Accounting issues in Infrastructure Industry

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Infrastructure Activities






Agenda

- **Accounting Issues**
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  - Service Concession Arrangements
  - Accounting for revenue during extension of projects
  - Accounting for Grant
  - Revenue from maintenance of contracts – Gross vs Net accounting
  - Interest Cost in CTC computation in case of EPC contractor
  - Expense incurred for securing project
  - Interest capitalization- Provisional COD
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- **Impact of IND-AS on Service Concession Arrangement**

Definition of operating cycle

Facts of case

- Companies being an infrastructure company, is engaged in construction of roads, highways, building and bridges etc.
- Project durations ranging from 12-18 months 96 months depending on the size of EPC projects

Issues

- What should be considered as the operating cycle for the company?

Guidance

- Para 7.2 of GN on *RSVI "The term "Operating Cycle" is defined as the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. A company's normal operating cycle may be longer than twelve months e.g. companies manufacturing wines, etc. However, where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months"*
- Para 7.2.1. of GN on RSVI *"Where a company is engaged in running multiple businesses, the operating cycle could be different for each line of business. Such a company will have to classify all the assets and liabilities of the respective businesses into current and non-current, depending upon the operating cycles for the respective businesses"*
- FAQ on Guidance note for Revised Schedule VI to the Companies Act, 1956 (now Schedule III under the Companies Act, 2013) - Doesn't allow operating cycle to be customer wise

Service Concession Arrangements

Facts of case

- Group is engaged in BOT project. EPC company (which is the holding company), enters into a separate construction agreement with the SPV (wholly owned subsidiary) which has been allotted and has entered into service concession agreement with Government (granter).
- Entire construction is done by EPC company (holding company) for the SPV (grantee).
- In standalone financial of the EPC company, revenue and cost for EPC contract has been considered in the same manner like any other independent construction contract and revenue is recognized on percentage of completion basis
- In SPV's financial EPC project cost is accounted for on accrual basis and shown under Intangible Assets -Toll Collection Right

Issues

- In Consolidated Financial Statements of the Group, the group does not eliminate the revenue and profit on the construction activity for BOT projects since the construction revenue earned by the EPC contractor is considered as exchange with grants against toll collection /user fee rights, profit from such contract is considered realised

Service Concession Arrangements (..Cont'd)

Guidance

- Under the Indian GAAP there is no accounting standard dealing specially with the accounting for BOT however there is a *"Exposure draft of Guidance Note on Accounting of Service Concession Arrangements"*
- IFRIC 12 – Service Concession Arrangement
- Paragraph 34 of As 26 *"An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets"*
- Paragraph 11.1 of AS 10 *"When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident"*

Accounting for revenue during extension of projects

Facts of case

- Company (SPV) entered into a Service Concession Arrangement with the Grantor for designing, engineering and construction for augmenting the ‘extension of four lane road’ (existing assets) to six lane road, construction period 2.5 years
- Appointed date of the project is day 1 and SPV started collecting revenue from existing assets from day 1 of the project
- Upfront Premium is payable by SPV to Grantor for as part of consideration against the toll collection right

Issues

- Toll collection during the construction phase of the project undertaken is capital receipts or revenue receipts?
- Premium payable to NHAI during concession period is capitalized and amortized from the date of completion of extension from four to six lane instead of appointed date

Guidance

- Expert Advisory Committee opinion (EAO-Vol-32-05) *“Toll collections during the construction/upgradation period is not a capital receipt rather it is revenue in nature and accordingly, accordingly it cannot be netted off from the total project costs”*

Accounting for Grant

Facts of case

- Government (Grantor) agrees to provide to the Concessionaire (SPV) cash support by way of an outright Grant in accordance with the concession agreement
- Condition the Grant is that *"it shall be applied by the Concessionaire (SPV) for meeting the capital cost of the project and shall be treated as part of share holders' fund"*

Issues

- Company has treated the grant received as in nature of Promoters' contribution and credited the same to Capital reserve, instead of treating grant as specific and reducing it from "Toll collection rights"

Guidance

- Para 5.1 of the AS 12 *Two broad approaches may be followed for the accounting treatment of government grants: the '<u>capital approach', under which a grant is treated as part of shareholders' funds,</u> and the '<u>income approach', under which a grant is taken to income over one or more periods.</u>*
- As per Para 5.2 (i) of the AS 12, *Many government <u>grants are in the nature of promoters' contribution</u>, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds*.

