Query No. 23

Subject: Accounting treatment of high sea sales/purchase.[1]

A. Fact of the Case

1. A company is a public sector undertaking registered under the Companies Act, 1956. It is engaged in refining and marketing of petroleum products. The company mainly imports crude oil and after refining it through its various refineries across India, sells the finished petroleum products and the petrochemicals after further processing, throughout the country.

2. The company also imports LPG (Propane and Butane) from different foreign suppliers and after bottling, it sells the same to end customers through its dealer network. Similarly, other Oil Marketing Companies (hereinafter called OMCs) also import LPG for similar purposes. Under a written agreement, all OMCs undertake high sea transactions among themselves, i.e., either high sea purchase or high sea sales out of their original import consignment.

3. The agreement between OMCs came into effect from 01.04.2002, the date from which the Administered Price Mechanism (APM) was dismantled by the Government of India.

4. As per the agreement, the querist company has been designated as coordinator for Industry Logistic Plan (ILP) of LPG. The demand for LPG has to be worked out by product co-ordinator in consultation with OMCs on the basis of monthly domestic production numbers and demand forecast submission. Based on this, the requirement of import of LPG would be ascertained and projected by product co-ordinator.

5. As per the terms of the agreement signed between OMCs, it covers inter-alia the sale of product/products (LPG) under the agreement by one or more parties to the agreement to one or more parties to the agreement of the quantity to be determined on month to month basis as laid down in ILP.

6. In the above background, these transactions are considered as high sea sale/ purchase transactions as they take place before entering the territorial waters of India. For this purpose, the importer and buying OMCs enter into a high sea sales agreement on a non-judicial stamp paper along with details of product, quantity, carrying vessel, bill of

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lading (B/L) date, high sea sale price (including HSS canalising charges of 0.5% of the cost + freight), applicable exchange rate and the fact that customs duty shall be settled by the buyer at the time of clearance as per the applicable rules and other charges for clearance of cargo shall also be paid by the buyer. Also, it states that the title of cargo will be transferred in the buyer's favour by way of endorsement of the documents of title/ bill of lading on high sea, i.e., before entering India's territorial waters. The agreement is jointly signed by the buyer and seller (importer).

7. The above is accompanied by a declaration to the customs department by the importer informing about the sales of imported LPG (butane and propane) to the buyer OMC indicating the quantities sold and the fact that filing of bill of entry and other necessary formalities connected with clearance of cargo shall be fulfilled by the buyer OMC.

8. The key features of the transaction comprise:

(i) The agreement among OMCs for high sea sale/ purchase transactions is denominated in Indian Rupee (INR) and finally settled in INR. However, the sale/purchase price is arrived at in INR on the basis of price fixed from the foreign vendor in foreign currency being a back to back arrangement + canalising charges @ 0.5% cost.

(ii) Purchase cost from the third party supplier on invoice plus canalizing charges, i.e., currently agreed at 0.5% of the cost and freight.

(iii) Importing OMC endorses the bill of lading (B/L) in favour of the buyer OMC any time when the vessel is sailing and before it enters the territorial waters of India. Ownership passes to the buyer OMC after such transfer by the importing OMC. Customs clearance is also done by the buyer OMC.

(iv) The importing OMC raises final invoice on the buyer OMC in INR for the cost, based on the conversion rate of USD on the date of payment which is settled by importing OMC on the due date, in INR.

Thus, the final consideration payable by the buying OMC is the cost applicable for the importing OMC which is inclusive of exchange variation suffered by the importing company.

9. The existing accounting treatment is as under:

(i) The purchase (import) and sales to OMCs are two distinct transactions, backed by two separate contracts.

(ii) Whereas the import is denominated and settled in USD, the sale to OMCs is denominated and settled in INR.

(iii) Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') applies to accounting for transactions in foreign currencies and translating the financial statements of foreign companies (paragraph 1 of AS 11).

(iv) A foreign currency transaction is one which is either denominated in foreign currency or requires settlement in foreign currency (paragraph 8 of AS 11).

