

Query No. 4

Subject: Disclosure of assets and liabilities held under projects being executed on behalf of the Government of India.¹

A. Facts of the Case

1. A company registered under the Companies Act, 1956 was incorporated in 1966. The company is a public sector enterprise, fully owned by the Government of India under the Ministry of Health and Family Welfare (MoHFW). The company was set up in the natural rubber rich state of Kerala, for the production of male contraceptive sheaths for the National Family Welfare Programme. As a part of diversification, the company has entered into health care sector in early nineties and today, it has grown into a multi-product/service, multi-unit organisation addressing various public health challenges facing humanity.

2. The service division of the company, inter alia, provides procurement consultancy services and infrastructure development consultancy for medical and allied infrastructure facilities to the Government of India, State Governments and other institutions. The Procurement and Consultancy Services Division (P&CD) provides consultancy services for procuring a range of healthcare and hospital products, equipments and services. It is designated as a National Procurement Support Agency (NPSA). The division undertakes consultancy assignments including bid process management, procurement of goods and stores, as well as project planning and monitoring. Procurement and Consultancy Services Division has ISO 9001 certification. The Infrastructure Development Division imparts consultancy services and undertakes turnkey projects for development of medical and allied infrastructure facilities. The company has been appointed by the MoHFW as in-house consultant for the upgradation of medical colleges. Medical infrastructure projects being executed by the company include the upgradation of medical colleges at different states and Aligarh under the Pradhana Mantri Swasthya Suraksha Yojana (PMSSY). Also, the company is upgrading the JIPMER Institute at Puducherry and is the in-house consultant to the Government of India for setting up six big Medical institutes in the states of Bihar, Orissa and Uttaranchal.

3. The company entered into consultancy agreement with the MoHFW. According to the querist, the salient features of the consultancy agreement with the Government of India for the infrastructure development and procurement and consultancy are as follows:

- The company, as in-house consultant of the MoHFW, will provide consultancy services for the construction of building and procurement of medical equipments for the upgradation of medical institutes.

¹ Opinion finalised by the Expert Advisory Committee on 03.05.11.

- The agreement entered into by the company with the MoHFW will not be construed as establishing a relation of master and servant or that of principal and agent as between the client (i.e., MoHFW) and the consultant (i.e., the company). The consultant subject to the agreement shall have the complete charge of personnel performing the services and shall be fully responsible for the services performed by them or on their behalf.
- The MoHFW will pay the company, consultancy fee for rendering timely and satisfactory services. The fee is paid to the company based on the completion of milestones/stages stipulated in the agreement.
- The company's service involves preparation of concept plan, preparation of detailed project report, preparation of bid documents, short-listing of bid, preparation of detailed design and structural drawings for civil construction including building service, scrutinising and processing the bid for final selection of the contractor as per the procedure laid down by the MoHFW, providing contractual framework alongwith drafting and execution of legal documents including the contract between the company and selected party (third party), monitoring, control and review of projects, obtaining necessary approvals from statutory authorities on behalf of the MoHFW, etc.
- The company's service also includes settlement of contractual disputes with the contractor/supplier including arbitration (third party).
- The company's service also includes procurement, supply, installation, testing and commissioning of medical equipments based on the equipment specification provided by the MoHFW.
- The consultant (i.e., the company) shall keep accounts and records relating to the project for inspection and audit for 5 years.
- The consultant (i.e., the company) shall always act in respect of any matter relating to the contract or services as faithful advisers to the client (MoHFW) and shall, at all times, support and safeguard the client's legitimate interest in any dealings with the third parties.
- The company shall pay taxes, duties, fees, levies and other impositions levied under the applicable laws. The client shall reimburse these expenses.
- The company enters into agreement with construction agencies/ suppliers for executing the project. The tenders were invited on behalf of the MoHFW and the acceptance of offers sent to the construction agencies/suppliers indicates that the

company accepted the same on behalf of the MoHFW. Thereafter, the work orders are issued by the company on behalf of the MoHFW. The payments to the agencies/suppliers are governed by the terms and conditions of the agreement made with them and are made out of the advance received from the MoHFW.

