Query No. 16

Subject: Accounting for sales tax exemption benefit under Ind AS.[1]

A. Facts of the Case

1. A leading cement manufacturing company in India has set-up cement plants across India including in the State of Maharashtra. Plants set-up in the State of Maharashtra are eligible for sales tax incentive under Package Scheme of Incentives, 1993 framed by the Government of Maharashtra (hereinafter referred to as the 'Scheme'). The querist has furnished a copy of the Eligibility Certificate from the State Industrial and Investment Corporation of Maharashtra (SICOM) Ltd., which is the implementing agency of the Scheme, for a Unit of the company.

2. As per the querist, the company is covered in Phase I of Roadmap for Convergence with IFRS and will be required to adopt Indian Accounting Standards (the 'Ind ASs') for the accounting periods commencing on or after the date to be notified. The company is conducting a diagnostic study based on Ind ASs as issued by the Ministry of Corporate Affairs to enable it to better prepare for migration to Ind ASs.

3. In the process of the diagnostic study, the company has identified one issue. The issue relates to accounting for sales tax exemption benefits available for the aforesaid Unit of the company under Ind ASs.

4. The querist has stated the salient features of the Scheme as below (copy of the Scheme with various amendments and a copy of the sample invoice for sale of goods have been furnished by the querist for the perusal of the Committee):

Objective of the Scheme

Sales tax incentive is given under Package Scheme of Incentives, 1993 (the 'Scheme') framed by the Government of Maharashtra. The Objective of the Scheme is to achieve dispersal of industries outside the Bombay –Thane – Pune belt and to attract them to the underdeveloped and developing areas of the State.

Units eligible to avail the benefit

Eligible Units operating in the Industries specified in the Scheme are considered for sales tax exemption benefit under the Scheme. To get the sales tax exemption benefit, the Eligible Unit needs to make specific Gross Fixed Capital Investment. Gross Fixed Capital Investment shall mean and include –

[1] Opinion finalised by the Expert Advisory Committee on 10.10.2011.

- new fixed assets;

- second hand fixed assets (cost of such fixed assets for computing Gross Fixed Capital Investment is the cost of acquisition or value certified by valuer whichever is lower); and

- shifting of fixed assets (depreciated value of fixed assets on the date of shifting together with the actual expenditure incurred on dismantling, transportation, insurance and re-erection which is allowed to be and is capitalised under the Indian Income Tax Act.

The term 'fixed assets' shall mean and include the following:

1. Land / area in effective possession and as required for the project,

2. Building, i.e., any built up area used for the Eligible Unit including administrative building, residential quarters, industrial housing and accommodation for all such facilities as are required for the manufacturing processes,

3. Plant and machinery, i.e., Tools and equipment including handling and haulage equipments, or tools as are necessarily required and exclusively used for sustaining the working of the Eligible Unit,

4. Cost of development of the environment of the location of the Eligible Unit,

5. Installation charges and pre-operative expenses capitalised,

6. Technical know-how including cost of drawings and know-how fees, and

7. The amount paid as non-refundable interest-free deposit to Maharashtra State Electricity Board for supply of power.

Other conditions to be satisfied are:

- Fixed assets acquired by an Eligible Unit and forming part of the Gross Fixed Capital Investment cannot be disposed of/sold/written off except with the prior written permission of the implementing agency.

- The holder of the Eligibility Certificate shall keep true and proper account of the value of raw materials purchased, finished goods manufactured/sold by the Eligible Unit, raw material/finished goods returned with proper classification of both purchases as well as sales of goods.

- Full record of the employment in the unit, wages and salaries paid should be kept.

- Government or its authorised entity shall have right to carry out full inspection of the Eligible Unit including its properties, assets, accounts, records, registers, documents etc., and cost of such inspection will be paid by the Eligible Unit.

- The holder of the Eligibility Certificate shall ensure that in the matter of employment of personnel for the Eligible Unit for which the Eligibility Certificate is issued, scheduled castes / scheduled tribes and local candidates are recruited in conformity with the guidelines issued from time to time.

- Monthly or quarterly returns applicable under sale tax law should be furnished.

- Such periodical statements / such information /follow up statements in the form and manner as required by SICOM should be furnished.

Nature of benefit

Eligible unit will get sales tax exemption on all sales (both local as well as inter-state) made from the Unit.

Extent of sales tax benefit

The company will get sales tax exemption without any ceiling on all sales made by it for a period of 18 years. During such period, if sales tax incentives are not availed to the extent of ceiling mentioned (i.e., 130% of fixed capital investment), an additional period upto 7 years shall be extended till such ceiling is reached.

Eligible period of incentive

The sales tax incentive will be without any monetary ceiling for a period of 18 years. During such period, if sales tax incentives are not availed to the extent of ceiling mentioned (i.e., 130% of fixed capital investment), an additional period upto 7 years shall be extended till such ceiling is reached.