(v) The import is denominated and settled in USD and AS 11 is applied. Accordingly, the foreign exchange (FE) variation, if any, from the BL date and settlement date is recognised as FE variation in the statement of profit and loss.

(vi) The sale transaction is a cost plus transaction denominated and settled in INR and thus the difference between the provisional price and final price settled with OMCs is accounted as part of sales. In other words, the consequential exchange variation arising out of settlement between the importing OMC and the foreign vendor is also settled by the importing OMC. However, FE gain/loss to the extent it pertains to other buyer OMC is recovered from it by adjusting the same in the final invoice raised by the importing OMC.

(vii) The querist has provided the scheme of entries passed during the course of this transaction by the company as Annexure 'A'.

10. The views of statutory auditors regarding treatment of expenditure of such nature are as follows:

Paragraph 11 of Accounting Standard (AS) 9, 'Revenue Recognition', notified under the 'Rules' states as follows:

"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of

ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

Further, paragraph 6.1 of AS 9, notified under the 'Rules' states as follows:

"6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. …"

11. As per AS 9, revenue should be recognised, when property, i.e., risks and rewards in goods is transferred and certainty of payment exists. In the case of high seas sales transaction, the company transfers bill of lading document to OMCs, through which all the risks and rewards are transferred. Certainty of payment also exists as all the OMCs are doing regularly these type of transactions. So all the conditions of AS 9 are satisfied regarding revenue recognition on the date as and when bill of lading is transferred to other OMCs and revenue should be recognised on that day only.

12. Accounting entries to be passed for booking a high seas sales, as per auditors have also been provided by the querist as Annexure B.

13. Thus, the statutory auditors are of the view that the difference between the provisional and final bill amounts of high sea sales transactions, arising due to exchange rate variation between the B/L date and the settlement date of the importing OMC should be accounted as exchange loss/ gain in the statement of profit and loss instead of adjustment to sales to buyer OMCs.

14. Some of the significant provisions of AS 11, notified under the 'Rules', that are attracted in the issue have been reproduced below:

"1. This Standard should be applied:

(a) in accounting for transactions in foreign currencies; and
(b) in translating the financial statements of foreign operations."

"Initial Recognition

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) buys or sells goods or services whose price is denominated in a foreign currency;
(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;
(c) becomes a party to an unperformed forward exchange contract; or
(d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency."

"Recognition of Exchange Differences

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15."

15. Therefore, in the view of the company, since the criteria for recognition of high sea sales/purchase transactions amongst OMCs (as discussed above) as a foreign currency transaction is not satisfied, the provisions of AS 11 shall not be applicable on such high sea sales/purchase transactions.

16. According to the querist, the above is also in line with the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), expressed on the accounting treatment of certain foreign currency transactions, as given in Volume XIX, Query No. 14 dated 4th March, 1999. A gist of the opinion has been provided by the querist as follows:

(a) The opinion deals with the correctness of the accounting treatment and disclosure of interest income on foreign currency loans on back-to-back basis and exchange variation on account of such interest.

(b) In the opinion, the Committee noted that paragraph 17 of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' recognises 'Substance over Form' which states that "the accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely the legal form."

(c) Further, the Committee noted that the corporation was required to pay a pre-determined rate of interest on the foreign currency amounts of the loans recorded in the books at the exchange rate prevailing on the date of remittance.

(d) The Committee was of the view that the economic substance and reality of the transactions was that the corporation lent to its borrowers at fluctuating rate of interest. In fact the entire interest in rupee terms payable by the corporation to its lenders was to be recovered from the borrowers.

(e) The Committee, inter alia, was of the view that the true nature of the amount reimbursed by borrowers is that of interest and should be disclosed as such in the profit and loss account. The Committee further viewed that it would be useful to disclose the nature of relevant transactions in the notes to the accounts.

Thus, the Committee was, inter alia, of the opinion that recording of interest income at the book value and crediting the exchange variation on account of such interest under a separate head was not in order. Such recovery of exchange variation from borrowers should be added to the interest recovered on loans.

