

Query No. 13

- Subject:** (i) *Accounting treatment of cost incurred on real estate development on lease land.*
(ii) *Accounting treatment of right to use the land given by the Government.*
(iii) *Accounting treatment of viability gap funding provided by the Government to the Concessionaire in a service concession agreement.*¹

A. Facts of the Case

1. A company (hereinafter referred to as the ‘company’ or ‘Concessionaire’), incorporated on 24th August, 2010, is a special purpose vehicle (SPV) promoted by A Limited and B Limited. The company was awarded a contract on competitive bidding basis by the Government of Andhra Pradesh (‘Government’) to implement metro rail system for Hyderabad city. The company signed the Concession Agreement (CA) with the Government on 4th September, 2010, a copy of which has been provided by the querist for perusal of the Committee. The company commenced construction of the project which is currently progressing in full pace. The relevant details of the CA have been given in the following paragraphs.

2. Scope of the Project (Extract from Article 2 of CA):

- (a) Construction and procurement of the rail system and real estate development on the site set forth in Schedule-A as specified in Schedule-B together with provision of project facilities as specified in Schedule-C and in conformity with the specifications and standards set forth in Schedule-D;
- (b) Operation and maintenance of the rail system in accordance with the provisions of this Agreement; and
- (c) Performance and fulfillment of all other obligations of the Concessionaire in accordance with the provisions of this Agreement and matters incidental thereto or necessary for the performance of any or all of the obligations of the Concessionaire under this Agreement.

3. Grant of Concession (Extract from Article 3 of CA)

- a. Subject to and in accordance with the provisions of this Agreement, the applicable laws and the applicable permits, the Government hereby grants to the Concessionaire the concession set forth herein including the exclusive right, license and authority to construct, operate and maintain the Project (the ‘Concession’) for a period of 35 (thirty five) years commencing from the Appointed Date, and the Concessionaire hereby accepts the Concession and agrees to implement the Project subject to and in accordance with the terms and conditions set forth herein.

Provided that in the event the Concessionaire shall have discharged its obligations without any material breach thereof for a period of 32 (thirty two) years from the

¹ Opinion finalised by the Committee on 21.7. 2016.

- Appointed Date, it may by notice to be given no later than the 33rd (thirty third) anniversary of the Appointed Date, seek extension of the Concession Period, and in such an event, it shall be entitled to an additional Concession Period of 25 (twenty five) years on the terms and conditions set out herein. For the avoidance of doubt, material breach shall for the purposes hereof mean suspension and/or cumulative levy of damages exceeding a sum equivalent to performance security.
- b. Subject to and in accordance with the provisions of this Agreement, the Concession hereby granted shall oblige or entitle (as the case may be) the Concessionaire to:
- (i) Right of Way, access and license to the site for the purpose of and to the extent conferred by the provisions of this Agreement;
 - (ii) Finance and construct the rail system;
 - (iii) Manage, operate and maintain the rail system and regulate the use thereof by third parties;
 - (iv) demand, collect and appropriate fare from users liable for payment of fare for using the rail system or any part thereof and refuse entry of any user if the fare due is not paid;
 - (v) perform and fulfill all of the Concessionaire's obligations under and in accordance with this Agreement;
 - (vi) bear and pay all costs, expenses and charges in connection with or incidental to the performance of the obligations of the Concessionaire under this Agreement; and
 - (vii) neither assign, transfer or sublet or create any lien or encumbrance on this Agreement, or the Concession hereby granted or on the whole or any part of the rail system nor transfer, lease or part possession thereof, save and except as expressly permitted by this Agreement or the Substitution Agreement.
- c. Subject to and in accordance with the provisions of this Agreement and applicable laws, the Concession hereby granted shall, without prejudice to the provisions of the above clause, entitle the Concessionaire to undertake development, operation and maintenance of the real estate and to exploit such development for commercial purposes (the 'Real Estate Development') with the right to sub-license any or all parts thereof by means of Project Agreements.

4. Definitions given in CA for important terms (Article 48 of CA)

4.1 Definition of 'Project'

'Project' means construction, operation and maintenance of the Rail System in accordance with the provisions of this Agreement, and includes all works, services and equipments relating to or in respect of the Scope of the Project.

