# Opinion

# Accounting Treatment of Interest Earned on Surplus Equity Funds

***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 public sector undertaking is wholly owned by the Government of National Capital Territory of Delhi (GNCTD). The company is in the business of generation of power. The company has two power stations in operation, the tariff of which is regulated by the Delhi Electricity Regulatory Commission (DERC)/Central Electricity Regulatory Commission (CERC). The company had planned to set up a project of 750 megawatt (MW) gas based combined cycle power plant at Bamnauli (hereinafter referred to as the 'project'). The same was to be set up with debt/equity ratio of 30:70.
2. Equity for the project was to be invested by the GNCTD and debt portion was proposed to be availed equally from the GNCTD and Power Finance Corporation. The GNCTD had contributed towards equity amounting to ₹100 crore and ₹300 crore on 04.04.2011 and 30.11.2011, respectively. The company had initiated the pre-construction activity by awarding the contract to A Ltd. for diversion of 400 KV Bawana-Bamnauli D/C and 400 KV Ballabhgarh-Bamnauli transmission line. As per the contract with A Ltd. for pre-construction activity of the project, the company has been making payment out of the equity funds. The GNCTD had directed to the company that it should not incur any cost for construction of the project without any firm commitment of allotment of gas by the Central Electricity Authority/Government of India.
3. The querist has stated that the company on a regular basis has been investing the amount available in surplus out of the equity received for the project in the term deposits with the public sector banks as per the investment policy of the company. As per the conditions of sanction of equity contribution of the GNCTD, the interest income, if any, on the equity amount of the GNCTD shall be utilised as additional equity of the GNCTD and is to be utilised for the respective project. As the interest earned on equity funds is income of the company, no additional equity shares are being allotted to the GNCTD against such interest earned. The company has accounted for the interest as 'income' and has been re-investing the interest amount alongwith the balance equity available in the term deposits with public sector banks. The said amount of interest, being accounted for as income, is subject to income tax and is being retained in surplus profit and loss account on year-to-year basis. As on 31.03.2014, the company had outstanding equity amount of ₹301.20 crore and interest income as ₹45.64 crore, which has been invested in term deposits of public sector banks and shown under investments.
4. The Comptroller and Auditor General (CAG) of India, while conducting supplementary audit for the financial year (F.Y.) 2013-14, has issued the following Half-Margin:

   "Half Margin No. 4
   Cash and Cash equivalents-(Note-20) -₹35,504.66 lakh
   Other income-₹3,948.52 lakh
   Interest on Bank deposits–₹3,571.02 lakh
   The cash and bank balance of ₹35,504.66 lakh includes ₹34,683.60 lakh received from GNCTD as equity contribution from GNCTD for the project at Bamnaulli. The equity contribution of ₹40,000 lakh was received in 2011-12 specially for Bamnaulli project with the condition that the expenditure will be incurred only for the purpose for which the equity has been sanctioned.

   The other income includes interest on bank deposit of ₹3,571.02 lakh received

and accrued on bank deposit of the equity contribution from GNCTD for the project at Bamnaulli. Since the equity was sanctioned for a specific project of Bamnaulli, the interest earned on these funds should not be included in the income of the company and special reserve should be created and interest earned should be credited in the special reserve. Thus, crediting ₹3,571.02 lakh to other income resulted in overstatement of 'profit before tax' of ₹3,571.02 lakh and understatement of 'Special Reserve' under the head of reserves & surplus.

The facts and figures mentioned above may kindly be confirmed and comments, if any, on the audit observation may be offered at the earliest. Documentary evidence in support of the contention made by the Company may kindly be furnished in support of the reply."

5. In reply to the half margin, the management has submitted the reply duly confirmed by statutory auditor, which is as below:

"The interest earned on balance amount available out of the equity contribution from GNCTD for the project at Bamnauli has been reinvested in the term deposit with public sector banks as per the investment policy of the Company.

The interest income earned by the Company on the above said investment is its income for the F.Y. 2013-14 as per the applicable accounting principles and also Income-tax Act, 1961. This had also been discussed and opinion obtained from two renowned Chartered Accountants' firms.

As regards the suggestion in audit observation to transfer the applicable interest (net of tax), the same is an appropriation of profits which needs to be approved by Audit Committee, Board of Directors and finally confirmed by the AGM. As an additional measure, we are obtaining expert opinion of the Institute of Chartered Accountants of India (ICAI) on the issue and necessary action would be taken thereafter accordingly.

In view of the above submission, it is requested that Audit may please drop this half margin."

The querist has also stated that there is no provision in the regulations of DERC/CERC for creation of any special reserve.

## B. Query

6. In view of this, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
   (i) whether the company has to create the special reserve as pointed out by the CAG in respect of the interest earned on the surplus amount available out of the equity contribution by the GNCTD, when there is no provision in the regulations of DERC/CERC and other accounting principles for creation of any special reserve.
   (ii) in case, EAC opines to create special reserve in line with the observations of CAG audit in respect of tthe interest earned (net of taxes) on the surplus amount available out of the equity contribution by the GNCTD, the accounting treatment of the same may be advised.

## C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting for the interest earned from the investments of the surplus equity funds, where there is a restriction on utilisation of interest amount. 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, treatment of equity contribution by the GNCTD, treatment of debt contribution by the GNCTD and A Ltd., disclosure of term deposits by the company in its financial statements, etc. Further, it may be mentioned that the opinion expressed hereinafter is purely from the accounting perspective and not from the perspective of interpreting any legal enactments, such as, Income-tax Act, 1961.
8. The Committee notes that in order to determine the treatment of interest earned from the investments of surplus equity funds

of the company, it is necessary to examine whether the interest earned by the company is an income to the company or not. In this regard, the Committee notes the following paragraph from the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, which reads as below:

> "69. ...
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> (a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
>
> (b) ..."

From the above, the Committee is of the view that although there are restrictions on the utilisation of funds for the purpose of project only, interest earned by the company by investing the equity funds results into enhancement of assets for the company and accordingly, is an income to the company. The Committee further notes paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006, as reproduced below:

> ***"5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."***

On the basis of the above, the Committee is of the view that the interest earned on investments made out of the surplus equity funds should be credited to the statement of profit and loss as income of the company. However, in view of the specific requirement as per the conditions of sanction of equity contribution of the GNCTD that the interest income, if any, on the equity amount of GNCTD, shall be utilised as additional equity of GNCTD and is to be utilised for the respective project, as stated in paragraph 3 of the Facts of the Case, the Committee is of the view that the said interest after routing through the statement of profit and loss may be transferred to a specific reserve as an appropriation of profits with necessary disclosure in financial statements.

## D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 6 above:
   (i) and (ii) The company should recognise the interest earned on the surplus funds available out of the equity contribution by the GNCTD as income by crediting the statement of profit and loss and thereafter, considering the specific requirements for utilisation of the said interest, it may be transferred to a specific reserve fund as an appropriation of profits with necessary disclosure in financial statements.

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| 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 December 11, 2014. 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 thirty two volumes. A CD of Compendium of Opinions containing thirty two 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 eac@icai.in. |