17. This further strengthens the treatment of exchange variation presently considered by the querist.

18. The querist has also separately informed the steps involved in import/high sea sales/purchases (i.e., signing of agreement with vendor, agreement between OMCs, etc.) which are as follows:

High Sea Sales:

(i) The company has entered into term contract with overseas suppliers for import of products, mainly LPG. As per the contract and agreed schedules, imports are

made on principal to principal basis and bill of lading (B/L) is made in favour of the company. Payments to the suppliers are effected in USD as per the agreed credit term, which is mostly after 30 days of B/L.

(ii) The above purchase is accounted by the company based on the exchange rate as on the date of B/L. When the payments are effected after the credit period, difference between the exchange rate at which payment was effected and the purchase cost (based on the B/L exchange rate) are accounted as exchange fluctuation loss or gain as the case may be.

(iii) Ownership of the product passes to the company on the date of bill of lading.

(iv) The company also enters into agreement with other OMCs for sale of imported product on a high sea sale basis. Such sale is made by endorsement of B/L anytime when the vessel carrying the product is on high sea.

(a) Agreement for sale is made with OMC.

(b) B/L is endorsed in favour of OMCs any time when the vessel is in high seas.

(c) The same is informed to Customs Authorities and OMC completes the customs formalities and takes the product.

(d) Sale invoices are raised on OMCs as per the above sale agreement. The sale is at a margin of 0.5% of INR value of the company's cost and freight.

(v) Such high sea sales to OMCs are accounted as sales in INR for the entire amount (without any exchange fluctuation). Following points are relevant in such sale transactions:

a. Contract of sale is in Indian Rupees and is in India and the product is transferred by endorsement of B/L anytime during the period when the vessel is in high seas.

b. At the time of sale, the company is the owner of the product.

c. Margin of 0.5% is collected on the total cost and freight. To protect the margin, all actual costs associated with the purchases are considered for sale price and payment due date is fixed as same as that of the due date of overseas supplier.

d. The sale realisation is in INR.

High Sea Purchases:

(i) Transaction of high sea purchase is also similar to the above.

(ii) The company enters into agreement with OMCs for purchase of LPG on high sea sale basis. Consideration of the purchase is in INR, which includes their cost plus margin which is agreed at 0.5% of the cost and freight.

(iii) OMCs endorse the B/L in favour of the company, any time when the vessel is in high seas. Ownership passes to the company after such transfer from OMCs. Customs clearance is done by the company.

(iv) OMCs raise an invoice on the company in INR for the cost, which is settled by the company on the due date, in INR.

(v) The total cost is debited to purchases.

19. The querist has also separately informed with regard to ensurement of quality control and normal course of taking insurance for these imports as follows:

- Mutually accepted surveyors are appointed by importers, who witness the tests and loadings as per the procedure in vogue in the terminals.
- Survey costs are also shared between the importer and vendor.
- High sea buyers are not conducting any surveys at load port.
- Insurance is arranged by the high sea buyers for their stock. Ocean loss is also shared in the ratio of ownership of the quantity imported.

B. Query

20. On the basis of the above, opinion of the EAC is sought by the querist on the following issues:

(i) Whether the accounting treatment of the transaction presently given by the querist for high sea sales/purchase to/from other OMCs as mentioned above is in order.

(ii) Whether the provisions of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' are applicable on such high sea sale/purchase transactions among OMCs denominated and settled in INR.

(iii) If yes, what should be the accounting treatment to be given by the querist for the differences between the provisional and final bill value arising on

such high sea sale/purchase transactions due to exchange variation between B/L date and settlement date of importing OMCs.