4.2 Definition of ‘Project Assets’

‘Project Assets’ means all physical and other assets relating to and forming part of the site including:

- (a) Rights over the site in the form of license, Right of way or otherwise
- (b) Tangible assets such as civil works and equipment including foundations, embankments, pavements, interchanges, bridges, drainage works, rolling stock, electrical systems, communication systems, fare collection systems, rest areas, relief centers, maintenance depots, administrative offices and stations
- (c) Project facilities situated on the site
- (d) Building and immovable fixtures or structures forming part of real estate development
- (e) All rights of the concessionaire under the project agreements
- (f) Financial assets, such as receivables, security deposits, etc.
- (g) Insurance proceeds and
- (h) Applicable permits and authorisations relating to or in respect of the Rail System

4.3 Definition of ‘Rail System’

‘Rail System’ means municipal tramway in Hyderabad comprising mass rapid transit system built or to be built and operated on the Site and includes civil, mechanical and electrical works, rolling stock, rail tracks, signaling and telecommunication equipment and all other Project assets necessary for and associated with operation of trains on the site and shall include real estate development.

4.4 Definition of ‘Real Estate Development’ (Article 3.1.3 read with Article 48 of CA)

Subject to and in accordance with the provisions of this Agreement and Applicable Laws, the Concession hereby granted shall, without prejudice to the provisions of Clause 3.1.2, entitle the Concessionaire to undertake development, operation and maintenance of the real estate specified in Schedule-A, subject to the conditions stipulated in Schedule-B and Schedule-D, and to exploit such development for commercial purposes (the “Real Estate Development”) with the right to sub-license any or all parts thereof by means of Project Agreements.

4.5 Definition of ‘Site’ (Article 10.1 read with Article 48 of CA)

The Site of the Rail System shall comprise of the real estate described in Schedule A and in respect of which the Right of Way shall be provided and granted by the Government

to the Concessionaire as a license under and in accordance with this Agreement (the “Site”). For the avoidance of doubt, it is hereby acknowledged and agreed that references to the Site shall be constructed as references to the real estate required for the Rail System as set forth in Schedule-A, and includes Real Estate Development.

5. Salient features of the Concession

Salient features of the concession have been provided by the querist as under:

5.1 The Concession

The Concession grants *exclusive right, license and authority to construct, operate and maintain the Metro Rail System including Real Estate Development* in Hyderabad in Public Private Partnership (PPP) model on Design, Build, Finance, Operate and Transfer (DBFOT) basis. (Emphasis supplied by the querist.)

5.2 Concession period

The concession period is for 35 years (including 5 years of construction period) which can be extendable by another 25 years at the option of the company subject to the following conditions:

- (a) Option should be exercised during 33rd year of concession.
- (b) The company should have discharged its obligations without material breach for 32 years. (Material breach shall for this purpose mean suspension of agreement and/or cumulative levy of damages exceeding a sum equivalent to performance security (Rs. 360 crs)

Note: The company does not foresee any challenge in discharging the above obligations and become eligible for exercising the option for extension of concession period.

5.3 Construction and operation periods

The construction of the project shall be completed within 5 years from the ‘Appointed Date’, as defined in the CA and balance period of 30 years is available for operation and maintenance. The Government declared 5th July 2012 as Appointed Date and the concession period started from the said date and currently the construction of the project is going on. While the cap on concession period of 35 years (extendable by another 25 years is applicable to real estate development also, there is no time limit prescribed for commencing and completing the construction of real estate development.

5.4 Concession fee (Article 26 of CA)

In consideration for grant of concession, the company shall pay to the Government:

By way of a concession fee a sum of Re. 1 per annum and

- (a) an additional concession fee for the 21st year commencing from commercial operations date (COD) @ 0.5% of the total realisable fare, net of any taxes on fare and for each subsequent year an additional concession fee @ 0.5% per annum as compared to the immediately preceding year, subject to a maximum of 10%.

5.5 Grant (Article 25 of the CA)

The clauses of Article 25 of the CA on this subject have been reproduced by the querist as below:

“Grant

The Government agrees to provide to the Concessionaire cash support by way of an outright grant equal to the sum set forth in the Bid, namely, Rs.1,458 crore (Rupees one thousand four hundred and fifty eight crore) only, in accordance with the provisions of this clause (the “grant”).

The grant shall be disbursed to the Concessionaire by way of equity support, and the balance remaining, if any, shall be disbursed as O&M support in accordance with the provisions of the following clauses.

Equity Support

Subject to the conditions specified in this clause, the grant shall be credited to the escrow account and shall be applied by the Concessionaire for meeting the total project cost (the “equity support”).

The equity support shall not exceed the sum specified in the bid and as accepted by the Government, but shall in no case be greater than the equity, and shall be further restricted to a sum not exceeding 30% (thirty per cent) of the total project cost. For the avoidance of doubt, the total project cost to be reckoned for the purposes of this clause shall include equity support.

