CHAPTER 2

Accounting treatment of other income earned from Externally Aided Project (EAP)

This article aims to:

Provide guidance on the accounting treatment of interest income earned on borrowed funds temporarily invested and covers a recent EAC opinion issued on the same topic.

Introduction

Ind AS 109, *Financial Instruments*, governs the accounting for interest income received on financial assets. As per Ind AS 109, interest income is required to be computed using the effective interest rate[1]. Further, based on the principles enunciated in Ind AS 107, *Financial Instruments: Disclosures* and Ind AS 1, *Presentation of Financial Statements*, interest revenue should be recognised in the Statement of Profit and Loss unless another Ind AS requires or permits otherwise.

Where an entity temporarily invests funds borrowed for the construction of specific assets[2], further analysis is required on treatment of interest income received on such investments – i.e. whether the interest income should be adjusted against borrowing cost to be capitalised or it should be recognised as interest income in the Statement of Profit and Loss. For this purpose, the company would additionally need to consider the principles of Ind AS 23, *Borrowing Cost*.

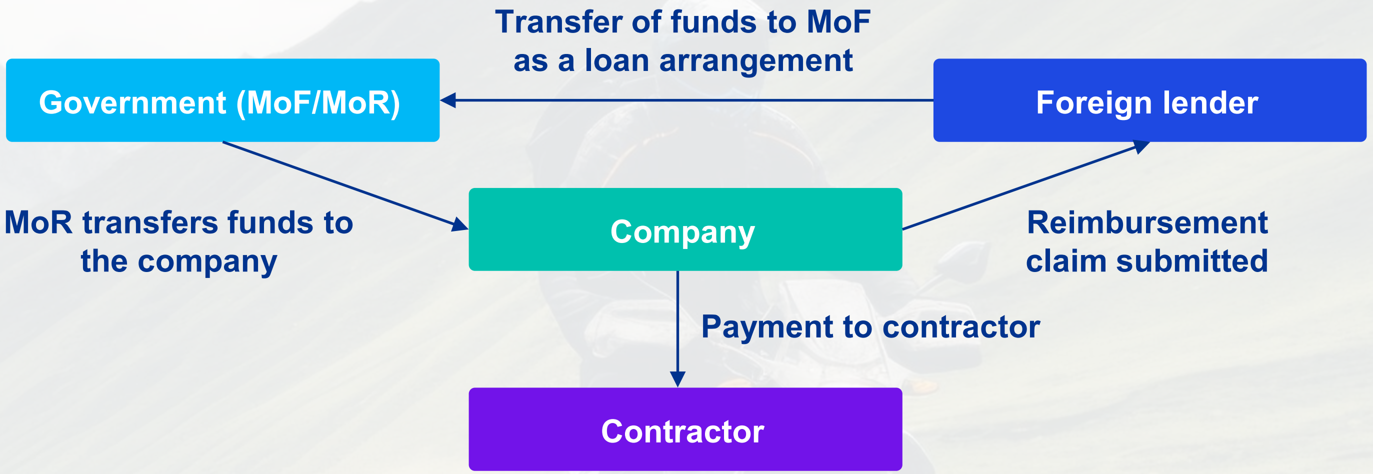
The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) deliberated on the accounting and presentation of the interest income earned on funds received by a company (the Company) from the government authorities for a specific project (an Externally Aided Project (EAP)) temporarily invested by the company in bank deposits[3].

This article aims to discuss some of the key factors considered by the EAC while clarifying the accounting for interest income on funds invested that were received as borrowings for specific projects. It is pertinent to note that in this article, we have highlighted EAC's conclusion on accounting for interest income. Accordingly, other factors pertaining to the measurement or presentation of the loan received (recorded as a financial liability) have not been deliberated.

Facts of the case

The Company is engaged in the creation of a self-constructed asset (railway between two states) and will own the assets created as a part of the project. In order to finance the project, the Ministry of Finance (MoF) has availed a soft loan[4] from a foreign lender. The company has received EAP[5] funds from the government against the loan taken by the government from a foreign lender.

Figure 1 – Depiction of finance arrangement for the project



(Source: KPMG in India's analysis, 2024 read with EAC opinion)

1. The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.
2. Such investments would be in cases where the construction of that asset has not yet commenced or the borrowed funds are lying idle.
3. EAC opinion on Accounting treatment of other income (Bank Interest on Funds invested out of advance received from Ministry of Railways (MoR) termed as External Aided Project (EAP)) under Ind AS framework dated 8 May 2023 (the EAC opinion)
4. Soft loan is a loan where the interest charged on the loan is lower than the market interest rate. The difference between the market interest rate and the soft loan interest rate is given by the donor as a gift.
5. Certain infrastructure projects require the government to take external assistance to aid in augmenting the resources required for the execution of the project. The external assistance plays a significant role in the development process in the form of an additional source of development finance for the states. Such projects fall under the category of 'Externally Aided Projects'.

Disbursement process explained

Step 1 - The Ministry of Railways (MoR) transfers funds to the company out of its budgetary resources.

Step 2 – The company incurs the expenditure and makes payments to contractor.

Step 3 – The company submits reimbursement claim to the foreign lender.

Step 4 – The foreign lender, after conducting its due diligence, remits funds to MoF. This helps in recouping the funds transferred by MoR to the company in step 1.

MoF pays interest on loan to the foreign lender as per the agreed terms. However, the terms and conditions between the company and MoF/MoR are pending finalization.

Currently, MoF and MoR do not charge any financing cost/borrowing costs on funds released to the company. Thus the company has presented the funds received as *'Other financial liabilities (at amortised cost)'* under the head 'Financial Liabilities – Non-current' with no consequential expenses in the financial statements.