C. Points considered by the Committee

21. The Committee notes that the basic issue raised in the query relates to accounting for the differences between the provisional and final bill value arising on high sea purchases/sales transactions due to exchange variation between B/L date and settlement date of importing OMCs. The Committee has, therefore, considered only the issues raised by the querist in paragraph 20 above and has not examined any other issue(s) that may be contained in the Facts of the Case, such as, accounting for canalising charges, accounting for expenses incurred towards the import transaction, disclosure requirements of Schedule VI to the Companies Act, 1956 in respect of imported items, the appropriateness of the timing of recognition of high sea sales or purchase and assumes that in case of high sea sales/ purchase transaction, the transfer of risks and rewards occurs on endorsement of the document in favour of the buyer, as per the Facts of the Case provided by the querist. The Committee has also not revisited its earlier opinion referred to in paragraph 16 above, with respect to the issues raised by the querist in paragraph 20 above. The Committee presumes from the Facts of the Case that there is no principal-agency relationship and that the OMCs act on a principal-to-principal basis. The Committee also wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective such as, legal interpretation of agreements including high sea sales/purchase agreement entered into between various OMCs since as per Rule 2 of the Advisory Service Rules, the Committee is prohibited from doing so.

22. The Committee notes paragraph 17(b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the 'Rules', 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."

In view of the above, 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'. In the extant case, the Committee notes from the Facts of the Case (paragraphs 8 (i) and (iv) above) that in respect of high sea sales/purchase, the importing OMC raises two invoices on the buying OMC - the provisional invoice and final invoice. The amount of both of these invoices is arrived at in Indian rupees on the basis of price fixed with the foreign vendor. From this,

the Committee notes that although the invoices so raised are denominated in Indian rupees, they are Indian Rupees equivalent of the price charged by the foreign vendor, which is denominated in foreign currency. Hence, the Committee is of the view that while it is true that the price charged to the buying OMC is in INR, it is actually 'linked' to foreign currency. That's why two invoices - provisional invoice and final invoice are raised. Accordingly, the Committee is of the view that while prime obligor in settlement of the liability denominated in foreign currency is the importing OMC, it is the buying OMC which, in substance, assumes the liabilities denominated in foreign currency in respect of high sea sales/purchase that are settled in Indian Rupee equivalent amount.

23. As far as applicability of AS 11 to high sea sales/purchase is concerned, the Committee notes paragraph 1 of AS 11, which deals with applicability of the Standard:

> "1. This Standard should be applied:
> (a) in accounting for transactions in foreign currencies; and
> (b) in translating the financial statements of foreign operations."

The Committee further notes paragraph 8 of AS 11, as provided below:

> "8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:
> (a) buys or sells goods or services whose price is denominated in a foreign currency;
> (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;
> (c) becomes a party to an unperformed forward exchange contract; or
> (d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency."

From the above, the Committee notes that AS 11 is applicable to foreign currency transactions where an enterprise acquires or disposes of assets or incurs or *settles liabilities, denominated in a foreign currency*. The Committee notes from the discussion in paragraph 22 above that the buying OMC is, in substance, settling the liabilities denominated in foreign currency and accordingly, the Committee is of the view that AS 11 is applicable to high sea sales/purchase in the extant case.

24. As regards accounting for the difference between the provisional bill and the final bill value of high sea sales/purchases, the Committee notes paragraph 9 of AS 11 which states as follows:

> ***"9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the***

exchange rate between the reporting currency and the foreign currency at the date of the transaction."

The Committee is of the view based on the above that since an enterprise initially, recognises a foreign exchange transaction on the date of the transaction, the exchange rate variation is recognised if rate of exchange changes thereafter. Presuming that provisional bill has been raised on the date of endorsement of B/L, the Committee notes that in the extant case, the date of transaction of high sea sales/purchase is the date of endorsement of B/L as the ownership in goods passes to the buying OMCs through endorsement of B/L. Accordingly, the high sea sales/purchase transaction should be recorded by applying the exchange rate prevailing on the date of endorsement of B/L and any foreign exchange variation occurring thereafter till the date of settlement irrespective of date of final bill should be recorded as foreign exchange difference in the books of buying OMC as per the principles of AS 11.

The Committee wishes to point out that if the provisional bill includes any exchange variation arising between the original date of bill of lading and the date of its endorsement, then it will automatically become a part of purchases/sales value as discussed above and no separate accounting treatment is required for such exchange difference.

