# Opinion

# Accounting treatment for the project assets under construction

***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. The Sardar Sarovar Project (SSP) is a collaborative effort between four states, viz., Gujarat, Maharashtra, Madhya Pradesh and Rajasthan (collectively referred to as Party states). On reference by the Government of Gujarat (GOG), the Central Government ('CG') constituted Narmada Water Disputes Tribunal (NWDT) in October, 1969, under the provisions of section 4 of the Inter-State River Water Disputes Act, 1956 to settle the disputes between the Party States. The project report of SSP prepared by GOG was submitted to Central Water Commission (CWC) for clearance. Narmada Water Scheme, 1980 was published in Gazette on 10-09-1980 by the Government of India (GOI). Narmada Control Authority (NCA) started functioning in December, 1980. As per the NWDT order, the GOG was given the primary responsibility for the execution of the project.
2. The querist has stated that to comply with NWDT order and with specific objective to execute the SSP, the GOG incorporated a company (hereinafter referred to as 'the company'), as a wholly owned Government company under the Companies Act, 1956 as per the Government Resolution ('GR') dated 21st March, 1988, passed by the Government of Gujarat. The relevant extracts of the NWDT order have been provided by the querist for the perusal of the Committee.
3. On formation of the company, the Government of Gujarat, Narmada Development Department vide Resolution dated 31st March, 1988 transferred en-bloc the entire staff and officers of the circles and other heads etc. working under the control of Narmada Development Department to the company. Further, the Government of Gujarat also transferred assets of Sardar Sarovar Narmada Project to the company vide G.G. No. COR-1488-H dated 27 October, 1988. The value of the assets transferred was tentatively fixed at Rs. 533.09 crore at the prices prevailing in the year 1988 for which the valuation was finalised at the same amount vide GR No. PARCH/2013/1323/74/N dated 10 July 2015. In consideration for the transfer of assets, equity shares were issued to Government of Gujarat.

*Brief of SSP assets and project status as on date*

4. The querist has further stated that SSP envisaged by the company can be divided into three broad parts:
   (i) Power Plants – Eleven (11) hydro power stations consisting of six units of canal head power houses (CHPH) and five units of river bed power houses (RBPH)
   (ii) Water Project – comprising of branch canals, distributaries, minors and sub minors
   (iii) Common Assets– consisting of dam and main canal
5. The querist has also stated that while the work on SSP commenced in 1980, work on some portions is still in progress. The project status for each of the segments identified as on 31st March, 2015 is as under:
   (i) Power Plants- The company started generation of electricity during F.Y. 2004-05 and all the five units of CHPH and six units of RBPH have been functioning since then. Generation of power mainly depends upon the reservoir level which is determined by the height of dam. At dam height of 138.68 meters, the power can be generated to 6343 MU. While at present dam height of 121.92 meters, the power is generated to the tune of 3600 MU. Thus, the additional 2743 MU, i.e., 43.25% is yet to be generated against the planned capacity. The full reservoir storage capacity will be reached only after the installation of gates.
   (ii) Water Project- The water project comprises of branch canals, distributaries, minors and sub minors. The physical work done in respect of canal network as on 31st March, 2015 is given under Table 1 below.
   (iii) The Dam and Main Canal- The Sardar

Sarovar Dam has reached the spillway crest level, i.e., EL 121.92 meters on December 31, 2006. At this stage about 96% of the total concrete work has been completed. The live storage capacity at full reservoir level (FRL) 138.68 meters is 5760 million cubic meter (MCM), whereas at the dam height of 121.92 meters, the live storage capacity is of 1565.84 MCM which is 27.18% of the total live storage capacity.

6. The construction of entire 458 Km length of concrete lined Narmada Main Canal (NMC) within Gujarat is completed. The water of Narmada is being released to Rajasthan State since March 2008 through Narmada Main Canal. In nutshell, at the present height of EL 121.92 of dam and Main Canal having completed its intended length of 458 Kms, the power plants are functioning at the level of not at the intended capacity, moreover the other irrigation network has been completed at a level which does not give 100% of its anticipated capacity but are functioning at sub-optimum level.

