

Query No. 7

Subject: *Accounting for discontinuance of service concession arrangement during first-time adoption of Ind AS.*¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’) is a wholly owned subsidiary of ABC Infrastructure Developers Limited and is engaged in the business of toll collection and maintenance under a concession agreement for a stretch of national highway on Operate, Maintain and Transfer (OMT) basis for a period of 9 years starting from 22nd September, 2013.
2. Under the terms of concession agreement, the company needs to pay Rs. 11.08 crore concession fee in 12 equal monthly instalments to National Highways Authority of India (NHAI) with an escalation of 10% every year.
3. The company also has an obligation to create project facilities such as toll plaza, medical aid post, traffic aid post, etc., and also has an obligation to do an overlay of the entire stretch (resurfacing of the road) on or before 31.03.2017.
4. Being the subsidiary of a listed entity having networth of Rs. 500 crore and above, the company was required to and has adopted Indian Accounting Standards (Ind ASs) for the first time for the financial year ending 31st March, 2017. The Group and all subsidiaries had presented comparative Ind AS financial statements for the year ended 31st March, 2016. Thus, the transition date was 1st April, 2015.
5. The querist has stated that obligation to pay concession fee over the concession period as specified in the concession agreement is considered as constructive obligation. The company is of the view that as per Indian Accounting Standard (Ind AS) 37, ‘Provisions, Contingent Liabilities and Contingent Assets’, when an entity has constructive obligation (‘obligating event’) provision is required to be created, if other criteria for recognition of provision are also met. However, the company has not recognised the provision over the concession period under previous Indian GAAP (viz., Accounting Standards) and hence, this has been considered as a GAAP difference, on first time adoption of Ind ASs.
6. The querist has further stated that the toll collection rights over the concession period as specified in the concession agreement may be recognised as an intangible asset to be amortised over the concession period. The company is of the view that as per Indian Accounting Standard (Ind AS) 38, ‘Intangible Assets’, paragraph 7AA: intangible asset arising from service concession arrangement, i.e., the toll collection rights should be recognized as an intangible asset. The company has not recognised the intangible asset of toll collection right under Indian GAAP and drawing an analogy from the discussion in Issue 6 of Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 5, (which discussion pertains to Property, Plant and Equipment) the fair valuing of the intangible asset has been considered as a GAAP difference, on first time adoption of Ind ASs.
7. In view of the above, the company has made a provision as per Ind AS 37, by applying for the first time, the Ind ASs at the time of preparing interim financial statements for the quarter and six months ended 30th September, 2016 (Q2 reporting date). Accordingly, on the Q2 reporting date, in regard to the constructive obligation, the financial statements record the said obligation as mentioned below:

¹ Opinion finalised by the Committee on 5.6.2018 and 6.6.2018.

- a. Provision, on the transition date (i.e. 1st April, 2015) has been created by debiting 'Retained Earnings' as per paragraph 11 of Indian Accounting Standard (Ind AS) 101, 'First-time Adoption of Indian Accounting Standards' and crediting to 'Provision for Concession Fees Payable A/c'.
- b. Intangible asset for toll collection has been recognised by debiting 'Toll Collection Rights A/c' as per paragraph 7AA of Ind AS 38 and crediting 'Provision for Concession Fees Payable A/c'. These effects have been given in the previous year column of the presentation in the prescribed format.

This has been done in all subsidiaries of the Group.

8. On 25th August 2016, the company has handed over (by way of discontinuance of the OMT) the project to the NHAI as per the amicable settlement between the company and NHAI.

9. At the time of preparing interim financial statements for the quarter and six months ended 30th September, 2016 (Q2 reporting date), an issue arose about the creation of an obligation (in the previous year column) under the Ind AS (as mentioned in paragraph 7 above) and its reversal on the same date as at the 'Q2 reporting date' (in the quarter 2 financials).

10. As the obligation to pay concession fee ceased to exist on account of handing over the project back to the authority, under paragraph 59 of Ind AS 37, the company had reversed the 'Provision for Concession Fee Payable' and credited the whole provision back to profit and loss account as an exceptional item with a detailed note explaining the accounting treatment in the profit and loss account. This was done in the interim financial statements for the quarter and six months ended 30th September, 2016 ('reporting date') (i.e., liability no longer required -written back). Similarly, the entire intangible asset for toll collection rights has been debited to the profit and loss account as an exceptional item with the note to the profit and loss account explaining the accounting treatment.