Equity support shall be due and payable to the Concessionaire after it has expended the equity, and shall be disbursed proportionately along with the loan funds thereafter remaining to be disbursed by the Senior Lenders under the Financing Agreements. The Government shall disburse each tranche of the equity support as and when due, but not later than 15 (fifteen) days of receiving a request from the Concessionaire along with necessary particulars.

In the event of occurrence of a Concessionaire default, disbursement of equity support shall be suspended till such Concessionaire default has been cured by the Concessionaire.

Subject to the provisions of the Scheme of Financial Support to Public Private Partnership in Infrastructure and the Jawaharlal Nehru National Urban Renewal Mission as notified by the Central Government (the “Schemes for Financial Assistance”), the Government shall, for funding the Grant, use its best endeavors and provide all reasonable support to the Concessionaire for obtaining viability gap

funding under the Schemes for Financial Assistance. For the avoidance of doubt, it is expressly agreed that in the event of the Concessionaire being able to receive such viability gap funding for the Project, the same shall, for the purposes of this Agreement be deemed to be Grant by the Government hereunder, to be disbursed in accordance with the provisions of the Schemes for Financial Assistance. It is further agreed that the Government shall at all times discharge its obligation to disburse Grant under and in accordance with this Article whether or not funds are disbursed to the Concessionaire under the Schemes for Financial Assistance.

O&M Support

The balance of the Grant, if any, remaining after disbursement of the equity support shall be disbursed to the Concessionaire in accordance with this Clause for meeting O&M expenses and debt service of the Project (the “O&M support”). The O&M support shall be disbursed by the Government in quarterly installments and the first such installment shall be released within 90 (ninety) days of Commercial Operation Date (COD). Each installment shall be a sum equal to 7.5 (seven point five) per cent of the equity support and such installments shall be disbursed by the Government until the Grant is exhausted.”

Notes:

- (i) In this connection, the querist has clarified that this grant is considered as part of promoters’ contribution by the lenders for the purpose of reckoning debt-equity ratio to fund the total project cost, and not an ‘equity share capital’ in the strict sense. No shares need to be allotted to the Government against this ‘Equity Support’.
- (ii) The eligible amount of grant of Rs. 1,458 crore as bid by the company constitutes only 12% of the total project cost as defined for this purpose and hence, it would be totally expended to meet the construction of the project and nothing would be left for availing during O&M phase.

5.6 Golden share (Extract from Article 5.4 of the CA)

5.4.1 The Concessionaire and the Selected Bidder (viz., A Ltd.) shall execute an agreement with the Government, substantially in the form specified at Schedule-W (the ‘Shareholders’ Agreement’), providing for the issue and allotment of one non-transferable equity share of the company (the “Golden Share”) in favour of the Government, and shall provide for the following:

- (a) Appointment of a nominee of the Government on the Board of Directors of the Concessionaire;
- (b) An irrevocable undertaking that the rights vested in the Government shall not be abridged, abrogated or in any manner affected by any act done or purported to be done by the Concessionaire or any of its Associates or Affiliates;

- (c) An irrevocable undertaking that any divestment of equity in the Concessionaire shall not in any manner affect the rights of the Government herein and that the successors, assigns and substitutes of the Concessionaire shall be bound by such undertaking; and
- (d) Any other matter mutually agreed upon between the Parties.

5.4.2 The Parties expressly agree that the Shareholders' Agreement shall further provide that so long as the Government holds the Golden Share, an affirmative vote of the Government or the Director appointed by the Government shall be necessary and required for the passing of, by the General Meeting of the Company or the meeting of Board of Directors thereof, as the case may be, any resolution providing for all or any of the following or any matter incidental or consequential thereto:

- (a) to alter or add to the provisions of the memorandum;
- (b) to alter or add to the articles of association;
- (c) to change the name of the company;
- (d) to purchase the company's own shares or specified securities;
- (e) to issue sweat equity shares;
- (f) to issue further shares without pre-emptive rights to non-members or to convert loans or debentures into shares;
- (g) to reduce the share capital;
- (h) to remove the registered office of the company outside the limits of the State;
- (i) to commence any new lines of business;
- (j) to keep registers and returns at any other place than within city, town or village in which the registered office is situated;
- (k) to consent to a director or his relative or partner or firm or private company holding an office or place of profit, except that of managing director, manager, banker, or trustee for debenture-holders of the company;
- (l) to make inter-corporate-loans and investments or guarantee/security to be given, etc., if the aggregate amount thereof, exceeds the limit of 10 per cent of the company's paid-up share capital;
- (m) to apply to a Court to wind-up the company;
- (n) to wind-up the company voluntarily;
- (o) for various other matters pertaining to the winding up of the company; and
- (p) any other matter which is required by the Companies Act, 1956 to be passed by a special resolution of the shareholders of the company.