   The table below summarises % of completion status as on 31st March, 2015 for various components of SSP:

**Table 1**

| Sr. No. | Particulars | Achieved till date 31.03.15 | Target | % completion | Parts as identified under section B |
|---|---|---|---|---|---|
| 1 | Power generation capacity - MU | 3,600 | 6,343 | **56.76** | **1** |
| 2 | No. of Power Plants | 11 | 11 | **100.00** | |
| 3 | Branch Canal – KMs | 2408 | 2,585 | **93.15** | **2** |
| 4 | Branch Canal - Nos. | 37 | 38 | **97.36** | |
| 5 | Distributaries – KMs | 3657 | 5,112 | **71.53** | |
| 6 | Minors – KMs | 10,222 | 18,413 | **55.52** | |
| 7 | Sub Minors – KMs | 10,444 | 48,058 | **21.73** | |
| 8 | Irrigation potential - Lac hectares | 11.11 | 17.92 | **62.00** | |
| 9 | Live storage capacity @MCM | 1,565.84 | 5,760 | **27.18** | |
| 3 | Dam Height – meters | 121.92 | 138.68 | **87.91** | **3** |
| 4 | Main Canal – KMs** | 458 | 458 | **100.00** | |

**certain structures are still remaining to be constructed.

*Notes:*

- Against the targeted Culturable Command Area (CCA) of 17.92 lac hectare to be developed, 3.70 lac hectare (21%) has been developed till March 31, 2015.
- Against the targeted irrigation potential of 17.92 lac hectare to be created, 11.11 lac hectare (62%) has been created till March 31, 2015.

*Present accounting policy with respect to capitalisation*

7. The querist has also reproduced the present accounting policy adopted by the company as below and duly disclosed in the annual accounts of the company for the financial year (F.Y.) 2013-14. The querist has also mentioned that the accounting policy was approved in the meeting of the board of directors (BOD) held on 25th June, 2009 and it was also decided to continue with the accounting policy and treatments for F.Y. 2008-09 and onwards and hence, the company has continued the same accounting policy and accounting treatment for F.Y. 2011-12 to F.Y. 2013-14. The said financial years have been duly approved in the same manner in the BOD meeting held on 22.11.12, BOD meeting held on 11.09.13 and BOD meeting held on 27.11.14, respectively. The company has also continued the same accounting policy and treatment for F.Y. 2014-15:

"6(d) Till the substantial completion of the project, all the direct expenditure incurred on the works are treated as Capital Work in Progress. All the indirect expenditure incurred in respect of such structures, Canals and Power Houses including its operational income and expenditure are stated under 'Incidental Expenditure Pending Capitalisation'. Balance of 'Incidental Expenditure Pending Capitalisation' will be apportioned to the various components of the project on substantial completion of the project."

8. Project will be considered as 'substantially' completed on satisfaction of the following two conditions together:
   (i) Achievement of 15.23 lac hectares, being 85% of 17.92 lac hectares of the land contemplated for irrigation potential; and
   (ii) Physical completion of dam and other allied components including power houses.

   Further, the company has taken a view that being incorporated specifically for the purposes of execution of the SSP, its existence is limited to completion of the said objective. Considering the provisions of the NWDT order, it would not be incorrect to consider the company as an agency for execution of the project and not the owner of the same.

