

Query No. 16

Subject: *Making provision for non-approved cost.*¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’) is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May, 2002 after unbundling of the erstwhile State Electricity Board (SEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP Notification No. 226 dated 31st May, 2005.

2. The company is engaged in the business of electricity distribution in the area of Indore and Ujjain Commissionaire of the State of Madhya Pradesh and is governed by the provisions of the Electricity Act, 2003. The company is responsible for all activities associated with distribution of power within its territory, including management of assets, operation and maintenance of network and supply, technical and financial planning, business development and management of human resources, legal and regulatory affairs etc.

3. The company X is a transmission licensee and as per provisions of the Electricity Act, 2003 and Regulations (Terms & Conditions for Determinations of Tariff) made thereunder, a transmission licensee can charge only such tariff which is approved by the MP Electricity Regulatory Commission (MPERC).

4. Accordingly, company X is regularly raising invoices to the company for the electricity supplied, on monthly basis which contain all approved charges like transmission charges, incentive charges and true up charges etc. Apart from above, company X also included one item ‘carrying cost of true up charges’, which, as per the querist, is not approved by MPERC in its Tariff order or True-up.

5. Since, the ‘carrying cost of true up charges’ is not elsewhere approved by MPERC, no provision has been made by the company in its books of account for the same following the directions issued in MPERC Regulations (clause-13). However, the amount of ‘carrying cost of true-up charges’ is being shown as ‘contingent liability’ in the books of account of the company.

6. While conducting audit of annual accounts of the company for the financial year (F.Y.) 2014-15, the government auditor (C&AG auditor) had following observations in this regard:

“This does not include an amount of Rs.13.58 crore towards the carrying cost levied on true up for the financial year 2011-12 by the company X in transmission bills for the year 2014-15. The monthly bills of company X include transmission charges, incentive charges, true up charges, and carrying cost of true up charges. However,

¹ Opinion finalised by the Committee on 10.11.2017 & 11.11.2017.

while releasing the payments to the company X, the company has been deducting the carrying cost on true up and no provision was made for the same. As the carrying cost on true up was billed by the company X and there is no evidence that the carrying cost is not payable by the company, a provision for the liability should have been made in the accounts. Non-provision of liability has resulted in understatement of power purchase and transmission charges and understatement of liability by Rs.13.58 crore. Consequently, loss for the year was also understated by Rs.13.58 crore.”

7. In response to above, the company submitted the following reply:

“CAG audit observed that the company did not make any provision of liability towards the *carrying cost amount Rs. 13.58 crore* levied on true up for F.Y. 2011-12 by the company X in transmission charges bills for the year 2014-15.

In this regard, it is stated that the company X is a transmission licensee and as per provisions of the Electricity Act, 2003 and regulations made thereunder, a transmission licensee can charge only tariff approved by the MP Electricity Regulatory Commission. It is submitted that although company X billed Rs. 13.58 crore towards the carrying cost on true up for F.Y. 2011-12, however in the true-up order of F.Y. 2011-12 no amount is approved by the MPERC on account of carrying cost.

Kind attention is drawn towards section 62 of the Electricity Act, 2003:

“62. (1) The Appropriate Commission shall determine the tariff in accordance with provisions of this Act for –

- a) supply of electricity by a generating company to a distribution licensee;
 - b) transmission of electricity;
 - c) wheeling of electricity;
 - d) retail sale of electricity.
- (2) The Appropriate Commission may require a licensee or a generating company to furnish separate details, as may be specified in respect of generation, transmission and distribution for determination of tariff.
- (3) The Appropriate Commission shall not, while determining the tariff under this Act, show undue preference to any consumer of electricity but may differentiate according to the consumer's load factor, power factor, voltage, total consumption of electricity during any specified period or the time at which the supply is required or the geographical position of any area, the nature of supply and the purpose for which the supply is required.
- (4) No tariff or part of any tariff may ordinarily be amended more frequently than once in any financial year, except in respect of any changes expressly permitted under the terms of any fuel surcharge formula as may be specified.

- (5) The Commission may require a licensee or a generating company to comply with such procedures as may be specified for calculating the expected revenues from the tariff and charges which he or it is permitted to recover.
- (6) If any licensee or a generating company recovers a price or charge exceeding the tariff determined under this section, the excess amount shall be recoverable by the person who has paid such price or charge along with interest equivalent to the bank rate without prejudice to any other liability incurred by the licensee.

