

Query No. 8

Subject: *Accounting for discontinuance of obligation under 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. The company is engaged in the business of toll collection and maintenance of a stretch of a 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 installments to National Highways Authority of India (NHAI) with an escalation of 10% every year.

3. Under the concession agreement, 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. The querist has stated that 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 the subsidiaries had chosen to present comparative Ind AS financial statements for the year ended 31st March, 2016. Thus, the transition date was 1st April 2015.

5. The querist has further stated that the major maintenance obligation 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 recognized the provision under previous Indian GAAP and hence, this has been considered as a GAAP difference, on first time adoption of Ind ASs. In view of the above, the company has made a provision as per Ind AS 37, by applying for the first time, the Ind AS at the time of preparing interim financial statement for the quarter ended 30th June, 2016 (Q1 reporting date). Accordingly, on the ‘Q1 reporting date’, in regard to the constructive obligation, the financial statements record the said obligation as mentioned below:

- a. Provision, prior to the transition date (i.e. 1st April, 2015) has been created by debiting ‘Retained Earnings A/c’ as per paragraph 11 of Ind AS 101, ‘First-time Adoption of Indian Accounting Standards’ and crediting to ‘Provision for Resurfacing A/c’.
- b. Provision post April 2015 by debiting ‘Road Repairing and Maintenance expenses’ in the statement of profit and loss and crediting to ‘Provision for Resurfacing 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 where such a major maintenance obligation was specified in the respective concession agreement.

¹ Opinion finalised by the Committee on 5.6.2018 and 6.6.2018.

6. 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.

7. According to the querist, this was the only project where the adjustments discussed in the following paragraphs were felt necessary because of the handing over of the project post the reporting date but before adoption of the financials in the Audit Committee meeting held on 2nd September, 2016 (hereinafter referred to as 'Adoption of Financial Statements Date').

8. At the time of preparing interim financial statements for the quarter ended 30th June, 2016 (Q1 reporting date), an issue arose about the creation of an obligation (in the previous year column) under the Ind ASs (as mentioned in paragraph 5 above) and its reversal on the same date as at the 'Q1 reporting date' (In the 1st quarter financials).

9. As the maintenance obligation 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 Resurfacing' 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 ended 30th June, 2016 ('reporting date') as an 'Event occurring after Balance Sheet Date' (i.e., liability no longer required – written back).

10. This has resulted in the company, using the following accounting treatment in the preparation and finalisation of one single financial statement, i.e. for the quarter ended 30th June, 2016:

- (a) Debiting Rs. 30,23,10,084 to 'Retained Earnings' as per paragraph 11 of Ind AS 101 and crediting to Provision for Resurfacing A/c for Provision prior to April 2015.
- (b) Provision post April 2015 by debiting Rs. 24,32,19,407 to 'Road Repairing and Maintenance expenses' in the statement of profit and loss and crediting 'Provision for Resurfacing A/c'.
- (c) Reversed Rs. 54,55,29,491 aggregate of the two amounts stated in points (a) and (b) being the Provision for Re-surfacing no longer required and credited the whole provision back to profit and loss account as an exceptional item of income.

11. The company is of the view that this accounting treatment is justified on a plain reading of Ind AS 101 as, in first time adoption of Ind ASs, 'hindsight' is not permitted. Therefore, the obligation not earlier recognised as per the then applicable AS, results in a reduction in (debited to) retained earnings in the previous year column on first time application of Ind AS. Further, as mentioned in paragraph 10(c) above, an equal amount is credited in the current period (Q1) as income.

B. Query

12. The Committee's opinion is sought on the accounting treatment given by the company.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to the company's recognition and derecognition of the company's obligation towards the NHAI for major maintenance under the concession agreement and the consequential gain recognised in the

statement of profit and loss during quarter ended 30th June, 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, accounting for toll collection right; accounting for obligation to pay concession fee to NHAI under the OMT concession agreement; disclosure of writing back of provision for resurfacing as an exceptional item of income; 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 the 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 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.

14. At the outset, the Committee notes that the querist has described in the Facts of the Case the obligation for major maintenance under the concession agreement as a constructive obligation. In this regard, the Committee notes that the term, 'constructive obligation' has been defined under paragraph 10 of Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets' 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 for major maintenance is not a constructive obligation as it is not an obligation arising from the action of the company by established pattern of past practice; rather, it is an obligation that emanates from the OMT concession agreement and is therefore a legal binding contractual obligation on the company.

15. With regard to obligation of major maintenance, 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. In this context, the Committee notes the requirements from Ind AS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’ as follows:

“A provision is a liability of uncertain timing or amount.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.”

“14 A provision shall be recognised when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event;**
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and**
- (c) a reliable estimate can be made of the amount of the obligation.**

If these conditions are not met, no provision shall be recognised.”

“36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.”

“45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.”

“59 Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.

60 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.”

16. The Committee notes that the company has an obligation to do an overlay of the entire stretch (resurfacing of roads) on or before 31.03.2017 as specified in the concession agreement. This obligation, being a contractual obligation towards NHAI, would meet the above definition of ‘provision’. Accordingly, in the extant case, a provision should be recognised, at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period and where the effect of the time value of money is material, the amount of provision shall be the present value of the expenditures expected to be required to settle the obligation at the date of initial recognition of the obligation. The Committee also notes that as per paragraph 60 of Ind AS 37, the provision so recognized should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. Further,

where discounting is used, the carrying amount of a provision should be increased in each period to reflect the passage of time and such increase is recognised as borrowing cost in the financial statements.

17. 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 ended 30th June, 2016 (Q1 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 AS, 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.

18. 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.”

19. Based on the above, the Committee is of the view that the net impact of the recognition of the provision should be recognised in retained earnings as of the date of transition to Ind AS, i.e., 1st April, 2015 in the first reporting period of its Ind AS based financial statements.

20. 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 paragraph 59 of Ind AS 37 provides that if it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed. Accordingly, the Committee is of the view that on discontinuance of the OMT, the provision recognised in respect of major maintenance/resurfacing obligation should be reversed through the statement of profit and loss.

21. 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 major maintenance obligation towards NHAI existed as at the 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. However, since before the adoption of interim financial statements for the quarter ended 30th June, 2016, the concession agreement was discontinued on August 25, 2016, the same should be analysed as to whether it is an adjusting event after the reporting period or non-adjusting event as per the requirements of Ind AS 10, ‘Events after the Reporting Period’ while preparing and presenting interim financial reports for the period ending 30th June, 2016. Accordingly, the company should consider making appropriate adjustments in the provision recognised and also consider impairment of the related intangible asset (viz., toll collection right) under service concession agreement. Further, the company should also bear in mind the requirements of Ind AS 34 if it prepares and presents its 30th June, 2016 financial statements in accordance with Ind AS 34.

22. 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 recognised 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), whereas in the other query, the querist has stated that the company has recognised 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). 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, 2016, 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 this 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 the other query, in respect of obligation of payment of concession fee under the same concession agreement, the provision for concession fee payable was recognised 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

23. On the basis of the above, the Committee is of the opinion that the major maintenance/resurfacing obligation should be recognised 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 reversal of provision should also be accounted for through the statement of profit and loss in the period of such discontinuance, however, it should also be analysed as to whether it is an adjusting event after the reporting period or non-adjusting events as per the requirements of Ind AS 10 for the interim financial statements for the quarter ended 30th June, 2016 and accordingly, adjustments to provision recognised and impairment of related intangible asset should be considered by the company, as discussed in paragraph 21 above.
