

Accounting for Expenditure Incurred as a Pre-Condition to Obtaining Environmental Clearance for Setting up Power Project and Coal Mines

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 incorporated as a wholly owned Government company under the Companies Act, 1956 during the year 1984-85 is engaged in construction and operation of thermal power plants in the State of Odisha. The company had set up two power plants of 2 x 210 MW (Units I and II that is Stage-1) as its maiden venture in the district of Jharsuguda known as IB Thermal Power Station and the units were commercially operated during December 1994 and June 1996 respectively. Power generated from units I and II is sold to A Ltd, a Govt. of Odisha Undertaking at a tariff determined as per Bulk Power Purchase Agreement executed during 1996. During 1999, as a part of power sector reforms, the Govt. of Odisha disinvested 49% of the shares in favour of ABC corporation, USA the strategic investor. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956 as amended from time to time.
2. The company is setting up two new power plants of 2 x 660 MW (Units III and IV that is Stage - 2) at same location of IB Thermal Power Station, Jharsuguda with capital cost estimated around ₹11,547/- crore which will be met out of 75% long terms loans and 25% as equity from the investors. Besides the above, two coal blocks i.e., Manoharpur (181.68MT) and deepside of Manoharpur II (350MT) were allotted by the Ministry of Coal during the year 2007 at Sundergarh district inside the State of Odisha. The quantity of coal which is to be extracted from the coal mine development by the company will be only utilised in generation of electricity for new power plants (2X660MW), which are under construction.
3. The company has incurred expenses in peripheral villages in the areas of health, education, drinking water, road, street lighting, lift irrigation, culture and sports functions etc. Expenses incurred as above are accounted as follows:
 - (a) *Expenses incurred in periphery villages of the operational units as well as areas where other units and establishments are situated are booked under accounting head 'Peripheral Development Expenses' and debited to the statement of profit and loss. (Emphasis supplied by the querist.)*
 - (b) It may be noted that the power project as stated above has been considered in accordance with the provisions of Environmental Impact Assessment (EIA) notification, issued by the Ministry of Environment and Forest vide SO-1533 (E) Sept-2006. Based on information submitted by the company, the Ministry of Environment has accorded environmental clearance of the above project under the provision of EIA notification dated 14th September, 2006 subject to compliance of different conditions as amended by its letter dated 4.2.2010 (a copy of which has been supplied by the querist for the perusal of the Committee). *As per Clause 4(xxvi) of above letter, an amount of ₹24.36 crore shall be earmarked as one time capital cost for CSR programme.* Similarly, for coal mine project, the Ministry of Environment and Forest, while granting environmental clearance for open cast coal mine project has informed compliance of certain conditions vide its letter dated 21.02.2014 (a copy of which has been supplied by the querist for the perusal of the Committee). As per clause 2(xx), the CSR cost has been calculated @ ₹5/Te. for 152.12 MT minable resources amounting to ₹7,606 lakhs. While according approval, the Ministry of Environment and Forest accorded environmental clearance of

open cast coal mine project under the provision of EIA notification 2006 and subsequent amendment thereto subject to the compliance of the terms and conditions as specified in the said letter. *As per special conditions contained in clause A (ix), the CSR amount should be ₹4 crores in initial 3 years, and thereafter it should be ₹5/T of coal /annum till the end of the life of project with the escalation of coal production.* In addition to above CSR compliances, it is also required to comply with other conditions like expenses on rehabilitation resettlement and wildlife conservation plan. (Emphasis supplied by the querist.)

4. The querist has stated that keeping in view the mandatory requirement as above and condition to environmental clearance accorded to both power project and coal mines, the treatment made in the accounts is as follows:

*Expenses incurred in periphery villages as a requirement and condition to new power plant (2 * 620MW) and coal mines booked under the head 'Peripheral Development' and grouped under the 'Expenditure During*

Development/Construction of Power Project' and 'Expenditure During Development Coal Mines' which will be capitalized on commissioning of the project/coal mines as the case may be.

(Emphasis supplied by the querist.)