- The company shall be receiving funds/bank guarantees from the supplier towards security deposit/performance bank guarantee, etc.
- The company shall be opening Letters of Credit (L/Cs) and establishing bank guarantees in favour of suppliers towards committing payment against supplies.
- The company has to settle all contractual disputes with the contractor/supplier including arbitration. However, all legal awards resulting in financial liabilities shall be borne by the MoHFW.
- The MoHFW shall advance the company 10% of the estimated cost of the project for making payments to the contractors based on the progress of the project. For procurement activities, 100% advance is made by the MoHFW before releasing letter of award to suppliers.
- The company will submit the utilisation/account of advance fund received from the MoHFW. The MoHFW will, in turn, replenish the fund utilised.
- The company shall operate separate bank account for the fund received for each individual project covered in the agreement.
- As per the terms of agreement, any interest earned on the advance and maintained as short-term deposit shall be considered as the amount advanced by the MoHFW.
- The company shall be liable to the client (MoHFW) for performance of the services in accordance with the provisions of terms and conditions of the contract and for any loss suffered by the client as a result of a default of the consultant, limited to a maximum of 10% of the consultancy fee in such performance.
- The consultant shall indemnify the Government against all actions, suits, claims, and demands brought or made against it in respect of anything done or committed to be done by the consultant and its staff in the execution of or in connection with the services provided under this agreement and against any loss or damage to the Government in consequence to any action or suit being brought against the consultant for anything done or committed to be done in the course of the execution of this agreement including losses/damages liable or claimed for infringement of intellectual property rights of any third party. The consultant will abide by the job safety measures prevalent in India and will free the client from

all the demands or responsibilities arising from accidents or loss of life, the cause of which is the consultant's negligence. The consultant will pay all indemnities arising from such incidents without any extra cost to the client and will not hold the client responsible or obligated. The Government may, at its discretion and entirely at the cost of the consultant, defend such suit either jointly with the consultant or singly in case the latter chooses not to defend the case. This obligation will survive the termination of the contract for one year.

- In the case of procurement and consultancy, the consultant (i.e., the company) will receive the Earnest Money Deposit (EMD) and security deposit in the name of Pay and Accounts Officer (PAO), MoHFW, which will be passed on to the PAO on opening of the tenders and issue of notification of award. The PAO will release the deposit amount only on hearing from the company.

4. The querist has stated that the company operates separate bank account for each project for the funds received from the MoHFW as per the terms and conditions of the agreement and maintains separate set of books of account for each project. Further, the company does not have any title to the project assets. Hence, the assets and liabilities pertaining to the projects are disclosed under notes forming part of annual accounts of the company. Only the consultancy fee received/receivable from the MoHFW is the revenue/turnover of the company and is accounted for in the books of the company.

5. The company keeps the funds of the projects in short-term fixed deposits on behalf of the MoHFW till the same is required for project payments. Such short-term deposits are also accounted for in the project's books of account. The interest received on such deposits is payable to the MoHFW, Government of India and hence, no income tax is paid/TDS is deducted by the bank on such interest.

6. On completion of the projects, the assets are taken over by the respective institutions. The surplus amount, if any, advanced by the Ministry will have to be returned to the Ministry (together with interest accrued and earned on advances) along with statement of accounts of the project. In the case of procurement consultancy, supplies are effected directly to the consignee (as designated by the MoHFW under the agreement) and settlement to the supplies is made based on the consignee receipts.