Further, clause 13 of the Madhya Pradesh Electricity Regulatory Commission (Terms and Conditions for Determination of Transmission Tariff) (Revision-II) Regulations, 2012 provides as under:

“13. Charging of Tariff other than approved

13.1. Any Transmission Licensee found to be charging a Tariff different from the one approved by the Commission from Beneficiaries shall be deemed to have not complied with the directions of the Commission and shall be liable to be proceeded against under Section 142 of the Act without prejudice to any other liability becoming due from the licensee under any other provisions of the Act. In case the amount recovered exceeds the amount allowed by the Commission, the excess amount so recovered shall be refunded to the Beneficiaries who have paid such excess charges, along with simple interest for that period equivalent to the State Bank of India’s Base Rate as on 1st of April of that year plus 3.50% besides any other penalty that may be imposed by the Commission.”

Further kind attention is also drawn towards paragraph 14 of Accounting Standard 29 which provides as under:

“14. A provision should be recognised when:

- (a) an enterprise has a present obligation as a result of a past event;***
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
- (c) a reliable estimate can be made of the amount of the obligation.***

If these conditions are not met, no provision should be recognized.”

Since MPERC has not approved any amount towards the carrying cost, there is no present obligation of the company to pay the same, hence need not required to be account for.”

8. The company has also requested C&AG auditor that the company has already shown the amount of ‘carrying cost of true up charges’ as ‘Contingent Liability’ in the books of account and after approval of MPERC, the same shall be duly recognized in the books of account of the company. However, the C&AG auditor has not considered the submission of

the company.

9. The querist has also separately supplied the following information for the perusal of the Committee:

- (a) In India, the electricity sector is regulated by the regulators (i.e. Electricity Regulatory Commission established under Electricity Act, 2003). The prices of supply of power to consumer as well as conditions of such supply are being decided by the regulator. Regulators allow licensees to charge rates from their consumers based on benchmark costs plus a reasonable mark-up. Components of such costs are interest cost, depreciation, operating and maintenance.

As per the provisions of the Electricity Act, 2003, no licensees are allowed to charge prices other than approved by the Regulatory Commission. In this regulatory framework, there are two stages of the approval by the regulators.

At the first stage, before commencement of each year, every licensee is required to file the tariff petition namely, 'Aggregate Revenue Requirement (ARR)' in accordance with the provisions of the regulation prescribed by the regulator in this regard, comprising projected revenue and cost. Based on this tariff petition regulatory commission approves the cost and determines tariff.

In the second stage, after completion of the financial year, based on the audited accounts licensee is again required to file a petition namely, 'True up petition'. The truing up exercise is meant to fill the gap between the actual expenses at the end of the year and the anticipated expenses at the beginning of the year. Based on this true-up petition and considering the provision of the regulation, Commission approves final cost of that year and allows recovery of any unrecovered cost by way of tariff-setting of subsequent year.

In this regulatory framework, it may happen that costs are allowed to be recovered from consumers in the period later than the period in which the costs are actually incurred. Therefore, regulatory commission based on the prevailing circumstances, if deemed fit, apart from cost incurred, may allow recovering the carrying cost also on account of such deferment of recovery of cost.

The carrying cost is allowed based on the financial principle that whenever the recovery of cost is deferred, the financing of the gap in cash flow arranged by the licensee from lenders and/or promoters and/or accruals, has to be paid for by way of carrying cost. In other words, it can be said that the carrying cost represent the interest component to compensate the time value of money for the period between ARR and True-up exercise.

In the present case, the company X has filed the true-up petition for the respective year. However, MPERC has not approved any amount under the head of carrying cost and therefore, the company has not admitted and accounted for the same.

- (b) The company has not paid any carrying cost of true up so far. Further, the company has represented the matter before company X (copy of the representations made have been supplied by the querist for the perusal of the Committee).

The company has followed this accounting policy consistently from the financial year 2013-2014, however, neither statutory auditor nor C&AG auditor has objected this treatment till F.Y. 2014-15 and the company has duly disclosed the carrying cost as contingent liability.