5. Significant accounting policies of the company are as follows:
Development of Power Projects & Coal Mines:
"Expenditure on exploration and development of new coal mines is capitalised as 'Development of coal mine' under 'Capital Works in Progress' till the Mines Project brought to operation."
"Expenditure on development of new power projects is capitalized as 'Development of Power Projects' under Capital Work in Progress."
6. The Comptroller and Auditor General of India (C&AG) while conducting supplementary audit under section 619(3) of the Companies Act for the financial years 2012-13 and 2013-14, has raised observations on accounting treatment of peripheral development expenses (CSR expenses). Observations of C&AG and management replies submitted in response to said observation are given as follows:

Years	Comments of C & AG of India	Management Reply
2012-13	Generation and other expenses (Note-26.4) Peripheral Development expenses: ₹42.85 lakh.	
	The company booked ₹63.71 lakh (₹35.75 lakh for 2008-09 to 2011-12 and ₹27.96 lakh for 2012-13) out of profit towards peripheral developments expenses as a part of its CSR activities to Capital Works in Progress, instead of charging to profit and loss account. This has resulted in understatement of prior period expenses (net) (Note-27) by ₹35.75 lakh, peripheral development expenses (Note-26) by ₹27.96 lakh, overstatement of capital work-in-progress (Note-26) by ₹27.96 lakh, overstatement of capital work-in-progress (Note-12) and profit for the year by ₹63.71 lakh.	As per paragraph 9.2 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. <i>However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.</i> Peripheral development expenses are <i>incurred specifically attributable to construction of units III & IV and coal mining project and correctly accounted as capital work in progress in compliance to AS 10.</i> In view of above, there is no understatement of prior period expenses (net) (Note-27) by ₹35.75 lakh, peripheral development expenses (Note-26) by ₹27.96 lakh, overstatement of capital work-in-progress (Note-26) by ₹27.96 lakh, overstatement of capital work-in-progress (Note-12) and profit for the year by ₹63.71 lakh.

Years	Comments of C & AG of India	Management Reply
2013-14	<p>Generation and other expenses (Note-27) Peripheral Development Expenses: ₹1.97 crore</p> <p>The company booked ₹1.29 crore (₹0.82 crore for development of coal mines and ₹0.47 crore towards construction of units 3&4) out of profit towards peripheral development expenses as a part of its CSR activities to capital works in progress, instead of charging to profit and loss account. This has resulted in understatement of peripheral development expenses (Note-27), overstatement of capital work-in-progress (Note-13) and profit for the year by ₹1.29 crore each.</p>	<p>As per paragraph 9.2 of AS 10, administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. <i>However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as a part of the cost of the construction project or as a part of the cost of the fixed asset.</i> Peripheral development expenses are incurred specifically attributable to construction of units- III & IV and coal mining project and are correctly accounted as capital work in progress in compliance to AS 10.</p> <p>In view of the above, there is no understatement of peripheral development expenses (Note-27), overstatement of capital work in progress (Note-13) and profit for the year by ₹1.29 crore each.</p>

7. The company is of the view that peripheral development / CSR expenses as stated above are mandatory and a condition to environment clearances for the project (2 * 660MW power plant and coal mines). Without such clearances, the power project and coal mining project will not come into existence. These expenses are specifically attributable to construction of a project and for bringing the said project into its working condition and satisfy the requirements under AS 10. So accounting treatment made by the company as stated above as part of cost of the construction project (units III & IV) and coal mining project is in consonance with generally accepted accounting principles and Accounting Standards.

B. Query

8. In view of the above facts and accounting requirements, the company seeks the opinion of the Expert Advisory Committee as to whether the accounting treatment made in the accounts for peripheral development expenses (CSR expenses) in respect of power project and coal mines as a condition to environmental clearance by way of 'Expenditure during Development / Construction of Power Project' and 'Expenditure during Development Coal Mines' which will be capitalized on commissioning of the project / coal mines as the case may be, is in consonance with generally accepted accounting principles

(GAAPs) and Accounting Standards. If not, what is the correct treatment?

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting for the expenditure (referred to by the querist as peripheral development expenses (CSR expenses)) incurred by the company during construction/development of power project and coal mines, as a pre-condition to obtaining environmental clearance in respect of power project and coal mines (hereinafter referred to as the 'expenditure'). Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, expenditure incurred on exploration and development of coal mine project, expenditure on development of power project, etc. The Committee also wishes to mention that the Committee has not examined the accounting treatment of peripheral development expenses (CSR expenses) incurred by the company after the development of the power project and coal mines as the issue is not raised by the querist. The Committee has also not examined whether the expenditure meets the requirements of CSR expenses as prescribed under various laws, such as, Companies Act, 2013, Regulations, Guidelines, etc. and the opinion is purely from accounting

perspective. The Committee has also not examined the details of expenditure incurred and has presumed that the company is incurring the expenditure as per the directions/instructions of the Ministry of Environment and Forest. Further, since the query is related to the power and coal mines development project, it is presumed that for capitalisation purpose, the whole project is being considered as a unit of measurement.