Revenue from maintenance of contracts – Gross vs Net accounting

Facts of case

- BOT contract is awarded by NHAI to the SPV through the Concession agreement.
- Maintenance contract is entered between the SPV and the Holding Company for maintenance of the BOT asset
- The maintenance work is sub-contracted by the Holding Company to its construction arm which its 100% subsidiary (i.e. sub-contractor)

Issues

- Accounting of contract revenue on these transaction in Holding company to be on gross or net basis

Guidance

- As per Emerging Issues Task Force (EITF) issued by Financial Accounting Standard Board (FASB), Issue no. 99-19 on Reporting Revenue Gross as a Principal versus Net as an Agent. Whether an entity is acting as a principal or an agent in transactions depends on the facts and circumstances of the relationship. The contractual arrangement between the two entities needs to be considered in order to evaluate the relationship

Interest Cost in CTC computation in case of EPC contractor

Facts of case

- The Company is in EPC business. Company has certain internal accruals and equity contribution through which some part of working capital is funded and significant part of working capital is funded through borrowing from various banks and financial institutions. These borrowings are general borrowing and are not linked to any specific project.

Issues

- Whether the interest cost of borrowing availed by the Company to fund working capital requirement is eligible to be capitalised as project cost?

Guidance

- *Para 15 of AS 7. "Contract costs should comprise: (a) costs that relate directly to the specific contract; (b) costs that are attributable to contract activity in general and can be allocated to the contract; and (c) such other costs as are specifically chargeable to the customer under the terms of the contract"*
- Para 16 of AS *7 "Costs that may be attributable to contract activity in general and can be allocated to specific contracts include: (a) insurance; Index (b) costs of design and technical assistance that is not directly related to a specific contract; and (c) construction overheads*"
- *"… costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs"*
- *Para* 3.2 of AS-16 *"A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale"*

Expense incurred for securing project

Facts of case

- Companies incurred certain expenses from the date of securing the contract to the final completion of the contract (e.g. project study cots, pre-operative expenses etc.)
- These expenses are easily identifiable and specific to the project

Issues

- Company recognizes the expenses incurred in obtaining the contract as a part of contract cost, as it can be easily identified and measured reliably and it is probable that the contract will be obtained

Guidance

- Para 20 of AS-7 *“Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period”*

Interest Capitalization- Provisional COD

Facts of case

- Company is in BOT business applies for provisional COD on acheiving 75% of physical progress
- As per AS-16- Borrowing cost, capitalization of borrowing costs should cease where substantially all the activities necessary to prepare the qualifying assets for its intended use are complete

Issues

- Can company capitalize the interest after the issuance of provisional COD?

Guidance

- Para 19 of AS-16 *“Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete”*

Corporate Debt Restructuring (CDR)

Facts of case

- Corporate Restructuring Empowered Group (CDREG) approved CDR package for ABC Ltd. The package has been implemented and related documents have been executed and security creation stands completed.
- In CDR package YOY applicable interest has also been agreed with bankers
- As stated in the conditions of the CDR Package “CDI Lenders, with the approval of CDREG, shall have the right to recompense the relief/ sacrifices/ waivers extended by respective CDR Lenders as per CDR Guidelines”.

Issues

- Should incremental interest rate be accounted for on a straight line basis?
- Disclosure of Right to recompense the relief/ sacrifices/ waivers extended by the respective CDE Lenders as per CDR Guidelines in the Financial Statements

Guidance

- Under IGAAP straight lining of future increment cost is suggested in AS 19 of Leases only
- Para 10 of AS-29 Provisions, Contingent Liabilities and Contingent Assets

Claim Accounting

Facts of case

- Most of construction contracts involve changes of specifications, scope, variations and delays that are often on account of the clients - and not the contractors. In such instances, the contractors place claims upon the clients to recover the additional costs