5. The querist has quoted the following definition given in paragraph 3 of Indian Accounting Standard (Ind AS) 20, ‘Accounting for Government Grants and Disclosure of Government Assistance’:

"*Grants related to assets* **are government grants whose <u>primary condition</u> is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held." (Emphasis supplied by the querist.)**

6. The querist has also drawn the attention of the Committee to the following paragraphs of Ind AS 20:

> "16. It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see Ind AS 1 *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received."
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> "19. Grants are sometimes received as part of a package of financial or fiscal aids to which a number of conditions are attached. In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another."

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the exemption is in the nature of government grant. The company is exempt from payment of sales tax on cement and accordingly, the company does not charge the sales tax to its customer on invoice. However, the sales tax is inbuilt in the price of cement. Is the exemption from collection and payment of taxes a benefit in the nature of government grant?

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(ii) Whether the sales tax exemption scheme benefit is a grant which relates to an asset or whether it is a revenue related grant.

(iii) Whether this grant is in the nature of fiscal aid.

(iv) If the grant is relating to asset, how it should be accounted for? Various possibilities are given below:

- Should the company estimate total benefit of sales tax exemption over the period of 18 years and recognise it upfront with a corresponding credit to deferred income?

- Would the accounting treatment be different if the present value of the estimated total benefit exceeds the cost of fixed asset?

- Recognise the exemption benefit based on sales made each year and recognise the grant in profit or loss by matching it with depreciation charge.

- Recognise cumulative exemption benefit received till current year over the life of the asset.

(v) If the grant is regarded as fiscal aid, then company needs to allocate the grant among various components of cost. Various possibilities are:

- Eligible sales are the primary condition to earn the grant and other obligations are more in the nature of going concern obligations on which a value cannot be placed. Thus, recognise grant to the extent of eligible sales made in profit or loss.

- Recognise the grant to the extent of depreciation of eligible capital investment made by the company and match the recognition of grant with depreciation. Recognise excess grant based on other appropriate basis.

- Allocate the grant revenue over the period for which cost is incurred to satisfy the various conditions relating to the grant (cost is actual cost and not incremental cost).

- Allocate the grant revenue over the period as the conditions are satisfied. However conditions are evaluated based on their significance/importance rather than based purely on cost. In this case, an issue will arise as to how the significance/ importance of conditions will be decided?

- Recognise the grant to income on a straight-line basis for term of the Scheme, i.e., 18 years.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to the treatment of sales tax exemption under the Package Scheme of Incentives, 1993 (the 'Scheme') in respect of sales made by the company in the context of Ind ASs. Therefore, the Committee has examined only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, exemption from the payment of any sales tax on the purchases made by the company. Further, the Committee has opined only from the accounting point of view and not from the point of view of interpreting any legal enactments, like the Scheme or implications under Income- tax Act, 1961 or various sales tax enactments. Incidentally, the Committee has noted that the objective of the Scheme is ''to intensify and accelerate the process of dispersal of industries from the developed areas and for development of the underdeveloped regions of the State, particularly those farther away from the Bombay-Thane-Pune belt".

9. The Committee notes the definition of the term '*Government grant*' as defined in paragraph 3 of Indian Accounting Standard (Ind AS) 20, 'Accounting for Government Grants and Disclosure of Government Assistance' and paragraphs 9, 34 and 35 thereof, as below:

> **"***Government grants* **are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity."**
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> "9. The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government."
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> "34. Excluded from the definition of government grants in paragraph 3 are certain forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.
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> 35. Examples of assistance that cannot reasonably have a value placed upon them are free technical or marketing advice and the provision of guarantees. …"

The Committee notes that in the extant case, sales tax exemption under the Scheme is granted by the Government subject to fulfillment of conditions relating to investment and operation in underdeveloped areas. The Committee is of the view that the sales tax foregone by the Government is, in substance, a transfer of resources by the Government to the company. Therefore, exemption from sales tax liability subject to conditions relating to the operating activities of the company should be treated as a government

grant. The Committee is also of the view that while it may not be possible to quantify sales tax exemption for the entire period of grant upfront, it is possible to quantify the amount of the exemption included in each sales transaction and accordingly, paragraphs 34 and 35 of Ind AS 20 quoted above are not applicable to the grant by way of sales tax exemption. In this regard, the Committee also notes Appendix A, Government Assistance—No Specific Relation to Operating Activities to Ind AS 20, which is an integral part of Indian Accounting Standard (Ind AS) 20 as follows:

> **"Issue**
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> 1 In some countries government assistance to entities may be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity. Examples of such assistance are transfers of resources by governments to entities which:
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> (a) operate in a particular industry;
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> (b) continue operating in recently privatised industries; or
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> (c) *start or continue to run their business in underdeveloped areas.* (Emphasis supplied by the Committee.)
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> 2 The issue is whether such government assistance is a 'government grant' within the scope of Ind AS 20 and, therefore, should be accounted for in accordance with this Standard.
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> **Accounting Principle**
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> 3 *Government assistance to entities meets the definition of government grants in Ind AS 20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors.* Such grants shall therefore not be credited directly to shareholders' interests." (Emphasis supplied by the Committee.)

From the above, the Committee is of the view that government assistance in the form of sales tax exemption in the extant case is government grant.