10. The Committee notes from the Facts of the Case that the company in question has obtained environmental clearance from the Ministry for development of coal mine and power project and as a condition to such clearance, the company has to incur the expenditure referred. In this regard, the Committee also notes the requirements of the environmental clearance for the coal mine and power project, respectively as follows:

Environmental clearance for Power Project

“...the Ministry of Environment and Forests hereby accords environmental clearance to the above project under the provisions of EIA notification dated September 14, 2006, subject to the compliance of the following conditions:

...

- (xxvi) An amount of ₹24.36 Crores shall be earmarked as one time capital cost for CSR programme. Subsequently a recurring expenditure of ₹4.87 Crore per annum shall be earmarked as recurring expenditure for CSR activities. ...”

“The Ministry of Environment and Forests reserves the right to revoke the clearance if conditions stipulated are not implemented to the satisfaction of the Ministry. The Ministry may also impose additional environmental conditions or modify the existing ones, if necessary.”

Environmental clearance for Coal Mine Project

“2. ... The proponent has informed that:

...

- xx. The CSR cost has been calculated @ ₹5/Te for 152.12MT mineable reserves amounting to ₹7606 Lakh. The CSR expenditure of ₹ 84.35 Lakh till date has been made on education, health, infrastructure, water, sports & culture, Social welfare etc.”

“3. ... The Ministry of Environment & Forests hereby accords environmental clearance...

under the provisions of the Environmental Impact Assessment Notification, 2006 and subsequent amendments thereto subject to the compliance of the terms and conditions mentioned below:

A. Specific Conditions:

...

- ix. The CSR amount should be ₹4 crores in initial 3 years, and thereafter it should be ₹5/T of coal/annum till the end of the life of project with escalation factor every year coal production.”

“8. Failure to comply with any of the conditions mentioned above may result in withdrawal of this clearance and attract the provisions of the Environment (Protection) Act, 1986.”

The Committee further notes the following paragraphs of AS 10, notified under the Companies (Accounting Standards) Rules, 2006:

“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

- (i) site preparation;
- (ii) initial delivery and handling costs;
- (iii) installation cost, such as special foundations for plant; and
- (iv) professional fees, for example fees of architects and engineers.

...”

“10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.”

From a wholesome reading of the above paragraphs of AS 10, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to a fixed asset/project under construction is that it should be directly attributable to the construction of the project/fixed asset for bringing

it to its working condition for its intended use, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. Accordingly, in the extant case, the Committee is of the view that it should be seen that whether the expenditure is directly attributable to the construction as discussed above. The Committee notes that in the extant case, incurrence of the expenditure is a specific pre-condition for the environmental clearance for the development of the coal mine and power projects and in case this expenditure is not incurred, it may result in withdrawal of the environmental clearance and attract the penalties as per the provisions of the Environment (Protection) Act, 1986. Accordingly, in the view of the Committee, the expenditure should be considered as directly attributable to the development/construction of the coal mine and power projects for bringing them to their working condition for their intended use. Therefore, the Committee is of the view that the expenditure to the extent required to be incurred for obtaining environmental clearance should be capitalised as a part of the cost of the coal mine and power project. With regard to the accounting policy of the company for treatment of such expenditure, the Committee notes from paragraph 4 above that the same is booked under the head 'Peripheral Development' and grouped under the 'Expenditure During Development / Construction of Power Project' and 'Expenditure During Development Coal Mines' which will be capitalised on commissioning of the project/coal mines. The Committee is of the view that since the expenditure is to be capitalised, the same should be capitalised initially as 'capital work-in-progress' as and when incurred with a suitable disclosure in the notes to accounts to explain the nature of such expenses and then recognised as a part of the cost of the related project/asset account as and when the project is ready for commencement of commercial production.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that capitalising the expenditure incurred as a pre-condition to obtaining environmental clearances as a part of the cost of power project and coal mines and not recognising the same in the statement of profit and loss is appropriate and is in consonance with generally accepted accounting principles (GAAPs) and Accounting Standards. However,

the expenditure should initially be capitalised as 'capital work-in-progress' as and when incurred with a suitable disclosure in the notes to accounts to explain the nature of such expenses and then recognised as a part of the cost of the related project/asset account as and when the project is ready for commencement of commercial production, as discussed in paragraph 10 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 April 23, 2015. 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 four volumes. A CD of Compendium of Opinions containing thirty four volume 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 .

Corrigendum

Opinion published in the last issue, *i.e.* March 2016, of the Journal had already been published as *Opinion* in November 2015 issue of the Journal. Inconvenience caused, if any, to our readers because of this repetition is sincerely regretted. Readers may kindly note.

— Editor