Further, the amount received is invested temporarily in bank fixed deposits till it is utilised for the project which generates interest income.

The question under deliberation is whether the company should reduce interest income earned from the value of Capital Work in Progress (CWIP) or recognise it in the Statement of Profit and Loss.

A. Initial recognition of financial liability

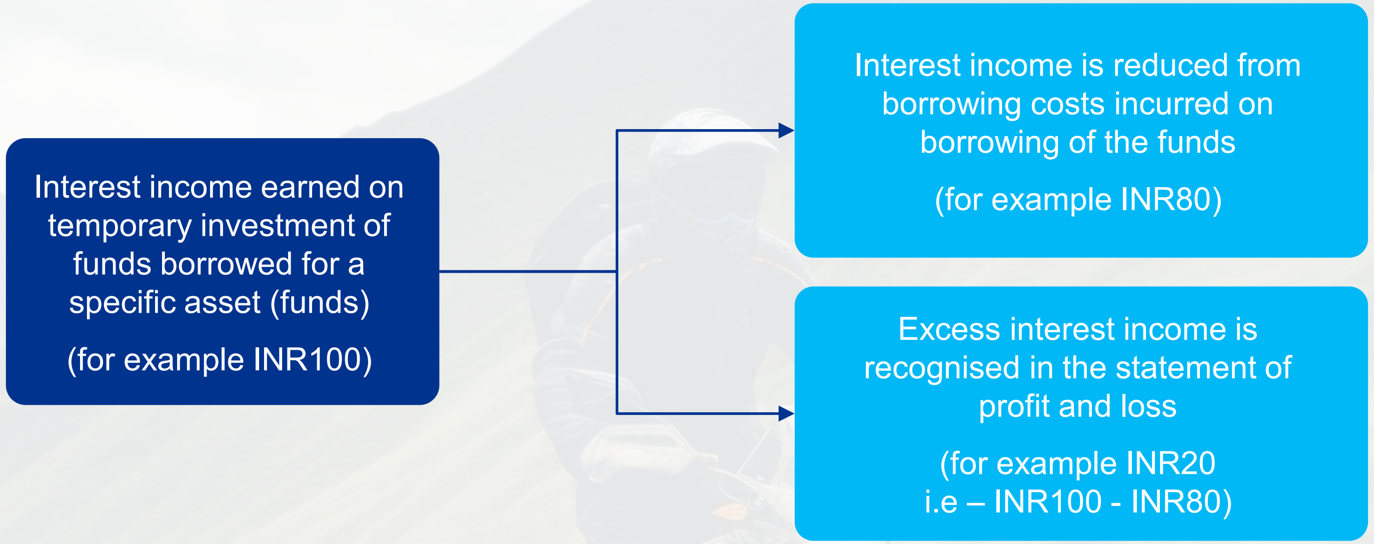
Ind AS 109 requires an entity to initially measure a financial liability at its fair value after being adjusted with the transaction costs that are directly attributable to the acquisition or issue of the financial liability. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash flows discounted using the prevailing market rate of interest for a similar instrument with a similar credit rating.

In the current case, the government is lending funds to the company with the terms and conditions related to the interest and repayment pending to be finalised. However, the company is measuring the said financial liabilities at amortised cost which requires the use of effective interest method.

From the above, it is concluded that the company should initially recognise a financial liability for the EAP funds by applying principles of Ind AS 109. Interest/ borrowing cost on such financial liability should be calculated using effective interest method as per the requirements of Ind AS 109.

B. Accounting treatment of interest income

The EAC noted that time deposits in which the borrowed funds were temporarily invested are financial assets. Accordingly, interest income on such assets would be computed in accordance with Ind AS 109, using the effective interest method. Furthermore, the EAC provided the following clarification with regard to accounting for interest income earned on temporary investment of funds borrowed for construction of a specific asset:



(KPMG in India's analysis, 2024, read with the EAC opinion)

Interest income to the extent of borrowing cost

Ind AS 23 states the following–

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as a part of the cost of the asset
- During construction stage, the borrowing cost is to be adjusted with the income generated from temporary investment of such borrowed funds

EAC's clarification- Thus in the current case, the EAC opined that, the interest income to the extent of the borrowing costs should be adjusted against the said borrowing costs. The borrowing cost is calculated using the effective interest method which is to be capitalised in the cost of the asset as per the requirements of Ind AS 23.

Surplus interest income earned over and above the borrowing cost

In order to conclude on the accounting treatment of excess interest income earned over and above the borrowing cost, the committee focused on the requirements of the Ind AS 107 along with Ind AS 1 and Ind AS 23.

Ind AS 107 and Ind AS 1 require interest revenue based on the effective interest method, related to financial asset measured at amortised cost, to be disclosed in the statement of profit and loss or notes.

Ind AS 1 further states that interest revenue is to be a part of statement of profit and loss unless an Ind AS requires or permits otherwise.

Ind AS 23 requires adjustment of interest income against borrowing cost to be capitalised. However, it is silent on the accounting treatment of surplus income over and above the borrowing cost.

The committee noted that the excess interest income does not arise from activities necessary for bringing the asset in the required condition for it to be capable of operating in the manner intended by management. Therefore, it is not eligible for capitalization under Ind AS 16, *Property, Plant and Equipment.*

EAC's clarification- Based on the combined analysis above, the committee opined that the excess interest income should be recognised in the Statement of Profit and Loss as per the requirements of Ind AS 1 read with Ind AS 107.