7. As per the agreement, the accounts shall be kept for a period of 5 years for inspection and audit by the MoHFW.

8. The company has been in the procurement and consultancy business since the financial year 1997-98 and infrastructure development consultancy services from the financial year 2006-07. In the initial years (upto the financial year 2004-2005), the company had been disclosing the assets and liabilities of the P&CD business as assets and liabilities held under trust (as per contra) in the balance sheet based on the suggestion by the then statutory auditors and Comptroller and Auditor General of India (C&AG).

Based on the suggestion of the subsequent auditor, this has been changed to the present system of disclosure in which the assets and liabilities of the projects are disclosed under notes forming part of accounts. Further, considering the nature of the agreement clauses, particularly the liability clause, the unexecuted part of the projects is not included in the contingent liabilities of the company.

9. However, in the financial year 2008-09, the statutory auditors have qualified the accounts stating that the assets and liabilities of the project (handled by the procurement and consultancy division and infrastructure development division of the company for and on behalf of the Government of India) are not incorporated in the balance sheet of the company. The company is keeping the unutilised amount of advance given by the Ministry in fixed deposits and interest received thereon is credited in the respective projects accounts as per the respective agreements. According to the statutory auditors, these assets and liabilities are to be incorporated in the financial statements of the company, because the company entered into commercial contract for the transaction relating to the respective projects and the funds are maintained with the bank in the name of the company.

10. The auditors' observations based on which the accounts have been qualified are given below:

- (i) There is contractual obligation for the company.
- (ii) Unutilised funds received for the projects are kept in the bank accounts opened in the name of the company and only the company can operate such accounts.
- (iii) Utilisation of funds is at the discretion of the company for the purpose of the project as per the agreement.
- (iv) The basis for the consultancy charges receivable is the utilisation of the funds, i.e., the revenue recognition is based on the utilisation of funds. Thus, the receipt and utilisation of funds are one of the normal business activities of the company. Hence, the assets and liabilities of the project must be disclosed in the financial statements of the company. Further, as per the generally accepted accounting practices, the entire transactions of the company must be reflected in the audited statements and the company has to ensure the completeness of the information furnished/disclosed in the financial statements.

B. Query

11. In view of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the present practice of the company disclosing the assets and liabilities of the project under notes forming part of the annual accounts is in order.
- (ii) Whether Accounting Standard (AS) 7, 'Construction Contracts' and Accounting Standard (AS) 9, 'Revenue Recognition' shall be applicable to the company with respect to the transactions of Procurement and Consultancy Division and Infrastructure Development Division business.
- (iii) Whether it is necessary to disclose the unexecuted part of the work of Procurement and Consultancy Division projects and Infrastructure Development Division projects under contingent liabilities.

C. Points considered by the Committee

12. The Committee notes that the basic issues raised by the querist are related to (i) disclosure of project assets and liabilities, (ii) applicability of AS 7 and AS 9, and (iii) need for disclosure of unexecuted part of work. Therefore, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of non-payment of income-tax/deduction of TDS on the interest on short-term deposits as per the provisions of Income-tax Act, 1961, or interpretation of the terms of the Agreements entered into with the MoHFW, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view.

13. As regards the first issue raised by the querist, the Committee notes that the terms 'Asset' and 'Liability' are defined in paragraphs 49(a) and 49(b) respectively of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India as follows:

“(a) 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.”

“(b) A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.”

14. The Committee is of the view that so far as the company is concerned, the project assets and project liabilities do not meet the definition of 'Asset' and 'Liability' respectively (reproduced in paragraph 13 above). This is because the future economic benefits from the project assets are not expected to flow to the company. On completion of the projects, the assets are taken over by the respective (medical) institutions. The project assets are not funded by the company. In substance, they are funded by the

MoHFW. Accordingly, the liabilities which arise during the transactions are those of the MoHFW and not that of the company. As such, the project assets and project liabilities should not be recognised by the company in its books of account.

15. As regards the second issue raised by the querist, the Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', which is reproduced below:

“b. Substance over Form

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.”