D. Opinion

25. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 20 above:

(a) No, the accounting treatment of the transaction presently given by the querist for high sea sales/purchase to/from other OMCs, as discussed above is not in order.

(b) Since the buying OMC is, in substance, settling the liabilities denominated in foreign currency, AS 11 is applicable to high sea sales/purchase in the extant case as discussed in paragraph 23 above.

(c) The cost of high sea sales/purchase should be recorded by applying the exchange rate prevailing on the date of endorsement of B/L, which is the date of high sea sales/purchases and any foreign exchange rate variation occurring thereafter till the date of settlement should be recorded as foreign exchange difference in the books of buying OMC as per the principles of AS 11, as discussed in paragraph 24 above.

Annexure A

Scheme of entries passed by the company

A. At the time of High Sea Purchase:

Debit Purchases
(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

Credit Sundry Creditors for Purchases - OMC A/c
(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

B. At the time of High Sea Sales:

a. At the time of Import:

Debit Purchases
(Cost of product USD @ exchange rate on the date of B/L)

Credit Sundry Creditors for Purchases
(Cost of product USD @ exchange rate on the date of B/L)

b. At the time of making payment:

Debit Sundry Creditors for Purchases
(Cost of product USD @ exchange rate on the date of Payment)

Credit Bank Account
(Cost of product USD @ exchange rate on the date of Payment)

Debit/Credit Sundry Creditors for Purchases
(Difference between Purchases as per (a) and Payment (b))

Debit/Credit Exchange Fluctuation Account
(Difference between Purchases as per (a) and Payment (b))

c. At the time of High Sea Sales

Debit OMC Customer A/c
(Cost of product USD + Margin@ 0.5% @ exchange rate on the B/L date)

Credit Sales

(Cost of product USD + Margin@ 0.5% @ exchange rate on the B/L date)

d. At the time of Account Closing date/Final invoice

Debit OMC Customer A/c
(With the amount of costs/ exchange variation recovered in High Sea Sales)

Credit Sales
(With the amount of costs/ exchange variation recovered in High Sea Sales)

Annexure B

Statutory Auditor's view on entries to be passed in a High Seas Sale/ Purchase transaction

1. In a High Sea Sale transaction, following entries should be passed

a. At the time of Import:

Debit Purchases
(Cost of product USD @ exchange rate on the date of B/L)

Credit Sundry Creditors for Purchases
(Cost of product USD @ exchange rate on the date of B/L)

b. At the time of making payment:

Debit Sundry Creditors for Purchases
(Cost of product USD @ exchange rate on the date of payment)

Credit Bank Account
(Cost of product USD @ exchange rate on the date of payment)

Debit/Credit Exchange Fluctuation Account
(Difference between Purchases as per (a)(ii) and Payment (b)(i)

c. At the time of High Sea Sales:

Debit OMC Customer A/c

(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of endorsement of bill of lading)

Credit Sales
(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of endorsement of bill of lading)

d. At the time of receipt of payment from other OMCs:

Debit Bank A/c
(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of invoice)

Credit OMC Customer A/c

(Cost of product USD + Margin@ 0.5% @ exchange rate on the date of invoice)

Debit/Credit Exchange Fluctuation Account
(Difference between as per c (i) and d(ii))

2. In a High Sea Purchase transaction, following entry should be passed:

a) Debit Purchases
(Cost of product USD @ exchange rate on the date of endorsement of bill of lading/date of invoice, margin @ 0.5% and all expenses payable to OMC)

Credit Sundry Creditors for Purchases - OMC A/c
(Cost of product USD @ exchange rate on the date of invoice/date of endorsement of bill of lading, margin @ 0.5% and all expenses payable to OMC)

b) Debit Sundry Creditors for Purchases - OMC A/c
(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

Credit bank A/c
(Cost of product USD @ exchange rate on the date of payment, margin @ 0.5% and all expenses payable to OMC)

Debit/Credit Exchange Fluctuation Account
(Difference between as per a (ii) and b (i))