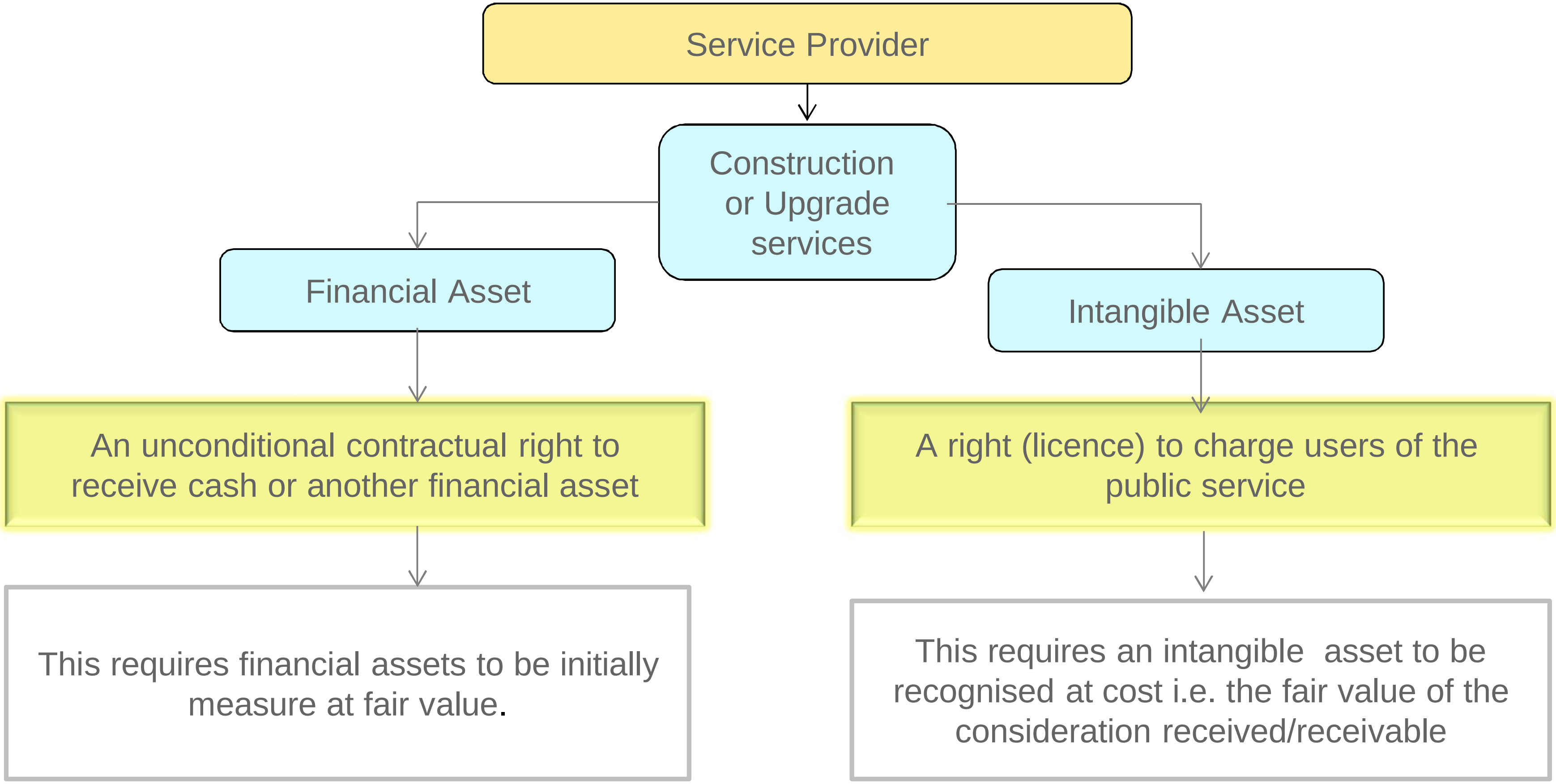
Issues

- Claim is accounted as Income in the period of receipt of arbitration award or acceptance by client or evidence of acceptance received
- Disclosure of receipts of awards/claims in the quarterly financial results under clause 41

Guidance

- Para 13 of AS-7 *"…measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue when: (a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and (b) the amount that it probable will be accepted by the customer can be measured reliably"*
- Clause 41 *"All items of income and expenditure arising out of transactions of exceptional nature shall be disclosed"*

Impact of IND- AS
Service Concession Arrangements (SCA) are accounted for under two model



Management needs critically evaluate whether all data is available in relation to past service concession arrangements

Impact of IND- AS (..Cont'd)

Activity	Indian GAAP Accounting	Ind AS Accounting
Cost of construction	▶ Construction cost is being recognized as an intangible asset on completion ▶ Were construction is in progress, cost incurred has been debited to intangible assets under development	▶ Construction cost is capitalized (recognized as Intangible asset) on day1 ▶ Recognize revenue and cost in the income statement for construction services at Fair Value ▶ In addition treatment of borrowing costs needs to be evaluated
Amortisation of Intangible assets	▶ Intangible Assets amortized by using revenue based amortization method	▶ Revenue based amortization is not applicable ▶ Amortization method which can be used under Ind AS includes straight-line method or unit of production method
Maintenance / resurfacing expense	▶ Recognize at carrying value using best estimate	▶ Recognize obligation and corresponding Intangible asset at day one at discounted value

Thank You