   The querist has also reproduced the net block of fixed assets as on March 31, 2015 (unaudited) as under:

**Table 2**

| Fixed Assets | Amount in ₹(crores) |
|---|---|
| Tangible Assets | **3,659.64** |
| Intangible Assets | **0.77** |
| Capital work-in-progress** | **43,108.64** |
| Intangible assets under development | **2.53** |
| Incidental Expenditure pending capitalisation | **(1,321.81)** |
| **Total** | **45,449.77** |

**Capital work-in-progress consists of major assets as follows as on March 31, 2015:

| Capital Work-in-progress | Unaudited Amount in ₹(crores) |
|---|---|
| Dam & Appurtenant works | 7,761.11 |
| Main Canal | 8,503.19 |
| Power | 5,063.02 |
| Branches & Distributaries | 21,780.05 |
| Buildings & others | 125.31 |
| Stock of Construction materials, stores & spares | 0.07 |
| Less: Receipts & Recoveries | (124.11) |
| **Total** | **43,108.64** |

9. The company's contention for each segment, as identified, is as follows:
   (i) **Power Project-** Hydro power project is functioning at sub-optimal level at the present dam's height of 121.92 meters considering the fact that the live storage capacity achieved is of only 27.18% as compared to that of at the full height of 138.68 meters. Though the company started generation of electricity during F.Y. 2004-05 and all the five units of CHPH as well as six units of RBPH are functioning, the generation of power mainly depends upon the reservoir level which is determined by the height of dam. The potential of power generation for additional 2743 MU i.e., 43.25% is yet to be achieved at the full height of the dam. *Therefore, the power project and dam have not been completed 'substantially'* (emphasis supplied by the querist).
   (ii) **Water Project –** With reference to table 1 above, while the targeted irrigation potential of 17.92 lac hectare is to be created at the full height of the dam, only 11.11 lac hectare (being 62%) has been created till 31st March, 2015. Therefore, the water project is also not substantially completed as on 31st March, 2015.
   (iii) The whole SSP is under implementation and the identifiable components should not be seen in isolation as they are interdependent and interlinked with one another. The concept of completion as envisaged in AS 10 implies completion of substantially all the material activities attributing to the qualifying assets. As per the accounting policy followed by the company consistently, the substantial completion of at least 85% of project components should be viewed in totality. Date of substantial completion is prerequisite for date of commissioning for commercial operation.
   (iv) The company has referred the matter to the Finance Department of Gujarat with respect to present accounting policy and the Department suggested to continue the same treatment.

10. The querist has also reproduced the observations/comments from the auditors and response of the management as follows:

| Summary of observations and comments | Summary of management responses |
|---|---|
| Statutory auditors have been qualifying/commenting the accounting policy and treatment adopted by the company since F.Y. 2007-08. | The management presented as under:<br>• SSP is an integrated project having interdependent and interlinked components and is still under execution. It is not substantially completed as on balance sheet date.<br>• The company was incorporated for the purposes of execution of the SSP and in terms of the object clause as well as the provisions of the NWDT order, there is no provision to own the project.<br>• SSP being a socio-economic project, the company is not an entity carrying on commercial or business activities and hence, accounting standards are not applicable.<br>• Management is of the view that it is not possible to arrive at an allocation of the common expenses and ascertain the amounts of rehabilitation & resettlement, forest & environment expenses and other indirect cost of various components required to be capitalised.<br>• Based on the allocation of the revenue and cost for various components as suggested by the NWDT order, it would not be prudent to capitalise full cost based on the matching concept.<br>• It is in line with the direction of the Finance Department, Department of Gujarat, as mentioned above. Detailed responses have been enumerated in the Annual Report of the company, which has been provided by the querist for the perusal of the Committee. |
| C&AG auditors have commented on non-capitalisation of power houses until F.Y. 2009-10. Post that, until F.Y. 2012-13, they have commented on non-capitalisation of the dam, main canal and parts of branches and distributaries in addition to power houses. They also emphasised on quantification of amounts involved. The querist has provided extracts of C&AG qualification for the perusal of the Committee. | The company has referred the matter to Finance Department of Gujarat, as mentioned above. The accounting policy as suggested there in has been followed. |