5.4.3 The Parties agree that the Shareholders' Agreement shall provide that till the time the Government holds the Golden Share, it shall be entitled to nominate a person of its choice for appointment as a non-retiring Director on the Board of the Concessionaire, and upon such nomination, the Concessionaire shall appoint such person as Director in accordance with the Applicable Laws.

6. Salient features of the project have been provided by the querist as under:

6.1 Construction and operation of the metro rail

The Hyderabad Metro Rail System will have a length of approximately 71.16 km consisting of 3 elevated corridors namely Miyapur – LB Nagar (28.87 kms) (referred to as Corridor-I), Jubilee Bus Station to Falaknuma (14.78 kms) (referred to as Corridor-II) and Nagole- Silparamam (27.51 kms) (referred to as Corridor-III). There will be three depots, one for each Corridor, located at Miyapur, Falaknuma and Nagole.

The Rail System shall be designed to a capacity of 50,000 PHPDT (Peak Hour Peak Direction Traffic) each for Corridors I & III and 35,000 PHPDT for Corridor II. All the three corridors pass through highly congested and busy traffic routes in Hyderabad city, with very high vehicular and pedestrian movement.

The Government shall provide right of way (ROW) to undertake construction of elevated corridors and also required land of 269 acres to undertake depot construction and real estate development in both depot lands and at select locations alongside the corridors including parking and circulation areas, for which no separate charges are payable to the Government towards cost of land.

6.2 Mechanical and electrical equipment required to be procured, erected and Commissioned for metro rail operation are:

The metro system can be operated only if the following systems are built, procured, installed and properly integrated to work in unison:

Main systems:

- (i) Viaduct - Viaducts are elevated civil structures constructed so that the Metro systems run above the road level allowing road based traffic to continue to move on road without much obstruction. The Viaducts typically occupy a small foot print on the existing roads.
- (ii) Depot buildings
- (iii) Station buildings
- (iv) Track system consisting of rails, fasteners, turnouts etc.
- (v) Overhead electrical traction system
- (vi) Rolling Stock – Modern electric multiple unit (EMU) which run on the tracks and carries people along the route.
- (vii) Signaling System – Signalling system ensures efficient train control and safety in train movements. It also assists in optimisation of metro infrastructure investments and running of an efficient train service on the network. The signalling system shall be based on fixed or moving blocks.
- (viii) Communication System – The proposed communication system will cater to the following requirements - Assistance to Train Traffic Control,

Maintenance Control, Emergency Control, Station to station dedicated communication, Telephone Exchange, Passenger Announcement System and Passenger Information and Display System within the station and from Central Control to each station, Centralized Clock System, Train Destination Indicator, Instant on line Radio Communication between Central Control and Moving Cars and maintenance personnel, Data Channels for Signaling, SCADA (Supervisory control and data acquisition), Automatic Fare Collection, BMS etc.

- (ix) Power Supply and SCADA (Supervisory control and data acquisition) System – Receiving substations, traction substations at stations, distribution lines.
- (x) Operation Control Center Equipment : The control of train operation will be done from computer based control centre. Facilities for setting of the route and clearing of the signals will be done by workstation which can be either locally (at station) operated or operated remotely from the Operation Control Centre (OCC). The whole section will have automatic signaling.

Other/Support systems (major ones):

- (xi) Elevators, Escalators and Lifts
- (xii) Air-conditioning in the enclosed and covered parts of the Stations and in Trains;
- (xiii) Lighting in Stations and Trains;
- (xiv) System-wide Graphics and Signage;
- (xv) Various Maintenance Equipment for maintenance of all equipment and subsystems of Rail system such as lathe machines, inspection cars, accident restoration units including retaining ramps, accident relief medical vans, and diesel engine for salvaging immobilized cars/trains;
- (xvi) Stand by DG sets to offset power failure etc;

6.3 Repairs and replacements during operation phase

The company (the Concessionaire) is responsible to operate and maintain the metro rail during the concession period as per the standards of performance stipulated in the CA. It is estimated that the company is required to add rolling stock (train cars) at the end of 5th, 10th and 20th years of operation to cater to the forecasted ridership increase. In addition, at the end of 20th year of operation, major replacements of other project assets are also expected to be incurred by the company which involves major capital outlay.

Upon expiry of concession period, the company is entitled to receive termination payment equal to 80% of the adjusted depreciated value of all project assets acquired and

installed after the 20th year of commercial operation date (COD). No compensation is payable for the assets acquired and installed before and during 20th year of COD.