Company X has not taken any coercive action against the company for recovery of carrying cost.

- (c) The MPERC has never approved any recovery of such carrying cost for any financial year till date and as per provisions of the Electricity Act, no licensee can charge any tariff other than that approved by MPERC.
- (d) As per provisions of the clause 1.30 (Detail to be furnished and fees payable by licensee or generating company for determination of tariff and manner of making application) of MPERC Regulations, 2004 and its amendment, any tariff comes in effect only after expiry of seven days from the publication of public notice of tariff order in two newspapers. Therefore, tariff order of MPREC applies prospectively.

B. Query

10. In the light of the above facts, the querist has requested the Expert Advisory Committee to provide the opinion that whether the company is required to make provision towards the 'carrying cost of true up charges' as billed by company X even if the same is not approved by MPERC as required by Electricity Act, 2003.

C. Points considered by the Committee

11. The Committee notes that the basic issues raised by the querist relate to whether the company is required to make a provision towards the 'carrying cost of true up charges' as billed by company X even if the same is not approved by MPERC, as required by Electricity Act, 2003. 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, accounting in the books of account of company X, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of the terms of the MPERC Regulations or Electricity Act, 2003, etc. The Committee also wishes to point out that since the query pertains to financial year 2014-15, the opinion expressed hereinafter is in the context of Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs) notified under the Companies (Accounting Standards) Rules, 2015.

12. With regard to issue raised, the Committee notes the following paragraphs from Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006:

"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

10.2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

10.4 A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made."

"10.6 Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

10.7 Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."

"14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

- (a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
- (b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).”

“22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).”

13. The Committee notes from the above that an element of judgement is required to determine whether a liability for carrying cost of true up charges should be provided for in the accounts or treated as a contingent liability and disclosed by way of a note to the accounts. It is for the management of the enterprise to decide and for the auditor to assess, considering the circumstances of each case, whether the said liability warrants recognition of provision or disclosure of contingent liability. The Committee is of the view that while making such judgement, *all* the evidences available as on the balance sheet date, including for example, opinion of an expert on the possibility and extent of outcome of the decision of the appropriate authority, experience of the company or other enterprises in similar cases, decisions of appropriate authorities, etc. should be considered. The Committee is also of the view that since in the extant case, as per the querist, appropriate authority (MPERC) has never approved the recovery towards carrying cost of true up charges till date, this in itself, indicates that there is no sufficient clarity as to whether a present obligation exists which may require recognition of a provision. However, the Committee is of the view that whether or not a present obligation exists for the carrying cost of true up charges and accordingly, whether the company may be required to create a provision or not does not merely depend on whether the regulator has already allowed/approved the recovery of carrying cost or not

in the past; rather it depends on whether based on all the evidences available in the facts and circumstances of the company (as discussed above) as on the balance sheet date, there exists an obligation which can be considered probable (i.e., more likely than not) arising from a past event. Further, for recognising a provision, other conditions as per paragraph 14 of AS 29 should also be fulfilled, viz., it is probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of such obligation.

14. The Committee is further of the view that based on certain facts available with us such as, non approval of carrying cost of true up charges till date, no order has been issued by MPERC in the past approving/allowing the recovery of such carrying cost, no explicit statement in the Act indicating whether such charges would be approved or not in future, no legal action initiated by Company X for non payment of carrying cost of true up charges by the Company, it appears that there is no present obligation or a probable obligation that an outflow of resources embodying economic benefits will be required to settle the obligation towards the carrying cost of true up charges at the balance sheet date. Accordingly, the company should not make a provision; rather in this situation, the company should disclose the same as a contingent liability, with relevant disclosures in this regard as per AS 29, until any further contrary facts emerge which indicates that a present or probable obligation towards carrying cost of true up charges exists at the balance sheet date.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the company should, based on all the available evidences in its own facts and circumstances, assess whether there is a present obligation or a possible obligation towards the carrying cost of true up charges. However, on the basis of certain facts and circumstances presently known and as discussed in paragraph 14 above, the company should disclose the same as a contingent liability, with relevant disclosures in this regard as per AS 29, until the possibility of an outflow of resources embodying economic benefits is remote and unless any further contrary facts emerge which indicates that a present or probable obligation towards carrying cost of true up charges exists at the balance sheet date.