## B. Query

11. On the basis of the facts and circumstances stated above, the company has sought the opinion of the Expert Advisory Committee on the following accounting issues:
    (i) Whether the present accounting policy followed by the company and the accounting treatment of non-capitalisation of the SSP in its books of account on the grounds that the entire SSP is not 'substantially' ready for its intended use, is in accordance with generally accepted accounting principles in India.
    (ii) If the answer to above query (i) is negative, should the SSP be broken into units of accounts (UOA), viz., (1) Power Plants (2) Water Projects and (3) Common Assets, with each part being evaluated for capitalisation under the guidance of generally accepted accounting principles in India?
    (iii) If the answer to above query (ii) is yes, would it be correct to capitalise the identified units of accounts at their present stage of completion considering the fact that they are functioning at

sub optimal capacity as compared to the intended full capacity? Whether subsequent expenditures would be evaluated for capitalisation based on the provisions enumerated under AS 10.

(iv) If the answer to above query (ii) & (iii) is yes, then would it be correct to consider dam and main canal as common assets for the purpose of capitalisation of SSP, the cost being allocated on the basis of allocation specified under Clause XII of the NWDT Order? If no then, what would be an appropriate basis for the purposes of allocation of the cost?

## C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to propriety of accounting policy of the company of recognising various items of expenditure incurred on the SSP as 'Capital Work-in-Progress'. 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 different items of costs (direct and indirect) which may be eligible for capitalisation as per the principles of AS 10 as the details pertaining to these expenditure have not been provided by the querist, non-preparation of the statement of profit and loss by the company till substantial completion of the Project, interpretation of the NWDT order, etc. The Committee further wishes to point out that the extent of readiness of intended full capacity of SSP, depending on technological evaluation of the project, has not been examined by the Committee.
13. At the outset, the Committee notes from the Facts of the Case that the querist has stated that the company being incorporated specifically for the purposes of execution of the SSP, its existence is limited to completion of the said objective and considering the provisions of the NWDT order. Thus, it would not be incorrect to consider the company as an agency for execution of the project and not the owner of the same. In this regard, the Committee wishes to point out that on formation of the company, the assets of the Narmada Development Department were transferred to the company and in consideration of that, equity shares were issued to the Government of Gujarat. Further, it is also observed from the Annual Report of the company that time and again shares have been issued to the Government of Gujarat. The Committee also notes that at present also, the company is recognising the expenditure incurred on project as 'capital work-in-progress' and shall capitalise the same in its financial statements as and when the project is substantially complete as per the company. From the above, it appears to the Committee that the project being undertaken by the company is controlled by the company that can be capitalised in its books.
14. The Committee further notes that the querist has further contended that SSP being a socio-economic project, the company is not an entity carrying on commercial or business activities and hence, accounting standards are not applicable. In this regard, the Committee wishes to point out that the company being incorporated under the provisions of Companies Act, all provisions including the provisions related to compliance with the Accounting Standards notified under the Companies Act shall be applicable to it unless specifically exempted.
15. With regard to the issue raised by the querist, the Committee notes from the Facts of the Case that at present, the dam has reached the spillway crest level , i.e., EL 121.92 meters and the power is generated to 3600MU whereas at the targeted/planned dam height of 138.68 meters, the power can be generated at 6343MU. Thus, the balance 2743MU is yet to be generated against planned capacity. Further, targeted irrigation potential of 17.92 lac hectare is to be created at full height of dam (viz., 138.68 meters), whereas only 11.11 lac hectare (being 62%) has been created till 31 March, 2015. On the basis of the above-mentioned facts, the Committee notes that the querist has contended that the power plants are functioning at the level of not at intended capacity. Moreover, the other irrigation network has been completed at a level which does not give 100% of its anticipated capacity but are functioning at sub optimum level. On this basis, the querist has contended that the power project and the relevant asset have not been completed 'substantially' and therefore, these should not be capitalised in the books of account. Thus, the Committee notes that the issue to be examined is the point of time at which the cost of the relevant assets of the project should be capitalised. In this regard, the Committee notes the following requirements of Accounting Standard (AS) 10,

'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> "9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.
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> 9.4 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. ..."