6.4 Real Estate Development

- (i) The Concession permits real estate development (also called Transit Oriented Development (TOD)) *on commercial basis* in the parking and circulation areas and depot lands through which the company can earn lease rentals, maintenance and parking income. For this purpose *the Government shall provide requisite land at depots (212 acres) as well as at different locations at or near the stations (57 acres)* to the company to take up real estate development, as part of concession (emphasis supplied by the querist). No separate charges are payable by the company to the Government for the said land parcels.
- (ii) Understandably, since the metro rail project is highly capital intensive and making it financially viable based on only fare box revenue within a short period of 15 years (loan tenor permitted by lenders) is not possible, the Government designed this public private partnership (PPP) model of granting concession rights to earn fare box revenue coupled with rights to make real estate development, to facilitate implementation of this project on commercially viable lines.

6.5 Scope of Real Estate

The volume of real estate development permitted to be undertaken as per the CA can be summarised as under, over which the company can earn lease, maintenance and parking income:

- i. Upto to 6 million sft over the parking and circulation areas at or near stations: For this purpose, 25 land parcels (totaling to about 57 acres) at different locations at or near the stations have been identified and handed over to the company to take up real estate development as part of concession. Entire ground floor area at these locations shall be utilised exclusively for parking and circulation and the floors above ground floor can be used for real estate development. *(No separate consideration is payable by the company to the Government towards the cost of the said land parcels.)*
- ii. Upto 12.5 million sft. of space in depot lands: For this purpose, 212 acres of land at three different locations have been identified and handed over to the company to take up both depot development and real estate development, as part of the concession. However, 80% of the depot lands shall be exclusively used to construct only depot buildings wherein stabling and maintenance of trains will be undertaken. The balance 20% of the depot land is available for exclusive real estate development. However, the Concessionaire is also entitled to develop real estate over and above the ground floor of depot buildings. However the total limit for real estate development in depot lands is restricted to 12.5 million. *(No separate amount is payable by the company to the Government towards the cost of the depot lands.)*

- iii. In addition, the company can demarcate upto 20% of the floor area of each station for shops and/or kiosks and paid services needed for commuters. This works out to approx. 1 million sft of space through which the company can earn lease rentals and maintenance income.
- iv. *To sum up, 18.5 million sft of real estate development at or near stations and depots and 1 million space within stations is available for the company to earn lease, maintenance and parking income.*

(Emphasis supplied by the querist)

6.6 Other important issues relating to real estate development:

- (a) The company has plans to develop commercial office space, malls, multiplex theatres, shopping complexes, retail space, built-to-suit (customised) buildings for IT companies etc. and lease out the space at best competitive lease rental rates and other terms and conditions.
- (b) As explained above, there is a cap on the total area permitted to be developed as real estate.
- (c) The company shall take prior permission from the Government for entering into lease agreements with lessees of real estate if the period of agreement is beyond 11 months. All real estate development shall however be subject to obtaining permissions and other governing rules of local administration, for example, plan approval, fire permission etc.
- (d) The company is not permitted to start earning revenue from the real estate development unless it achieves COD (commercial operations date) of metro rail first. However, the company can start construction and firm up marketing arrangements of leasing real estate space before it achieves COD of metro rail.
- (e) *However, there are no restrictions imposed on the company under the Concession Agreement as to the type of development e.g., office space, commercial space, IT space, residential space etc. Also there are no restrictions on 'pricing' (or rates) of lease rents and maintenance charges that can be charged by the company. The company is free to develop any type of real estate development and collect lease rents and maintenance charges at the rates as deemed fit by the company. (Emphasis supplied by the querist.)*

6.7 Revenue Sources:

As permitted by the concession agreement, the following are the various sources of revenue to the project:

- Fare box revenue: This is ticket tariff to be collected from passengers at the predetermined rates notified by the Government from time to time and linked to year on year changes in wholesale price index plus an annual fixed percentage increase.

- Non-fare box revenue:
 - Rental income from lease of real estate space.
 - Maintenance income for operating and maintaining the real estate development
 - Parking charges for operating and maintaining the parking space
 - Advertisement revenue by leasing the space for display of advertisements in stations and real estate buildings.

6.8 Transfer of Assets on Expiry of the Concession Period

The project assets constructed by the company shall be transferred to the Government at the end of the concession period without any consideration in return for the terminal value. However, in respect of additions to project assets acquired and installed by the company after the 20th year of Commercial Operations Date (COD), the company is entitled for a termination payment equal to 80% of the adjusted depreciated value of such project assets.

6.9 Depreciation (Clause 47.3.1)

Article 47.3.1 of CA provides as under:

“For the purpose of depreciation under the Applicable Laws, the property representing the capital investment made by the Concessionaire in the Project Assets shall be deemed to be acquired and owned by the Concessionaire. For avoidance of doubt, the Government shall not in any manner be liable in respect of any claims for depreciation to be made by the concessionaire under the Applicable Laws”.

