COMMERCIAL ACCOUNTING FOR INDIAN RAILWAYS: SOME ISSUES

The letter dated 18.03.2015 of Executive Director/AIMS&AR on Accrual Based Commercial Accounting ushers in a new era in accounting system for the Indian Railways system, which is also looking at fundamental management overhaul. The Accounting System of served well so far, designed for a system exclusively funded through Government and internal resources. However, as the Indian Railway is preparing to break the vicious cycle of low investment, low efficiency and low returns and move towards the virtuous cycle of high investment, high efficiency and high returns by extensive funding through Extra Budgetary resources, a move to Commercial Accounting suited for such a vast and unique organization is imperative.

The mindset that Railways has a big role in the development of the country, where commercial orientation is unsuitable and only Government sector can perform needs to be revisited. The mindset of justifying non- performance and ignoring viability on the pretext of National Development has ceased to attract popular opinion. Indian Railways has to some extent managed, since independence, to cope with ever burgeoning demand for passenger and freight transportation with growing population and economy – but now the people of the country want more efficient service. The concept of subsidy/ subsidized travel over a long period of time can prove to be counterproductive in terms of the matured and sustained growth of the economy. So, it is a choice between shutting the shop or growing to meet the demand.

Here it is important to talk about the business environment prevailing on Indian Railways and its compatibility with the general business environment both within India and globally, because the same shall have a great impact on the choice of accounting liberalization (mode and extent) of the Indian Railways. Accountancy basically consists of recording of information and generation of information bringing out situations which require managerial attention, both favourable and adverse; information for the investors with regards to risk and return etc. Indian Railways never had any investors in the real sense till recently and as a result the cash based accounting system has survived till date. Only user of the information being the government the IR could do with the cash based Government accounting system. However, since now the IR are inviting private investors, who are demanding and cautious, the financial information demanded would be qualitatively much better and the Accounting system to be adopted should have the ability to provide the same.

We wish to point at the core of the exercise i.e. Accrual based Commercial Accounting with emphasis on Commercial Accounting. Commercial accounting is a wider canvas which would suit the future needs and automatically take into account transactions as soon as a right to receive revenue and/or an obligation to pay a liability is created. Commercial Accounting takes into account all aspects which we may struggle to accept in piecemeal. So, at this very stage, we would propose to drop the word Accrual and name the whole effort as Commercial Accounting.

While discussing the prerequisites of commercial accounting following areas will have to be taken up for detailed consideration:-

1. Suitable Accounting Standard for the Railways

Accounting Standards provides the basis for presentation of general purpose financial statements to ensure comparability both with the organization's financial statements of previous periods and with the financial statements of the other entities. It sets out overall requirement for the presentation of financial statements, guidelines for their structure and minimum requirement for the content. Presently the only source of Accounting Standards for Railways is the Accounts Code, predominantly geared towards Government Accounting with provision of Suspense Heads for links to Commercial Accounting. This is quite inadequate from Commercial viewpoint.

Accounting policies on the Indian Railways will have to be designed keeping the end result in mind i.e. the financial statements. Financial statements are a structured representation of the financial position and financial performance of an entity. The object of a financial statement is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. It is expected that financial statements shall present a true and fair view of the financial position and financial performance of an entity. Presentation of true and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with definitions and recognition criteria for assets, liabilities, income and expenses set out in the framework. The application of accounting standards with additional disclosure when necessary is presumed to result in financial statements that present true and fair view.

2. Capital Structure

The capital structure of Indian Railways basically consists of Capital-at-charge and investments financed from internal resources.

The two principal sources of finance for a business firm are equity and debt. The choice of a firm's capital structure is essentially concerned with how the firm decides to divide its total capital requirement into equity and debt. Since the interest on debt is pre- tax expenditure (i.e. an allowable expense), there is definitely a relationship between the choice of capital structure and the value of the organization. Financial leverage (i.e. the need of debt capital) has a positive effect on firm's value up to a point and has negative effect thereafter.

