Issues under IND AS for Infrastructure Companies

By

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Differences

* There is not much differences between the accounting for construction contracts as per AS-7 and IND-AS11 and therefore there will be minimal impact in revenue recognition and Statement of Profit and Loss for a construction contractor.
* However the said INDAS – 11 has an Appendix A relating "Service Concession Agreements".
* The said appendix deals with the accounting nuances relating to a Company which carries on business on PPP basis on BOT or BOOT basis.

* Issues in accounting for

Service concession Agreements.

GIST of accounting for service concession agreement.

* Infrastructural facilities within the scope should not be recognized as PPE of the operator because the contractual service arrangement <u>does not convey the right to control </u>the use of the public service infrastructural facilities to the operator. The operator has access to operate the infrastructural facilities to provide the public service on behalf of the grantor in accordance with the terms specified in the contract
* **Under the terms of contractual arrangements the operator acts as a service provider .**
  * **construction or upgrade services used to provide a public service and**
  * **operation services for a specified period of time**

Recognition and measurement of arrangement consideration

* The operator should recognise and measure revenue in accordance with IND-AS-11, *Construction Contracts for construction services and IND-AS-18*, *Revenue Recognition* for the services it performs.

* If the operator performs more than one service under a single contract or arrangement, consideration received or receivable should be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable.

* The nature of the consideration determines its subsequent accounting treatment for consideration .i.e. an intangible asset or a financial asset.

Construction Service

Construction Services in the hands of the SPV

- To be accounted under IND AS - 11.
- Consideration received or receivable to be recognized at fair value which may be a financial asset or an intangible asset.

Operation Services

- To be accounted under IND AS-18 (Revenue)
- The operator may have contractual obligations it must fulfill as a condition of its license
  - (a) to maintain the infrastructural facilities to a specified level of serviceability or
  - (b) to restore the infrastructural facilities to a specified condition before these are handed over to the grantor at the end of the service arrangement.

Journal Entries in SPV

Intangible asset / Financial asset Dr

To Revenue Cr

(value of the contract with a nominal margin. This has to be accounted using principles of IND-AS11)

Cost of Construction Dr.

To Contractor Cr.

(at the contract value given to the sub-contractor for carrying out the construction)

Resultant would be recognised as profit being the margin determined initially.

In the case of construction for annuity projects this margin is critical as the

Financial Asset

Financial asset is when the entity has an

* unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services;
* The grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law.
* if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator to ensure that the infrastructural facilities meet specified quality or efficiency requirements.

Intangible Asset

* The operator should recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.
* The nature of the consideration given by the grantor to the operator shall be determined by reference to the contract terms.
* If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration.

Contractual Obligations

* These contractual obligations to maintain or restore infrastructural facilities, except for any upgrade element (see paragraph 14), should be recognised and measured in accordance with Accounting Standard IND-AS-37, *Provisions, Contingent Liabilities and Contingent Assets* i.e. at the best estimate of the expenditure that would be required to settle the present obligation at the balance sheet date

Major Issues in the Accounting for Financial Asset

The total consideration has to be split into components

* Towards Construction Cost (repayment of principal portion of financial asset).
* Towards the operations phase
* Towards the interest on the financial asset
* Towards the periodic maintenance.

The aforesaid split will have to be done on the basis of the fair value of the services rendered, recovery of the financial asset and the implicit rate of return on the investment made in the financial asset.

Issues for Financial Assets

* **Therefore there will be a fall in Top line for Annuity projects as only the portion relating to the return on financial assets and the portion relating to the revenue towards O&M services would be recognised.**
* **The interest during construction period cannot be capitalized as INDAS 23 – borrowing costs prohibits capitalization of borrowing costs to financial asset.**
* **Margin on the construction service would partly offset the profit and loss account but where there are time and cost overrun, there the entity would report loss during construction phase.**

Accounting treatment :- Intangible assets

* Accounting Standard (IND-AS) 38, *Intangible Assets*, applies to the intangible asset recognised in accordance with paragraphs 17 and 18, provides guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.

MAJOR Issues in INTANGIBLE ASSETS

During the Construction Phase

* The construction of the asset shall be recognized in the profit and loss account of the SPV as and when the construction progresses as revenue and would lie as part of intangible asset in the balance sheet.
* Borrowing costs shall be directly capitalized to the cost of the intangible asset in accordance with IND AS-16 , borrowing costs.
* Margin on the construction activity shall be considered on the same which shall be based on the

DIFFERENCES BETWEEN ANNUITY & TOLL PROJECT

PARTICULARS	TOLLING	ANNUITY
Revenue during Construction period	Entire cost of the project incl Margins	Entire cost of the project incl Margins
Treatment of asset in the Balance sheet	Intangible asset	Financial Asset
Revenue During the Operations period	Entire Toll Collections from users shall be revenue	Annuities received shall be considered as recovery of financial asset. Only interest income computed on effective interest shall be recognized in the profit and loss account
Borrowing costs during construction phase	To be capitalised	Charged off to the Profit and loss account during the construction phase

Issues for Power Generating Companies and other Companies where there is a Take or Pay arrangement

Application of IFRIC4 principles for power generating Companies

* IND AS17 – leases incorporates Appendix C where certain arrangements may be treated as leases. Appendix C is drawn from IFRIC 4 which treats certain outsourcing arrangements, take or pay arrangements where purchasers have to make specified payments regardless of whether they take delivery of the contracted products or services
* eg a take-or-pay contract to acquire substantially all of the output of a supplier's power generation.
* This creates issues in such companies where they have PPA with distributing companies and this maybe treated as leases creating complications in accounting

Evaluation of applicability of Appendix C

- Each of such arrangements have to be scrutinized to ensure that they do not classify as a lease as per Appendix C of IND-AS 11.
- Some of the major considerations which needs to be vetted are
  - Whether the fulfillment of the arrangement depends on the use of specific asset
  - Whether the arrangement conveys a right to use the asset by either ability to operate the asset or ability to control physical access to the underlying asset.
  - Pricing mechanism over the output of the plant whether the same is at fixed price or at current market price or is ot

Issues relating to Holding Company Guarantees

HoldCo Guarantees.

* Fair value of holding Company guarantees will have to be accounted and accordingly would entail accrual of additional revenue and taxes thereon.
* These guarantees are generally a parental guarantee and do not have a cross charge but IND-As109 requires fair value of these guarantees and its accounting which may have MAT implications.
* Therefore these guarantees have to accounted in accordance with IND-AS 109 – Financial Instruments.

Questions

Thank You