Update

VINOD KOTHARI & COMPANY

MCA Circular saves corporate bottom lines against Forex losses

(MCA further clarifies the applicability of provisions of AS 11 and AS 16)

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Update

1. Background

1.1 Schedule VI of the Companies Act provides for capitalisation of increase or decrease of a liability(loan) of a company directly attributable to cost of the asset purchased from outside India, due to fluctuation of exchange rates. The relative increase or decrease of the liability should be *adjusted with the cost of asset* in the books of the company.

1.2 As per AS 11, the "monetary assets" or liabilities of a Company including borrowings/loan, denominated in foreign currency, are to be converted into the functional currency chosen by the Company at the time of preparation of its financial statements. Any gains/losses arising in such valuation are required to be recognised in the statement of *profit and loss*.

1.3 In 2003, ICAI had made an announcement on 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956', stating that AS11 should be complied irrespective of Schedule VI.

1.4 Subsequent to the issuance of the above Announcement, the MCA issued the Companies (Accounting Standards) Rules, 2006, by way of Notification in the Official Gazette dated 7th December, 2006, effective from Accounting Period 2006-07. Again in Rules it was clarified by MCA that accounting treatment of exchange differences will be made as per AS 11 and further categorically mentioned that provisions of AS-11 is required to be followed irrespective of the relevant provision of Schedule-VI to the Companies Act, 1956.

1.5 On July 18, 2007, ICAI withdrew the Announcement on 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956'. Accordingly, the accounting treatment of exchange differences contained in AS 11 notified as above is applicable and not the requirements of Schedule VI to the Act, in respect of accounting periods commencing on or after 7th December, 2006.

1.6 MCA has amended the Companies (Accounting Standards) Rules 2006, to incorporate Clause 46A (referred as Amendment) which states as follows-

"46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements , in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

2. Status prior to Amendment

2.1 There has been a tug war for the treatment of 'gain/loss' arising out of foreign exchange fluctuations attributable to borrowings made for acquiring capital asset (referred as gain/loss). Schedule VI of Companies Act, suggests treatment of the '*gain/loss*' as capital in nature and should be adjusted to the cost of relevant asset, whereas Accounting Standards 11 suggests that treatment of 'gain/loss' attributable to foreign borrowings should be reflected in profit and loss account.

2.2 Even though the Announcement referred in Para 1.4 indicated the intention of statutory bodies to account for the foreign exchange fluctuation in profit and loss account, however it was difficult to envisage a situation where the companies borrowing significant funds for capital expenditure would have to account the '*gain/loss*' for foreign exchange fluctuations to their profit & loss account. This would have widely impaired the profit and loss statement, and casted a completely wrong picture of revenue/costs.

2.3 Further AS 16 stipulated that the Borrowing costs directly attributable to the acquisition, construction or production of a *'qualifying asset'*[1] , should be capitalized as part of the cost of that asset. A combined reading of AS 10 & 16 supported the treatment laid in Schedule VI, however AS 16 was limited to '*gain/loss*' arising out of increase or decrease in liability towards cost of *qualifying assets* which are not ready for its intended use or sale.

2.4 It is also pertinent to note here the treatment for the '*gain/loss*' in view of Income Tax provisions. The corresponding section to AS 11 in Income Tax Act(Section 43A) provides for treatment of the *gain/loss* as capital in nature, which view has been supported by the Supreme Court judgments in Woodward Governor India (P) Ltd and Honda Siel Power Products Ltd (Apr 2009)--irrespective of accounting treatment.

3. Status Post Amendment

After a long lull on the issue discussed above, MCA have now made suitable amendment in Companies (Accounting Standards) Rules 2006, to treat the *gain/loss* as capital in nature. A new provision 46A has been introduced in the Rules which provide as follows:

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1. [1] The *qualifying asset* as referred in the AS is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; and includes manufacturing plants.

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The Recognition of gain/loss due to effect of foreign exchange fluctuations on *long term foreign currency monetary items* [2]relating to **acquisition of depreciable capital asset**, to be adjusted with the cost of asset and depreciated over a period of time

- ➔ Hence the capital asset purchased through foreign borrowings has to be suitably adjusted every year to accommodate the effect of exchange fluctuations in borrowings, thus matching asset and liability.
- ➔ Apart from above if a gain/loss is arising due to exchange differences on long term asset/liability such as borrowings other than for acquisition of capital asset, then such gain/loss should be transferred to "Foreign Currency Monetary Item Translation Difference Account" to be amortized over the remaining period of long term asset/liability.
- ➔ The treatment as stated above will not be in accordance of AS 11, hence necessary disclosures should be made in *Directors' Report*

4. Conclusion

The present economic scenario is witnessing a depreciating Rupee against foreign currency, the rupee closed at 53.07 to a dollar on 30th December as against 48.97 at the end of September. Indian Corporates heavily depend on *foreign funds for their capital expenditure*; most of the corporates have huge foreign borrowings in their balance sheet. These borrowings have to be reinstated every year to an equivalent sum payable in Indian currency at the prevailing exchange rate as on the date of Balance Sheet. Hence the exchange difference which arises due to reinstatement of such liability should be treated as in accordance of the Accounting Standards and amended Rules as discussed above in Point 3, i.e.-

- Capitalised in case borrowings are attributable to acquisition of capital asset, and depreciate the resultant cost of asset; or
- In other cases Amortise over the remaining period of long term asset/liability

The capitalisation of profits will help the corporates to match its assets and liability without affecting/impairing its revenue and costs. These companies will absorb forex losses on their balance sheets, by artificially inflating the value of plant and machinery that have been bought with the foreign

[2] Long term foreign currency monetary item is defined an asset or liability denominated in foreign currency with a term of twelve months or more at the time of origination of asset.

currency loan, which has jumped in rupee terms due to the drop in the local currency.

However the depreciating money would still widely affect the areas not covered by the amendment. The gain/loss as an effect of foreign exchange fluctuations on short term obligations of a term less than one year will impact the profit and loss, and will still be a matter of concern to Indian Corporates. Further exporters, will have to book mark-to-market (MTM) losses on forward contracts and derivative deals in accordance with the respective Accounting Standards.

5. **Further clarification by MCA**

Though the department clarified that the exchange difference arising due to reinstatement of liability is to be capitalised but it remained silent on the aspect of interest cost treatment as per AS 16. Para 4 of AS 11 clearly stipulates that interest cost has to be dealt with in accordance with AS 16 and AS 16 in turn deals with the capitalisation of interest cost with the asset cost subject to the provisions of AS 16. Therefore, it was creating problem in implementing para 46A introduced. Hence, MCA vide circular no. 25/2012 dated August 09, 2012 released on August 18, 2012[3] clarified that in case a company is following para 46A of AS 11 wherein the exchange rate difference on loans and interest can be adjusted with the asset, the company need not follow the provisions of para 6 of AS 11[4] and para 4 (e) of AS 16[5] in relation to the interest cost adjustment.

[3] http://www.mca.gov.in/Ministry/pdf/General_Circular_25_2012.pdf
[4] http://220.227.161.86/27277asb-as-11.pdf
[5] http://220.227.161.86/27282asb-as-16.pdf