On Indian Railways there is no such dilemma about the capital structure as the business is not subject to corporate taxation. However, in a long term scenario, when there is a shift towards commercial mindset, some sort of corporate taxation cannot be ruled out. So it is advisable at this stage only to comprehend the same and make necessary accommodations in the accounting system. The current capital at charge can be treated as the debt capital and the Dividend payable to the general revenues be treated on similar lines as Corporate Tax. Railways own funds and the other EBR can be accordingly treated as equity depending upon their nature and be entitled to the surplus generation from operations. Accounting standards also gives certain amount of freedom in the management of capital, it may manage capital in a number of ways and be subject to a number of different capital requirements. Para 134 of Accounting Standards 1 – prescribes “An entity shall disclose information that enables users of its financial statements to evaluate the entity’s objectives, policies and process of managing capital”. In this regard following will have to be taken care of :-

(a) Qualitative information about its objectives, policies and processes for managing capital including
    (i) a description of what it manages as capital,
    (ii) when the railways is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into management of capital, and
    (iii) how railways is meeting its objectives for managing capital.

(b) Summary of quantitative data about what it manages as capital. Some entities regard some financial liabilities (e.g. some form of subordinate debt) as part of capital. Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges – it will also have to be thought of in the railway which has huge amount of float).

(c) Any changes in (a) and (b) from the previous period.

(d) Whether it has complied or not with any externally imposed capital requirements.

In the commercial sense Railways may be allowed to manage capital in a number of ways and be subject to a number of different capital requirements. However, all such information will have to be disclosed in the financial reporting.

3. Assets (Property, Plant & Equipment)

The requirement of Accounting Standards 16 in this regard is explicit. The objective of this standard is to prescribe accounting treatment for property, plant and equipment so that users of the financial statements can discuss information about an entities investment with property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognized in relation to them.

On Indian Railways even before we think of revamping our accounting system we have to immediately focus on one of the most important issue of recognition of

Assets, that is, to decide the mode of depreciation of various assets, accounting treatment of such asset and the recorded carrying amount of all assets. Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.

Regarding Depreciation Accounting Standards provides that each entity has to provide an amount initially recognized in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. The depreciation charge for a period is usually recognized in profit or loss. However, sometimes the future economic benefits embodied in an asset are absorbed in producing other assets. In this case the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example depreciation on manufacturing plant e.g. Bridge Workshop is included in the cost of conversion of inventories. Similarly, depreciation of property, plant and equipment used for development activities may be included in cost of an intangible asset recognized in accordance with Accounting Standard for intangible assets.

The future economic benefits embodied in an asset are consumed by an entity principally through its use. Specific to the Railway, there may, however, be other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Accounting Standards also provides that the depreciation methods applied to an asset shall be reviewed at least at each financial year end and if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such change will have to be accounted for as a change in an accounting estimate in accordance with accounting standard 8. Also the asset accounting will have to ensure that the carrying amount of an item of property, plant and equipment shall be derecognized on disposal.

Suitable accounting procedure will have to be developed for Asset Accounting & Depreciation so that financial statements shall disclose for each class of property, plant and equipment :-

(i) the measurement basis used for determining the gross carrying amount;
(ii) the depreciation method used;
(iii) the useful lives or the depreciation rates used;
(iv) the gross carrying amount and the accumulated depreciation at the beginning and end of the period and
(v) a reconciliation of the carrying amount at the beginning and end of the period showing
    (a) additions

(b) assets classified as held for sale (e.g. sale of locos)
(c) acquisition through business combinations
(d) theft and losses of assets written off
(e) net exchange differences arising on translation of the financial statements from functional currency into a different presentation currency.

The accounting standards further states that the financial statements shall also disclose the amount of contractual commitments for the acquisition of property, plant and machinery (purchase through COFMOW).

4. Inventories Accounting

A primary issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized.

Huge amount of inventories are held by the various manufacturing units of the railway including workshops (Mechanical, Signal & Bridge) which are under the control of the Zonal Railways. Accounting Standard 2 deals with the determination of cost and its subsequent recognition as an expense, including any write down to net realizable value. It also deals with the cost formulas that are used to assign costs to inventories.

Huge amount of inventories are also held in the depot (both Stores & Track) which are purchased for running of the service facilities and are chargeable to revenue (mostly). There is a huge time lag between the procurement and the actual utilization which in turn results into a large inventory holding cost. The inventory holding and servicing cost on the Railway do not find their way to the cost of issues and as a result the cost of inventory used is to a large extent under reported.