The above clause entitles the company to treat the entire project assets (rail system assets and real estate assets) as free hold fixed assets and accordingly to account / claim depreciation.

6.10 Construction Pattern – Stage-wise implementation and operation plan

To facilitate early and effective completion of the construction and early generation of revenues, the company decided to implement the total project in 6 stages, each stage covering a distance of around 8 to 12 Kms. Stage 1 is expected to be completed within 40 months from the commencement of construction and thereafter each of the remaining stages will be completed in a span of 3 to 4 months, thus the total project will be completed within the maximum stipulated time of 60 months.

As and when construction of each stage is completed and certified by the Competent Authority to be fit for operation, such stage comes into commercial operation and fetches fare revenue. For earning income from real estate development, it is not necessary for the company to wait for achievement of COD for all stages that is upto 60 months. Immediately after the Stage 1 becomes operational, the company can start booking revenues from real estate development and other non-fare revenues.

Hence, during the fourth and fifth years of construction, there will be a scenario on the financial year end date, wherein some of the stages would be operational and earning revenue while remaining stages would still be under construction. (Emphasis supplied by the querist.)

B. Query

7. Based on the aforementioned facts, the company seeks professional opinion from the Expert Advisory Committee on the following issues:

- (i) As per the concession agreement entered with the Government, the scope of the project (refer paragraph 2) includes construction and procurement of the Rail System and real estate development. The rights for commercial exploitation of real estate development will be available only if the Rail System is constructed, operated and maintained. There is no compulsion in the Concession Agreement that the company must carry out the real estate development. However, to make the project financially viable, it is necessary for the company to exploit the real estate development. The company is free to develop its own product mix say commercial space, office space, residential space, etc. and the company is free to charge the lease rentals and maintenance charges at the rates as deemed fit by the company. However, right to operate and earn revenue is subject to overall concession period of 35 years or 60 years as the case may be. After the commercial operations, 60% (approx.) of the revenue will come from fare revenue and 40% (approx.) from non-fare revenue, i.e., mainly from real estate development. The land for construction of the real estate development will be provided by the State Government at free of cost. Upon expiry of the concession period, the company will hand over the Rail System and the real estate development done by it to the State Government.
 - (a) Since the Government is giving the land free of cost for real estate development, it could be argued that an element of cost is included in the cost of construction of the rail system which is attributable to the cost of the land used for real estate development. In such scenario, whether the company needs to estimate the cost of the land attributable to real estate and account for it in the books accordingly. If yes, what is the appropriate method for estimating the cost? Does this cost be deducted from the cost of Rail System and added to the cost of real estate assets?
 - (b) In the above scenario, since the real estate development is not fully regulated by the Government unlike metro rail system, whether, the costs incurred on real estate development fall outside the scope of AS 26 and shall be accounted as fixed assets governed by the principles of AS 10, 'Accounting for Fixed Assets'²? What would be appropriate policy for amortisation or depreciation?

² The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. However, it may be noted that the Standard has been subsequently revised as AS 10, 'Property, Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

- (ii) With a view to support the infrastructure projects, the Central Government announced the Scheme for support to PPPs in infrastructure (viability gap funding Scheme) in 2004. The Scheme aims to ensure wide spread access to infrastructure provided through the PPP framework by subsidising the capital cost of their access. Meeting the funding gap to make economically essential projects commercially viable would obviate the need for Government funding for such projects and allow private sector participation in the projects, thus facilitating private sector efficiencies in infrastructure development. The scheme provides for financial support in the form of grants, one time or deferred to infrastructure projects undertaken through public private partnerships with a view to make them commercially viable. The Scheme provides for viability gap funding upto 20% of the project cost.

As per the concession agreement, the Government agrees to provide to the Concessionaire, cash support by way of an outright grant equal to the sum set forth in the bid, namely, Rs. 1,458 crore. The grant shall be disbursed to the Concessionaire by way of equity support, and the balance remaining, if any, shall be disbursed as O&M support (Refer paragraph 5.5 above). In the case of the company in the extant case, the entire grant will be utilised to meet the project cost. The concession agreement provides that the company has to put in their committed equity before availing the grant from the State Government for construction and implementation of the rail system. In the event of occurrence of Concessionaire's default, disbursement of grant shall be suspended till such default is cured by the Concessionaire. The Concession Agreement or VGF scheme does not envisage for refund of the grant already paid by the Central Government in the case of default of any of the conditions of the concession agreement either by the Concessionaire or the State Government.