11. This has resulted in the following accounting treatment in the preparation and finalisation of one single financial statement, i.e., for the quarter and six months ended 30th September, 2016:

- a. For opening balance sheet (i.e., 1st April, 2015) Rs. 66,43,12,069 is debited to 'Retained Earnings' and 'Intangible Assets (Toll collection Rights A/c)' is debited by Rs.703,82,18,187 as per paragraph 11 of Ind AS 101, and 'Provision for Concession Fees Payable A/c' is credited by Rs. 770,25,30,256.
- b. For F.Y. 2015-16, revenue based amortization of intangible assets is made by debiting Rs. 56,98,14,658 to 'Amortization A/c' and crediting 'Toll collection Rights A/c'. Further, interest cost on unwinding of trade payable is debited by Rs. 107,77,51,528, 'Provision for Concession Fees Payable A/c' debited by Rs. 20,03,21,335 and credited to operating cost (Concession Fees A/c) Rs. 127,80,72,863.
- c. Aggregate of the two amounts stated in points (a) and (b) being the 'Provision for Concession Fees Payable' no longer required, and impaired the full value of Toll Collection Rights and credited the net impact Rs. 103,38,05,392, of the 2 items, back to profit and loss account as an exceptional item of income.

The querist has also furnished to the Committee, the numerical workings to derive the above figures.

12. The company is of the view that this accounting treatment is justified on a plain reading of Ind AS 101 as, on first time adoption of Ind AS, 'hindsight' is not permitted. Therefore, the obligation not earlier recognised as per the then applicable accounting standards, results in a reduction in retained earnings in the previous year column on first time application of Ind ASs. On the very same date however, an equal amount is credited in the current period (Q2) as income as mentioned in paragraph 11(c) above.

B. Query

13. Based on the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed is in line with the requirements of Ind AS.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised in the query relates to the company's recognition and derecognition of the toll collection right (intangible asset) and obligation towards the fees payable to NHAI, and the consequential gain recognised in the statement of profit and loss during the quarter ended 30th September 2016. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, appropriate classification of the OMT concessions agreement as intangible asset in accordance with Appendix A to Ind AS 11, rather than as financial asset; appropriateness of revenue-based amortisation of toll collection rights; presentation of writing back of 'Provision for Concession Fee Payable' and impairment of full value of 'toll collection right' in the statement of profit and loss as an exceptional item; applicability of Ind AS 105, 'Non-current Assets Held for Sale and Discontinued Operations'; appropriateness of the company's accounting under previous GAAP (Accounting Standards notified under Companies (Accounting Standards) Rules, 2006); and the regulatory aspects of the discontinuance of concession agreement and handing over the same to NHAI. The Committee has also not verified the accuracy or the appropriateness of the calculations separately shared by the querist. Further, the Committee presumes that the OMT concession arrangement in the extant case is within the scope of Appendix A, Service Concession Arrangements to Indian Accounting Standard (Ind AS) 11, 'Construction Contracts'. The Committee also wishes to point out that since the financial year referred to in the query is F.Y. 2016-17, the Committee has considered the issue in the light of the Indian Accounting Standards applicable for that period.

15. At the outset, the Committee notes that the querist has described in the Facts of the Case, the obligation towards the NHAI fee payable as a constructive obligation. In this regard, the Committee notes that the term, 'constructive obligation' has not been defined under Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', however paragraph 10 of Ind AS 37 defines the term as follows:

“A *constructive obligation* is an obligation that derives from an entity's actions where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and**
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.”**

From the above, the Committee is of the view that the obligation towards fee payable to NHAI is not a constructive obligation as it is not an obligation arising from the action of the company by an established pattern of past practice; rather, the obligation towards NHAI fee payable emanates from the OMT concession agreement and is therefore a legal binding contractual obligation on the company.

16. The Committee further notes, based on the facts provided, that the company is getting toll collection right against multiple obligations under the concession arrangement, including:

1. Obligation to create Project facilities such as Toll plaza, Medical Aid post, Traffic Aid Post, etc., and also has an obligation to do an overlay of the entire stretch (resurfacing of the road) on or before 31.03.2017.
2. Obligation to pay Rs. 11.08 crore concession fee in 12 equal monthly instalments to NHAI with an escalation of 10% every year.

In the above context, the Committee notes the following paragraphs of Appendix A to Ind AS 11:

“12 Under the terms of contractual arrangements within the scope of this Appendix, the operator acts as a service provider. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.

13 The operator shall recognise and measure revenue in accordance with Ind AS 11 and Ind AS 18 for the services it performs. ...”

“21 The operator may have contractual obligations it must fulfil as a condition of its licence (a) to maintain the infrastructure to a specified level of serviceability or (b) to restore the infrastructure to a specified condition before it is handed over to the grantor at the end of the service arrangement. These contractual obligations to maintain or restore infrastructure, except for any upgrade element (see paragraph 14 of this Appendix), shall be recognised and measured in accordance with Ind AS 37, ie at the best estimate of the expenditure that would be required to settle the present obligation at the end of the reporting period.”