From the above, the Committee notes that the above provisions require a fixed asset (comprising the plant) to be capitalised once it is *ready* to commence commercial production. The Committee is of the view that the date when an asset is ready to commence commercial production is a question of fact which should be determined on the basis of various factors, such as, technological evaluation of the readiness of the project and other facilities, the quality and the quantity of the output produced, etc. Commercial production means production in commercially feasible quantities and in a commercially practicable manner. Thus, if an asset is operational and is able to produce the commercially feasible quality and quantity of goods, then the costs should be capitalised even if it is not achieving targeted or 100% production. The Committee further notes that what is important is when the project is ready to commence commercial production and not the intended capacity to be achieved. In this regard, the Committee also notes paragraphs 21 and 22 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the 'Rules', which although addresses the issue from the point of view of the borrowing costs, however, the Committee is of the view that the principle enunciated in these paragraphs can be applied to other expenditures also. Paragraphs 21 and 22 of AS 16 are reproduced below:

> ***"21. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.***
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> 22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill."

From the above, the Committee is of the view that those units/parts of the project which are ready for their intended use and can be operated independently of the remaining units/parts, should be considered to be ready for commencement of commercial production/intended use. In this context, the Committee notes that in the extant case, the project is functional although at sub-optimal level and the company has started generation of power, from which income is also being recognised. Accordingly, it appears to the Committee that although the project may not be substantially complete to operate at its intended capacity and the components/units of the project are interdependent and interlinked (as being contended by the querist), since the project is functional and can be operated for its intended use as mentioned above, it can be considered to be ready to commence commercial production and therefore, relevant asset(s) of the project should be capitalised.

16. With regard to the issue raised by the querist relating to breaking of the project into different units of account in case of capitalisation of the project, the Committee is of the view that those units/parts of the project which are ready for their intended use and can be operated independently of the remaining units/parts, should be capitalised as and when these are so ready, as discussed in paragraph 15 above using

appropriate heads and classification, considering the requirements of Schedule II and Schedule III to the Companies Act, 2013. In this context, the Committee also wishes to point out that once the relevant assets are capitalised, depreciation should be provided on such capitalised asset(s) as per the provisions of Accounting Standard (AS) 6, 'Depreciation Accounting', notified under the Rules.

17. In the context of expenditure incurred subsequent to capitalisation since the project is still under implementation and activities to reach the intended capacity of the project are still in progress, the Committee notes the following paragraphs of AS 10, notified under the Rules:

> "12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.
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> 12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately."

From the above, the Committee is of the view that the subsequent expenditure on the project should be evaluated for capitalisation as per the above-reproduced requirements of AS 10. If the expenditure incurred increases the future benefits from the existing asset beyond its previously assessed standard of performance, e.g., an increase in capacity, it should be capitalised and if it becomes an integral part of the existing asset, it should be included in the gross book value of the existing asset.

## D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 11 above:

(i) The fixed asset/project should be capitalised once it is ready to commence commercial production. Since in the extant case, the company has started generation of power, from which income is also being recognised, it appears to the Committee that the project is functional and can be operated for its intended use as mentioned above. Accordingly, it can be considered to be ready to commence commercial production and therefore, relevant asset(s) of the project should be capitalised, as discussed in paragraph 15 above.

(ii) The units/parts of the project which are ready for their intended use and can be operated independently of the remaining units/parts, should be capitalised as and when these are ready, as discussed in paragraph 15 above using appropriate heads of assets, considering the requirements of Schedule II and Schedule III to the Companies Act, 2013, as discussed in paragraph 16 above.

(iii) The identified units of account should be capitalised as and when these are ready to commence commercial production irrespective of the fact that these are functioning at sub-optimal capacity and not at intended full capacity. Subsequent expenditure on the project should be evaluated for capitalisation as per the requirements of AS 10, as discussed in paragraph 17 above.

(iv) Answer to this question does not arise in view of (ii) and (iii) above.

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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 February 1, 2016. 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. |