10. The Committee further notes that Ind AS 20 defines only two types of government grants, viz., grants related to assets and grants related to income. There is no separate category of grants in the nature of financial or fiscal aids. The Committee notes that paragraph 19 of Ind AS 20 (which makes reference to grants received as part of a package of financial or fiscal aids) quoted by the querist in paragraph 6 above merely emphasises the need for identifying the conditions giving rise to the costs and expenses for determining periodic allocation of the grant to profit or loss, when multiple conditions

are involved. In a broad sense, all government grants are in the nature of financial or fiscal aids.

11. The Committee notes that the principal conditions for sales tax exemption under the Scheme are investment of certain amount in certain fixed assets and operating in specified activities (production of specified products) in underdeveloped areas for the operative period of the grant. The grant is receivable only on sale of the finished product. One important condition as per the copy of the Eligibility Certificate furnished by the querist is that during the operative period of the grant, the Eligible Unit should not be closed or should not continue to remain below the normal production during the year. (Some conditions such as maintenance of records, conformity with guidelines in the matter of employment etc., are merely of administrative nature, though their non-compliance will result in the grant becoming repayable). The Committee is of the view that while it may appear that the purpose of the grant is partly to subsidise the capital cost of the project and partly to act as an incentive in operating in underdeveloped areas, *the grant is not related to assets* considering the totality of the following facts (and not based on any individual factor in isolation):

(i) The main purpose of the grant as evident from the Preamble to the Scheme is to encourage entities to make investment in underdeveloped areas *in preference* to developed areas. This is to compensate for the disadvantages generally faced in *operating* in underdeveloped and developing areas.

(ii) There is no monetary ceiling for the exemption from sales-tax during the period of 18 years. The monetary ceiling linked to quantum of investment (130% of the investment) becomes relevant only if the ceiling is not reached within the period of 18 years. Thus, during the period of 18 years, the actual grant is linked to value of sales made without any limit. If the amount of such grant does not reach the monetary ceiling during the period of 18 years, during the extended period of 7 years the grant is still linked to the value of sales made, subject to the monetary ceiling.

(iii) Part of the investment can be made even after the commercial production starts as per the copy of the Scheme and various amendments furnished by the querist for the perusal of the Committee. Further, apart from acquisition of new and second-hand fixed assets in some situations, even existing assets shifted by the Eligible Unit to the project eligible for the benefits under the Scheme can form part of the Gross Fixed Capital Investment subject to some conditions as per the Scheme. Thus, investment requirement appears to be more of the nature of a qualifying condition rather than the purpose of the grant.

(iv) The grant enables the company to earn additional revenue on a recurring basis during the operative period of the grant. In the absence of the grant,

the company would have paid the sales tax to the government. The grant enables the company to retain the entire sale consideration including sales tax element inbuilt in the price. This results in additional revenue to the company each time a sale transaction occurs.

12. From the above, the Committee is of the view that since the grant is not related to assets, it should be treated as the grant related to income. In this connection, the Committee notes the following definition given in paragraph 3 of Ind AS 20:

> **"***Grants related to income* **are government grants other than those related to assets."**

13. As regards recognition of government grant, the Committee notes the following paragraphs of Ind AS 20:

> **"7. Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:**
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> **(a) the entity will comply with the conditions attaching to them; and**
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> **(b) the grants will be received."**
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> "8. A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled."
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> **"12. Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate."**
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> "16. It is fundamental to the income approach that government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see Ind AS 1 *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received."
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> "29. Grants related to income are sometimes presented as a credit in the statement of profit and loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense."

14. The Committee notes that in the present case, it is not possible to infer from the Scheme, the costs intended to be compensated by the grant. The purpose of the grant seems to finance the general activities of the company subject to compliance with the conditions attached with the grant. The various conditions do not clearly indicate the costs intended to be compensated. The Committee notes that paragraph 7 of Ind AS 20 provides that grant should be recognised only when there is a reasonable assurance that the entity will comply with the conditions attached to the grant and that the grant will be received. The Committee is of the view that in the extant case, the conditions relating to recognition of grant for sales tax exemption are fulfilled as and when sales take place subject to the reasonable assurance that the other conditions as specified in the scheme are fulfilled and accordingly, as and when sales take place, the portion of the price representing the sales tax element should be recongised as government grant. The Committee is further of the view that since sales tax exemption is a grant, it cannot be a part of sales and accordingly, it should be disclosed separately under the head 'other income'.

D. Opinion

15. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 7 above:

(i) The exemption is in the nature of government grant. The exemption from payment of sales tax is a benefit in the nature of government grant, when the sales tax is inbuilt in the price of cement and retained by the company.

(ii) The sales tax exemption scheme benefit is a revenue related grant.

(iii) Although sales tax exemption is in the nature of fiscal aid, however, it should be recognised as discussed in paragraph 14 above.

(iv) This question does not arise since the grant is not related to assets.

(v) Grant related to sales tax exemption in the extant case should be recognised as discussed in paragraphs 13 to14 above.