From the above, the Committee notes that the Appendix A to Ind AS 11 requires an operator to recognise contractual obligations towards maintenance of the infrastructure in accordance with Ind AS 37 and in case of any upgrade element, account for revenue and costs in accordance with Ind AS 11. However, the Committee has not looked into these aspects in the opinion as the same is not the issue raised by the querist in the extant case.

17. With regard to obligation to pay Rs. 11.08 crore concession fee in 12 equal monthly instalments to NHAI, the Committee notes the definition of ‘financial liability’ from Indian Accounting Standard (Ind AS) 32, ‘Financial Instruments: Presentation’ as follows:

“A financial liability is any liability that is:

(a) a contractual obligation :

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

...”

18. The Committee notes that the company has an obligation to pay concession fee over the concession period as specified in the concession agreement. This obligation, being a contractual obligation towards NHAI payable in cash terms, would meet the above definition of financial liability. Accordingly, in the extant case, a financial liability should be recognised at fair value at the date of initial recognition of the obligation (refer paragraph 5.1.1 of Ind AS 109) and subsequently should be measured in accordance with Ind AS 109, ‘Financial Instruments’. Under previous GAAP, the Committee notes that the company did not recognise any liability towards the contractual obligation payable to NHAI.

19. The Committee further notes from the Facts of the Case that the company has made a provision towards the aforesaid obligation by applying for the first time, the Ind ASs at the time of preparing interim financial statements for the quarter and six months ended 30th September, 2016 (‘Q2 reporting date’). In this regard, the Committee wishes to point out that the Ind AS transition adjustments should be made as of the date of transition to Ind ASs, i.e., 1st April, 2015 by making adjustments or passing entries on that date in the first reporting period of its Ind AS financial statements and assumes that the same has been followed by the company in the extant case.

20. With regard to the toll collection right, the Committee notes the following guidance in Appendix A to Ind AS 11 and Ind AS 38, ‘Intangible Assets’ for determining the initial cost of an intangible asset:

Appendix A to Ind AS 11

“17 The operator shall 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.”

“26 Ind AS 38 applies to the intangible asset recognised in accordance with paragraphs 17 and 18 of this Appendix. Paragraphs 45–47 of Ind AS 38 provide guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.”

Ind AS 38

“25 Normally, the price an entity pays to acquire separately an intangible asset will reflect expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion in paragraph 21(a) is always considered to be satisfied for separately acquired intangible assets.

26 In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

27 The cost of a separately acquired intangible asset comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

- (b) any directly attributable cost of preparing the asset for its intended use.
- 28 Examples of directly attributable costs are:
- (a) costs of employee benefits (as defined in Ind AS 19) arising directly from bringing the asset to its working condition;
 - (b) professional fees arising directly from bringing the asset to its working condition; and
 - (c) costs of testing whether the asset is functioning properly.”
- “32 If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with Ind AS 23, *Borrowing Costs*.”

“Exchanges of assets

- 45 One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an intangible asset is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.
- 46 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:
- (a) the configuration (ie risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
 - (b) the entity-specific value of the portion of the entity’s operations affected by the transaction changes as a result of the exchange; and
 - (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity’s operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

- 47 Paragraph 21(b) specifies that a condition for the recognition of an intangible asset is that the cost of the asset can be measured reliably. The fair value of an intangible asset is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.”

21. From the above, the Committee is of the view that the initial recognition of the financial liability at fair value will be part of the cost of the toll collection right (intangible asset) at the point of initial recognition. The Committee is further of the view that the intangible asset so recognised should be subsequently amortised using an appropriate method considering the requirements of Ind AS 38 and Ind AS 101. Further, the financial liability should also be subsequently amortised in accordance with Ind AS 109.

22. The Committee further notes that Ind AS 101, 'First-time Adoption of Indian Accounting Standards' sets out the following requirements with regard to first time adoption of Ind ASs:

“10 Except as described in paragraphs 13–19 and Appendices B–D, an entity shall, in its opening Ind AS Balance Sheet:

- (a) recognise all assets and liabilities whose recognition is required by Ind ASs;
- (b) not recognise items as assets or liabilities if Ind ASs do not permit such recognition;
- (c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind ASs; and
- (d) apply Ind ASs in measuring all recognised assets and liabilities.

11 The accounting policies that an entity uses in its opening Ind AS Balance Sheet may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to Ind ASs. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to Ind ASs.”

23. Based on the above, the Committee is of the view that the net impact of the recognition and subsequent measurement of the financial liability and toll collection right (intangible asset) should be recognised in retained earnings at the date of transition to Ind AS, i.e., 1st April 2015 in the first reporting period of its Ind AS based financial statements.

