

# Treatment and disclosure of interest on fixed deposits in the financial statements of a financial enterprise.

*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 company (hereinafter referred to as 'the company') is a public limited company registered under the Companies Act, 1956. The entire equity of the company is held by the Government of India. The company was set up as a special purpose vehicle to provide long-term infrastructure finance as per Scheme for Financing Viable Infrastructure Projects (hereinafter referred to as 'the financing scheme'). The company provides infrastructure finance through direct lending, refinancing and take out finance as per the financing scheme.
2. The company is engaged in the business of providing long-term financial assistance to infrastructure projects in the country. The paid-up equity capital of the company is ₹2,000 crore. The company has raised long-term debt by way of loans from Life Insurance Corporation of India, National Small Saving Fund (NSSF), bonds listed in India and foreign currency loans from bilateral and multilateral institutions. Borrowings of the company are backed by sovereign guarantee.
3. The resources raised by the company are utilised for providing infrastructure finance through direct lending, refinancing and take out finance as per the financing scheme. Pending disbursement, the resources of the company are held in the form of bank deposits and investments, such as, Central/State Government securities, bonds issued by public sector undertakings (PSUs), Certificate of Deposits with scheduled banks, etc. as per investment policy approved by the board of directors of the company.
4. As per the Office Memorandum of Government of India dated 23<sup>rd</sup> April, 2007, the company is also recognised as 'sui-generis' organisation under direct supervision of the Ministry of Finance, Government of India. The company is not registered as a Non-Banking Financial Company (NBFC) with the Reserve Bank of India although the statutory auditors of the company have opined that the company is an NBFC.
5. The querist has stated that as the nature of its business is that of an NBFC, the company has been treating interest on bank deposits as income from operations in its books of account and accordingly, considers and discloses interest on bank deposits as income from operations in the financial statements as well as in the cash flow statement.
6. The Comptroller and Auditor General of India (CAG) which conducts supplementary audit of accounts of the company under section 619(3) (b) of the Companies Act, 1956, while conducting audit of accounts of the company for the year ended 31<sup>st</sup> March, 2010 and subsequently for the year ended 31<sup>st</sup> March, 2011, inter-alia, however, commented that interest on fixed deposits with banks has been included under income from operational activities instead of disclosing the same as other income. This has resulted in the overstatement of income from operations and understatement of other income by ₹56,516.94 lakh. In this regard, the company, vide letter dated 27<sup>th</sup> June, 2011, has given assurance to CAG that matter regarding treatment of interest on fixed deposits with banks as operational income will be referred to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for its opinion for appropriate treatment from the next financial year.
7. As per the observations of CAG auditors, the interest income from fixed deposits with banks should be treated as 'other income' instead of 'income from operations'. Their observations are as follows:
 

“As per MOU of the company, the core activity of the company is to provide long-term financial assistance to infrastructure projects in India

and surplus funds arising out of asset-liability mismatch is to be invested only in marketable government securities till its deployment in financing the infrastructure projects in terms of the guidelines issued by the Ministry of Finance, i.e., the financing scheme which is the mandate for the company. However, the company has invested partial amount of surplus funds into the fixed deposits with banks which do not fall under the category of marketable government securities.

*It is observed that interest of fixed deposit with banks has been included under the income from operation activities instead of showing the same under the other income. This has resulted in the overstatement of the income from operations and understatement of the other income by ₹56,516.94 lakh (emphasis supplied by the querist)."*

8. According to the querist, the company has been treating interest on fixed deposits with banks as income from operations considering the following factors:

- (a) Nature of disbursement of infrastructure loans- The period of implementation of infrastructure projects generally extends over 3 to 5 years and accordingly, the disbursement of loan is made in tranches over this period as per the progress of implementation of projects. As a result, funds raised by the company get deployed over a period of time. It may be highlighted that as on 31<sup>st</sup> March, 2011, the company had made net sanctions of ₹25,205 crore and undertaken disbursements aggregating ₹15,325 crore.

Pending disbursement, surplus funds are invested in various short-term instruments as per the investment policy of the company approved by the board of directors. These include Central or State Government securities, bonds issued by PSUs, Certificate of Deposits with scheduled banks, etc. The company believes that this activity is an integral part of its operations to fund infrastructure loans; hence it has classified the interest income from these investments as 'income from operations' in the profit and loss account as well as cash flow statement.

- (b) Compliance with Accounting Standard (AS) 3, 'Cash Flow Statement' – The company is a financial

enterprise. Therefore, while forming the above opinion, the company has also taken guidance from paragraph 30 of AS 3, which reads as follows:

***“30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.”***

#### B. Query

9. In view of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether it is appropriate for the company to treat interest on bank deposits as income from operations in its books of account and accordingly, to consider and disclose interest on bank deposits as income from operations in the preparation of financial statements including cash flow statement.

#### C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to the disclosure of interest on bank deposits received by the company in the financial statements including cash flow statement. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, classification and disclosure of bank deposits made by the company, classification of the company as an NBFC or a financial institution, etc. Since the querist has raised the issue in the context of AS 3, the Committee presumes that AS 3 is applicable to the company. Further, since the query makes reference to the financial statements for the periods ending March 31, 2011 and prior to that, it is presumed that the query has been raised in the context of pre-revised Schedule VI to the Companies Act, 1956. Also, the opinion expressed hereinafter is purely from the accounting angle and not from the angle of interpreting the provisions of any legal

document/agreement, such as, the financing scheme or MOU.

11. The Committee is of the view that the fact that the MOU/the financing scheme did not permit the investment of funds in fixed deposits with banks does not change the nature of the interest received from such deposits and accordingly, its accounting would remain the same irrespective of whether it was permitted or not to invest the funds of the company in fixed deposits. As far as the disclosure of such interest income in the financial statements including cash flow statement is concerned, the Committee notes the definition of the term ‘operating activities’ as provided under paragraph 5 of AS 3 and paragraphs 12 and 30 thereof which provide as follows:

**“Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.”**

“12. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. ...”

***“30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.”***

From the above, the Committee is of the view that operating activities are the principal revenue-producing activities of the enterprise. The Committee is of the view that being a financial enterprise, the main business of the company in the extant case is to provide long-term infrastructure loans and financial assistance while optimally managing and utilising its funds. The Committee is of the view that the company

is in the business of earning income by managing its funds which also includes the management of surplus funds between the date of receipt of funds to the date when the funds are finally disbursed. Accordingly, the Committee is of the view that interest earned on investment of surplus funds of the enterprise arises from its principal revenue-producing activities and therefore, it should be treated and classified as income from operating activities. Further, in the context of cash flow statement, the Committee notes that paragraph 30 of AS 3 specifically states that cash flows arising from interest and dividends received in case of financial enterprise should be classified as ‘cash flow from operating activity’.

#### D. Opinion

12. On the basis of the above, the Committee is of the opinion that it is appropriate for the company to treat interest on bank deposits as income from operations in its books of account and, accordingly, to consider and disclose interest on bank deposits as income from operations in preparation of financial statements including cash flow statement as discussed in paragraph 11 above.

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 10.10.2011. 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 nine volumes. A CD of Compendium of Opinions containing twenty nine 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 <a href="mailto:eac@icai.org">eac@icai.org</a> .