Given the nature, purpose and conditions of the 'grant' to be received as viability gap funding from the Government as detailed in paragraph 5.5 above, whether the 'grant' shall be treated as a capital reserve as part of shareholders' funds or to be reduced from the cost of assets or to be recognised as income in the statement of profit and loss.

C. Points considered by the Committee

8. The Committee notes that the querist has raised the following three issues:
- (i) Recognition and measurement of the land provided by the Government to the company to develop real estate.
 - (ii) Treatment of costs incurred on real estate development on the land provided by the Government (Grantor) and appropriate policy for amortisation or depreciation.
 - (iii) Recognition of the viability gap funding referred to as 'Grant' under the Concession Agreement.

The Committee has, therefore, considered only the above issues and has not considered any other issue that may arise from the Facts of the Case, such as, treatment of metro rail infrastructure

developed by the company, treatment of obligation to replace assets, treatment of reimbursement for addition to assets after 20th year, treatment of ‘golden share’, timing of recognition of viability gap funding, etc.

Issue: Recognition and measurement of the land provided by the Government to the company to develop real estate:

9. The Committee notes that the company receives under the concession agreement, a right to charge users of the metro rail and a right to use land for real estate development which can be used subsequently for earning lease rentals over the period of the concession agreement in exchange for the construction services of the metro rail infrastructure provided by the company. Thus, in the view of the Committee, it is a composite project, where in exchange of construction service, the company is receiving the afore-mentioned two rights.

10. With regard to accounting for the right to use of land for real estate development, the Committee notes that paragraphs 1 and 3.1 of Accounting Standard (AS) 19, ‘Leases’, notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the ‘Rules’) defines lease as:

“1. This Standard should be applied in accounting for all leases other than:

(a) ...

(b) ...; and

(c) lease agreements to use lands.”

“3.1 A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.”

The Committee notes that in the given case, the grantor has conveyed to the company in return for construction services for metro rail infrastructure, the right to use land for the concession period. Thus, the company has obtained the land on leasehold basis for real estate development. However, since paragraph 1 of AS 19 excludes the accounting for lease agreements to use land, the Committee is of the view that the accounting for right to use of land would be governed by the principles of Accounting Standards (AS) 26, ‘Intangible Assets’. In this regard, the Committee notes that paragraph 6.1 of AS 26, notified under the Rules, defines an intangible asset as ***“an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes”***. The Committee is of the view that the right to use of land evidenced by a contract (Concession Agreement) is an identifiable non-monetary asset. Accordingly, such right shall be recognised and measured in accordance with the requirements of AS 26. Similarly, the right to charge fare from the users of metro rail is also an intangible asset and shall also be recognised and measured in accordance with the requirements of AS 26. Thus, there are two intangible assets.

11. From the above, the Committee is of the view that the company has received more than one intangible asset for a composite consideration. The Committee notes that in the given case, the company is giving a non-cash consideration, that is, construction services, for acquiring the

intangible assets. In this regard, the Committee notes that paragraph 34 of AS 26 states that “An intangible asset may be acquired in exchange or part exchange for other 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”. The Committee further notes that paragraphs 11.1 and 22 of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, notified under the Rules, state as follows:

“11.1 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. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration.”

“22. When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. ...”

On a harmonious reading of paragraphs 11.1 and 22 of AS 10, the Committee is of the view that the cost of the asset acquired is determined by reference to the fair market value of the consideration given or fair market value of the asset acquired, whichever is more clearly evident. The Committee is further of the view that in the given case, the more evident of the two, fair market value of the intangible assets acquired and the fair market value of the construction services rendered, is the fair market value of the construction services rendered. Therefore, the intangible assets should be recognised at fair market value of the construction services which, in the view of the Committee, would ordinarily be cost plus estimated margin of construction services.

12. As discussed above, the Committee notes that the company has received more than one intangible asset for a composite consideration. The Committee notes that AS 26 does not provide any guidance on how to recognise and measure where an enterprise receives more than one intangible asset for a composite consideration. However, the Committee notes that paragraph 15.3 of AS 10, provides as follows:

“15.3 Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.”

Accordingly, on a composite reading of paragraph 15.3 of AS 10 and paragraph 11 above, the Committee is of the view that the fair market value of the construction services will be apportioned to the composite consideration received from the Government including right to charge users of the metro rail and the right to use land for real estate development on a fair basis determined by competent valuers. The company shall recognise the right to use land for real estate development as an intangible asset and measure it at the apportioned fair market value of the construction services rendered.