Thus, the transactions and events are accounted for and presented in accordance with their substance, i.e., the economic reality of events and transactions, and not merely in accordance with their legal form. In other words, it is the 'economic reality' that is important in accounting and not only the 'legal reality'.

16. The Committee notes from the Facts of the Case that the company is getting the construction done through other agencies/parties and procuring the equipments, etc., from other suppliers on behalf of the MoHFW. The Committee notes that the company is mainly providing consultancy services in relation to construction/procurement services for which it is receiving a fixed consultancy fee. Thus, all risks (financial liability, project liabilities, etc.) and rewards (control over project assets, etc.) shall rest with the Ministry. Accordingly, the Committee is of the view that keeping in view the consideration of substance over form as explained above, the principle of revenue recognition for agency relationship as enunciated in the following definition of 'revenue' as per AS 9 notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') should be applied in the extant case:

“4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.”

The Committee, however, is of the view that though the principle of revenue recognition for agency relationship as stated above is applicable both for procurement and consultancy services and infrastructure development services, considering the nature of services involved, the applicable Standard for the two services will differ as explained in paragraph 17 below.

17. The Committee notes that there are two agreements, viz., (i) for procurement and consultancy services and (ii) for infrastructure development including consultancy services. As regards the procurement and consultancy services, the Committee notes that the company is providing only consultancy services in relation to procurement of medical equipments and products which does not seem to be related to construction activities. Accordingly, in substance, it seems to be covered by AS 9 and therefore, the consultancy fee received on this account should be recognised as revenue following the principles of AS 9.

As regards the infrastructure development related services, stated by the querist in respect of turnkey projects for development of medical and allied infrastructure facilities, the Committee is of the view that the company is rendering services directly related to the construction as in case of project managers and accordingly, the principles of AS 7 should be applied while recognising revenue (viz., consultancy fee) from such services. In this connection, the Committee notes paragraph 4 of AS 7, notified under the 'Rules', which is reproduced below:

- “4. For the purposes of this Standard, construction contracts include:
- (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
 - (b) ...”

18. As regards the money received by the company from the MoHFW, the Committee is of the view that this seems to be of the nature of 'asset held in trust' and accordingly, the asset and liability in respect thereof should be recognised in the books of account of the company. This will be so whether the money received is kept in bank account or in short-term fixed deposits. As and when the expenditure is incurred, the 'asset held in trust' should be credited with corresponding debit to the related liability. In case the adjustment is to be done at a later date, the expenditure should be debited to receivable account. In case amount receivable by the company for the services is also adjusted against the money received from MoHFW, in addition to the entry for revenue recognition, two more entries are required to the extent the adjustment is made, viz., (i)debiting liability with corresponding credit to receivable (for the services) and (ii)debiting company's bank account with corresponding credit to 'asset held in trust'.

19. The Committee is also of the view that considering the fiduciary nature of the company's responsibility, the company may, if it desires, disclose in the notes forming part of accounts, project assets and project liabilities with disclosure of their nature.

20. As regards the third issue, the Committee notes that Schedule VI to the Companies Act, 1956 requires disclosure of 'Estimated amount of contracts remaining to be executed on capital account and not provided for' as part of 'contingent liabilities'. The projects are not capital in nature for the company. Only for the MoHFW, the projects may have elements which are capital in nature. The Committee is, therefore, of the view that the question of making the aforesaid disclosure by the company does not arise at all.

D. Opinion

21. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 11 above:

- (i) The present practice of the company disclosing the assets and liabilities of the project under notes forming part of accounts is in order only if it is supplemented with the disclosure of their nature.
- (ii) For consultancy services of the Procurement and Consultancy Division, AS 9 is applicable. For infrastructure development related services of the Infrastructure Development Division, AS 7 is applicable. As regards the money received by the company from the MoHFW, see paragraph 18 above.
- (iii) The unexecuted part of the work of Procurement and Consultancy Division projects and Infrastructure Development Division projects should not be disclosed under 'contingent liabilities'.