A detailed study of the inventory carrying cost including cost of placing order should be carried out so that the cost of carrying inventory could be loaded on certain predetermined rate to the cost of material consumed and the closing inventory. The gap between the value of inventory so valued and the net realizable value of the inventory would reflect upon in efficiency of the procurement mechanism/establishment. Such accounting procedure shall also help in materials management decision making.

5. Contract Accounting

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely inter related or inter dependent in terms of their design, technology and function or their ultimate purpose or use. It also includes agreements of real estate development to provide services together with construction material in order to perform contractual obligation to deliver the project to the buyer.

On Railway a large number of contractors are employed to carry out various works of the railway, a majority of which are chargeable to Demand No.16. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually falls into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract cost to the accounting periods in which construction work is performed.

Normally a contractor is paid a certain percentage of the value of the work done by the contractor (say 90%, 80%, etc.). Payment is made after the Principal (various Railway Engineers) is satisfied that such and such stage has been completed. Thus there is a gap between the work certified and the payment made. Accounting entries under accrual system of commercial accounting could be credit to the contractor by debit to the project with the amount of work certified. At the time of payment Cheques & Bills could be credited by debit to the contractors account, balance in the contractors account will represent work certified but not paid representing outstanding contractual obligations.

At the end of the financial year, certain work may not have reached a stipulated stage and in respect of such work there will be no certificate by the Engineer and there will be no payment from the Principal until the necessary certificates are issued. Such work may be called work in progress uncertified and should be valued at cost. The amount is debited to work in progress account and credited to the project. The entries will have to be reversed at the beginning of the next year. The advantage would be that each project would be shown at its true completion level and the works in progress would be shown separately for the assessment of the ways and means for the next accounting period. Material at site and other stores would also be dealt with similarly and debited to the work in progress account. Such provision in the frame work would ensure that true and fair view of the progress of the respective projects is ensured in the financial reporting of the Railways.

6. Provisions of Corporate Tax in the New Accounting frame work

The objective of the discussion under this head is to prepare the policy making machinery from the commercial viewpoint. Tax has got an all permeating presence in the financial dynamics of any organization. Such discussions shall stabilize the accounting requirement for corporate tax. The principal issue in accounting for corporate tax is how to account for the current and future tax consequence of :-

(a) the future recovery (settlement) of the carrying amounts of assets/liabilities that are recognized in the entities balance sheet, and
(b) transactions and other events of the current period that are recognized in an entities financial statements.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is possible that recovery or settlement of that carrying amount will make future tax payments larger/smaller than they would be if such recovery or settlement were to have no tax consequence then accounting standard 12 requires an entity to recognize a deferred tax liability/ deferred tax asset with certain limited expectations.

The accounting standards in this regard requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognized in profit or loss, any related tax benefits are also recognized in profit or loss. For transactions and events recognized outside profit or loss any related tax effects and also recognized outside profit or loss. Similarly, the recognition of deferred tax assets and liabilities in a business affects its assessment of goodwill and the amount of bargain purchase gain. A detailed consideration will have to be made keeping the accounting standards in mind for recognition of deferred tax assets arising from unused tax losses or unused tax credits and presentation of corporate tax in the financial statements and the disclosure of information relating to such tax.

Where an organization/entity uses accrual based accounting system, an organization recognizes items as Assets, Liabilities, Equity, Income and Expenses when and only when they satisfy the definition and recognition criteria for those elements in the basic accounting frame work. An entity should present separately each material class of similar items. An entity should present separately items of a dissimilar nature or function unless they are immaterial except when required by law. Financial statements result from processing large number of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data which form line items in the financial statements. If a line item is not individually material, it is aggregated with other item either in those statements or in the notes. As such a detailed ground work for each item will have to be done item wise including the few important items that have been mentioned above to evolve an accounting system which will be able to sustain itself over a long period of time. It is suggested to form an Accounting Standards Committee for the Railways for which separate terms of reference will have to be developed. It is also suggested that formation of an Advisory Body on Cost Accounting of services namely Cost Ascertainment, Cost Reduction and Cost Control methods is also essential which is to work in consonance with the Accounting Standards Board for Railways.

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