Issue: Treatment of costs incurred on real estate development on the land provided by the grantor and amortisation or depreciation policy thereof

13. With regard to treatment of costs incurred on real estate development resulting into creation of real estate assets on the land provided by the grantor, the Committee notes that paragraph 49 (a) of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, defines an asset as follows:

*“An **asset** is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.”*

The Committee notes that in the given case, real estate development on the leasehold land is a resource controlled by the company since, in terms of the concession agreement, the company has the ability to direct the use of and obtain substantially all of the benefits from such a resource and can also prevent others from directing the use of and obtaining the benefits from the resource. Further, lease rentals are economic benefits that are expected to flow to the enterprise from the real estate development. Therefore, the costs incurred for real estate development meet all the characteristics of an asset.

14. Further, the Committee notes that paragraph 6.1 of AS 10, notified under the Rules, defines a 'fixed asset' as follows:

“6.1 Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.”

In the given case, real estate development is the asset which is held with the intention of being used for the purpose of providing services and not held for sale in the normal course of business. Therefore, the cost incurred on real estate development satisfies the definition of fixed asset and accordingly, should be accounted for as per the principles of AS 10.

15. With regard to amortisation or depreciation of cost incurred on real estate development recognised as fixed asset, the Committee notes that paragraph 3.2 of Accounting Standard (AS) 6, 'Depreciation Accounting'³, notified under the Rules, defines depreciable asset as:

“3.2 Depreciable assets are assets which

- (i) are expected to be used during more than one accounting period; and***
- (ii) have a limited useful life; and***
- (iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.”***

³ The opinion should be read in the context of Accounting Standard (AS) 6, 'Depreciation Accounting'. However, it may be noted that the Standard has been withdrawn by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

The Committee notes that the developed real estate is expected to be used by the enterprise during more than one accounting period which has a limited useful life and is held by the enterprise for use in providing services for lease rentals and not for the purpose of sale in the ordinary course of business. Therefore, the real estate development satisfies the definition of depreciable asset and should be amortised as per AS 6. In this regard, the Committee notes that paragraph 3.4 of AS 6 defines ‘depreciable amount’ as follows:

“Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.”

In the given case, the real estate development is not held by the enterprise for sale, therefore, the residual value of the real estate development is nil and the depreciable amount will be the cost incurred on the real estate development.

16. With regard to the policy for depreciation, the Committee notes that paragraphs 3.1 and 3.3 of AS 6 defines ‘depreciation’ and ‘useful life’, respectively as follows :

“3.1 Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.”

“3.3 Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.”

In the given case, the depreciable asset is expected to be used by the enterprise till the concession period. Therefore, the useful life of the real estate development is the concession period which is pre-determined. Accordingly, depreciation should be charged in each accounting period over the useful life considering the requirements of AS 6.

Issue: Recognition of the Viability Gap Funding

17. With regard to the recognition of the ‘Viability Gap Funding’ referred to as ‘Grant’ under the concession agreement, the Committee notes that paragraph 3.2 of Accounting Standard (AS) 12, ‘Accounting for Government Grants’, notified under the Rules, defines ‘government grants’ as follows:

“3.2 Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.”

18. From the Facts of the Case, the Committee notes that the concessionaire receives viability gap funding from the State Government in exchange of its services in the form of the infrastructure and real estate development under concession agreement. The Committee is of the view that a grant

is of the nature of a non-exchange transaction. Therefore, the viability gap funding in the extant case cannot be considered as grant for the purposes of AS 12.

19. Accordingly, the Committee is of the view that the viability gap funding received or receivable from the State Government referred as 'grant' in the concession agreement is also a consideration received or receivable from the grantor, viz., the Government for the services to be rendered in the contract apart from the two intangible assets acquired as discussed above. Therefore, the same should be recognised as a 'receivable' as and when the same accrues.

20. The Committee is of the view that the amount received or receivable as viability gap funding cannot be treated as a capital reserve as part of shareholders' funds or reduced from the cost of assets. However, since it is part of the consideration, it should be recognised as part of the contract revenue the statement of profit and loss and not as 'other income'.

D. Opinion

21. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

- (i) (a) Right to use land is an intangible asset and shall be accounted for in accordance with paragraphs 10, 11 and 12 above.
- (b) Cost incurred on real estate development is a fixed asset and should be depreciated over the concession period, as discussed in paragraphs 13 to 16 above.
- (ii) Viability gap funding received or receivable from the Government is a consideration received or receivable from the Government for the services to be rendered in the contract. Therefore, the same should be recognised as a receivable as and when the same accrues. The amount received or receivable as viability gap funding cannot be treated as a capital reserve as part of shareholders' funds or reduced from the cost of assets. However, since it is part of the consideration, it should be recognised as part of the contract 'revenue' in the statement of profit and loss and not as 'other income'.