24. The Committee also notes that subsequent to the transition date, on 25th August 2016, the company has handed over (by way of discontinuance of the OMT) the Project to the NHAI as per the amicable settlement between the company and NHAI. In this regard, the Committee notes that as per the requirements of Appendix A of Ind AS 11, after initial recognition, the subsequent measurements of the respective assets and liabilities shall be in accordance with the applicable Ind ASs. Accordingly, the Committee notes that Ind AS 38 provides the following requirements with regard to derecognition of intangible assets:

“112 An intangible asset shall be derecognised:

- (a) on disposal; or**
- (b) when no future economic benefits are expected from its use or disposal.**

113 The gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognised in profit or loss when the asset is derecognised (unless Ind AS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.”

The Committee also notes that Ind AS 109 provides the following requirements with regard to derecognition of financial liability:

“B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:

- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)”

25. The Committee notes that the intangible asset and the financial liability are derecognised when the above conditions are respectively met and in both the cases, the consequential gain or loss is recognised in the statement of profit and loss. The Committee is of the view that the discontinuance of the OMT and the settlement with NHAI is effectively a legal release of the financial obligation towards NHAI and also disposal of the toll collection right (intangible asset).

26. The Committee notes that Ind AS 101 provides the following requirements with regard to use of estimates and hindsight while first time adoption of Ind ASs:

“14 An entity’s estimates in accordance with Ind ASs at the date of transition to Ind ASs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

15 An entity may receive information after the date of transition to Ind ASs about estimates that it had made under previous GAAP. In accordance with paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with Ind AS 10, *Events after the Reporting Period*. For example, assume that an entity’s date of transition to Ind ASs is 1 April 2015 and new information on 15 July 2015 requires the revision of an estimate made in accordance with previous GAAP at 31 March 2015. The entity shall not reflect that new information in its opening Ind AS Balance Sheet (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 March 2016.”

On the basis of the above, the Committee is of the view that a first time adopter of Ind AS is prohibited from using hindsight while preparing first Ind AS financial statements. The toll collection right (intangible asset) and the obligation towards NHAI (financial liability) existed as at the Ind AS transition date and, therefore, should be recognized in the opening Ind AS balance sheet as at 1st April, 2015, notwithstanding the fact that subsequently, there was a discontinuance of the OMT agreement. The discontinuance of the OMT agreement is a subsequent event, which cannot be considered while preparing the opening Ind AS balance sheet at the date of transition.

27. Incidentally, the Committee notes that the querist has raised two separate queries for the different obligations (viz., obligation for major maintenance and the obligation to pay concession fee to NHAI) arising from the same concession agreement.

The Committee further notes that in this query, the querist has stated that the company has recognized the provision for concession fee payable for the first time, by applying Ind AS 37 at the time of preparing interim financial report/statement for the quarter/six months ending 30th September, 2016 (Q2 reporting date), whereas in the other query, the querist has stated that the company has recognized the provision for resurfacing (major maintenance) for the first time, by applying Ind AS 37 at the time of preparing interim financial report/statement for the quarter ending 30th June, 2016 (Q1 reporting date). Thus, there is an apparent contradiction in the two queries as to when the company has applied Ind ASs for the first time, viz., Q1 or Q2 reporting date. Moreover, if the Ind ASs compliant financial statements were prepared for the quarter ending 30th June, why the company did not make provision for concession fee payable in the first quarter itself is not clear.

Further, the Committee notes that in the other query, the querist has stated that the adjustment relating to reversal of provision for resurfacing was made in the first quarter itself as the financials for that quarter were adopted on 2nd September, 2016 and the OMT was discontinued on 25th August, 2016; whereas in this query, in respect of obligation of payment of concession fee arising under the same concession agreement, the provision for concession fee payable was recognized for the first time in the second quarter ending 30th September, 2016.

However, the Committee has examined these two queries separately and independently without examining the consequential effects or impact that the one issue may have on the other from accounting perspective.

D. Opinion

28. On the basis of the above, the Committee is of the opinion that the toll collection right (intangible asset) and the obligation towards NHAI (financial liability) should be recognised and measured in accordance with the requirements of Appendix A of Ind AS 11, Ind AS 38 and Ind AS 109 respectively (as discussed in afore-mentioned paragraphs) as of the date of transition to Ind ASs, i.e., 1st April, 2015, notwithstanding the fact that, subsequently, there was a discontinuance of the OMT agreement. The discontinuance of the OMT agreement resulting in derecognition of the toll collection right (intangible asset) and the obligation towards NHAI financial liability should be accounted for during the period in which the handover of the OMT and the settlement between the company and NHAI were legally effective. The consequential gain or loss should be recognized in the statement of profit and loss during that period (i.e., during quarter ended 30 September 2016).