to the profit and loss account from the day one the interest liability arises in view of no proper calculation/allocation of interest being done asset/location wise.

8. *The company is now of the view that since borrowings are mainly for acquisition of new fixed assets for new locations and expansion of its activities in present locations, the interest cost for the period during which the test run is continuing and a sizeable number of customer base is not created at the relevant locations ought to be capitalised as per paragraph 9 read with paragraph 4(a) of AS 16 and not charged off fully to the profit and loss account* (emphasis supplied by the querist).

9. As per the querist, if the debt cost from the day one is charged to the profit and loss account, there would be serious bottom line problem and the company would never be able to make bottom line positive with such huge interest cost burden during its initial period of expansion.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee that considering the nature of the business and assets of the company, whether (i) the company ought to capitalise borrowing cost for the period as stated in paragraph 5 above when commercial operation is not feasible for certain period initially, and (ii) charging off fully the interest to the profit and loss account will not be proper in view of applicability of AS 16.

C. Points considered by the Committee

11. The Committee while expressing its views has examined only the issues raised in paragraph 10 above and has not examined any other issue arising from the Facts of the Case, such as, treatment of other expenses during the pre-operative period, allocation of general borrowing costs, capitalisation in parts / phases and bifurcation of loan and equity components, etc. At the outset, the Committee also wishes to point out that from the Facts of the Case, the nature of the assets, which are being constructed or coming into existence as a result of construction activity is not clear. In other words, what is the 'qualifying asset(s)' in the extant case is not clear. Accordingly, in the following paragraphs, the Committee is laying down the broad principles to be kept in mind while capitalising the borrowing costs.

12. The Committee notes from the Facts of the Case that the company is entering into new locations and is also expanding in its existing locations, and for this, it is incurring borrowing costs. The Committee is of the view that broadly, such borrowing costs can be classified into two categories, viz., (i) those borrowing costs that are directly attributable to construction/ creation of an asset and (ii) those borrowing costs that are not directly attributable to such construction / creation.

13. For the sake of convenience, at first, the Committee deals with the second type of borrowing costs, i.e., those which are not directly attributable to construction of an asset. In this regard, the Committee notes paragraph 6 of AS 16, notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, which provides as follows:

> ***"6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred."***

From the above, the Committee is of the view that the borrowing costs that are not directly attributable to construction/creation of an asset (e.g., borrowing costs related to repair charges of an already existing centre or for expenses relating to deployment of manpower) should be expensed in the period in which these are incurred.

14. As regards the first type of borrowing costs, i.e., which are directly attributable to construction of an asset, the Committee notes the definition of the term 'qualifying asset' and paragraph 5 of AS 16 which are reproduced below:

> ***"A <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale."***
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> "5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. *Assets that are ready for their intended use or sale when acquired also are not qualifying assets*." (Emphasis supplied by the Committee.)

From the above, the Committee notes that only those assets that necessarily take a substantial period of time to get ready for their intended use or sale can be considered as qualifying assets in the context of capitalisation of borrowing costs as per AS 16. The assets which are ready to use when acquired cannot be considered as qualifying assets within the meaning of AS 16, although there may be some time lag between their acquisition and actual use. The Committee further notes the Explanation to the definition of the term 'qualifying asset' and paragraphs 14, 16 and 20 to 22 of AS 16, notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, which provide as follows:

> **Explanation:**
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> ***"What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered."***
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> ***"14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:***
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> ***(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;***
> ***(b) borrowing costs are being incurred; and***
> ***(c) activities that are necessary to prepare the asset for its intended use or sale are in progress."***

> "16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place…"
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> "20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.
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> ***21. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.***
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> 22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill."

15. On the basis of the above, the Committee is of the view that the company should evaluate what constitutes a substantial period of time considering the peculiarities of the facts and circumstances of its case, such as, nature of the asset being constructed. In this regard, time which is taken by an asset, technologically and commercially to get ready for its intended use or sale should be considered. The Committee notes from the Facts of the Case that the time taken to prepare the assets in question for its intended use is not clear. However, the querist has stated that there is a time lag to arrange for the pay channels and that the customer would not be interested to avail the facility unless all the channels are available. The Committee is of the view that once the asset is technologically ready, evaluation of optimum number of channels for commercial feasibility (i.e., commercial exploitation) of the asset should be done based on facts and circumstances of the case. In the view of the Committee, when a facility is technologically and commercially ready for distribution to the end-customers, the subsequent activities do not add value to the asset and therefore, the borrowing costs incurred thereafter should not be capitalised. The Committee is also of the view that the querist's argument on business feasibility, viz.,

consolidation of business and getting sizeable number of customers is not a criterion for determining the commercial readiness to estimate the substantial period of time. The Committee is of the view that commercial readiness should be determined on the basis of the assets providing output which can be commercially exploited in the market, not necessarily at profit. In this context, the Committee also wishes to point out that when a group of assets is being constructed and if an asset of that group can be individually used, the borrowing costs incurred in respect of it should cease to be capitalised as and when that asset is ready for its intended use, as discussed above.

D. Opinion

16. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

(i) No, the time taken in getting a sizeable number of customers, as being argued by the querist in paragraph 5 above, should not be a consideration for determining "substantial period of time". Accordingly, borrowing costs incurred during that period should not be capitalised. Capitalisation of borrowing cost would depend on whether the constructed asset meets the definition of 'qualifying asset' and other provisions of AS 16, as discussed above.

(ii) In case the interest incurred is not directly attributable to construction/creation of an asset, it should be fully expensed in the period in which it is incurred. However, if the interest incurred is directly attributable to construction/creation of a 'qualifying asset' as per the provisions of AS 16, as discussed in paragraphs 14 and 15 above, charging it off to the profit and loss account will not be proper in view of AS 16.