

Query No. 32

Subject: Accounting treatment of Hybrid Annuity Projects under Ind AS framework.¹

A. Facts of the Case

1. A private limited Company (hereinafter referred to as 'the Company') is a Special Purpose Vehicle (SPV), incorporated under the Companies Act, 2013, which started its business operations in financial year (F.Y.) 2022-23. Total revenue of the SPV company for F.Y. 2022-23 was Rs. 43.86 crore. The SPV has been promoted by M/s H Ltd. (100% shareholding) for taking a highway project for construction of 4 lane Access Controlled New Greenfield Highway Section of Inter Corridor Route under Bharatmala Pariyojana on Hybrid Annuity mode, which was awarded by the National Highways Authority of India (NHAI).

Hybrid Annuity Mode (HAM) projects:

2. The querist has stated that in Hybrid Annuity Model, private player constructs the roads in 2/2.5 years and maintains the road for 15 years. Certain portion, say 40% of the project costs is paid by the National Highways Authority of India (NHAI)/ Government during construction period and remaining 60% of the cost is paid as annuity during the concession period which runs in 15 years along with the agreed interest. This model is a combination of both Engineering, Procurement and Construction (EPC) and Build, Operate and Transfer (BOT) annuity. In terms of an example, in a contract worth Rs. 1000 crore, NHAI releases Rs. 400 crore during the construction phase in 10 milestones of 4% each. After due process of verification, NHAI issues COD (Commercial Operations Date) which means that the construction phase is over and the contractor becomes eligible to receive annuity payments (60%) as per the terms of the Concession Agreement.

New Special Purpose Vehicle (Company) Creation

3. The flow of the entire agreement process is as under:

- HAM Tender is issued by NHAI / Government.
- Bid to this Tender is submitted by a Holding Company. NHAI announces the winning bid.
- Bidder who wins the bid must form a new SPV company, which is a pre-condition in such contracts.
- NHAI awards work to new SPV and enters into a Concession Agreement with this SPV.
- SPV awards turnkey EPC contract for construction of road.

Consideration and Payment thereof under HAM:

4. Consideration under HAM projects is agreed upon through a well laid out tendering process and is chartered by a Concession Agreement. Payment under HAM project by NHAI to SPV is as follows:

¹ Opinion finalised by the Committee on 16.10.2023.

During Construction Period: On achieving predefined milestone, NHAI releases 4% payment on each such milestone. As per standard agreement, there are total 10 milestones till the completion of the construction, which means 40% payment is released during construction period.

After Construction Period: 60% payment will be paid in the form of bi-annual equated annuity along with interest payment.

For EPC contract: SPV will make 100% payment of EPC work to Holding Company during the construction phase itself.

Other Important Clauses related to HAM Projects:

5. As per the Concession Agreement:

- Concessionaire has to construct the road but also has to operate and maintain the same for the entire concession period.
- Project is being bidden by the sponsor company.
- Sponsor company is 'selected bidder' of the project awarded by the Authority (client).
- As per the requirements of the client, sponsor company has formed a Special Purpose Vehicle (SPV) company i.e. 'the Concessionaire'.
- Total Bid Project Cost (BPC or Contract Value) is consisting of the following expenses:
 - EPC civil road construction cost
 - Interest during construction (IDC) as loan is taken for arrangement of 60% remaining amount.
 - Other pre-operative expenses, i.e., loan processing fees, independent engineer fees, audit fees, insurance, salary of SPV employees, BG commission, secretarial compliance cost and other administration cost.
- During maintenance period, there will be receipt and expenses towards O&M which are separate from BPC.
- Total project cost and estimates will be considered for entire duration of the project, i.e., up to COD + O&M (2+15=17 Years).
- Basic object and intention for creation of SPV is to effectively control and monitor the project execution and funds separately.
- There will not be any other project or business for the SPV company and post completion of period, SPV will get dissolved.
- Thus, margin for the SPV company will be at a very minimum level as the project is bid based on the cost estimates for the above-mentioned cost components.

Accounting by the SPV under Ind AS:

6. Considering the nature of Hybrid Annuity Model (HAM) construction projects, there is distinct provision under Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers' wherein accounting treatment and disclosures in financial statements are prescribed. Appendix C 'Service Concession Arrangements' to Ind AS 115 is applicable for such projects.

7. As per the Concession Agreement provisions, SPV (the Concessionaire) is going to receive 40% of contract value during construction (COD) period as construction grant. Remaining 60% amount will be received during the operation and maintenance period of 15 years as annuity along with interest on it. As per Ind AS 115, during construction period, revenue is recognised by taking the cost incurred till date *plus* margins and financial asset has been created. Further, the fair value of the transactions is to be calculated considering the project cash inflows and outflows in different periods. The difference between cash flows is represented as finance income (present value of cash flows) derived on the basis of effective IRR on net cash flows. The SPV company is following the above-mentioned Ind AS for accounting for its transactions.

B. Query

8. As mentioned above, the contract cost includes EPC cost, IDC cost, other borrowing costs and other pre-operative costs. Estimated margins have been derived for the project by comparing the total cash inflows vis-a-vis total outflows. Revenue is accounted based on the cost incurred till date plus margins. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether borrowing costs (IDC, other financing cost etc.) can be considered as part of total cost while calculating the margins for the project for revenue recognition.
- (ii) When the financial asset is being created based on cost + margin = revenue method, can this borrowing cost also be treated as part of financial assets by considering the borrowing cost as part of total cost?
- (iii) Considering the nature of SPV company and HAM project, where SPV has been created for only business of construction and maintenance of this single project on behalf of the client (NHAI) and no other business can be taken by SPV, will borrowing costs become part of total cost base?
- (iv) Considering the relevant provisions of Ind AS for borrowing costs, where borrowing costs are to be expensed out and charged to profit and loss (P&L) if these are not related to qualifying asset to be capitalised, does it restrict that the borrowing costs cannot be a part of financial asset even by considering the same as part of total cost?

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the borrowing costs incurred by the operator under the service concession arrangement under hybrid annuity model. 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, revenue recognition during the construction or the operation and maintenance phase including

appropriateness of the method of revenue recognition by the Company, i.e., input method or output method, commercial terms of the arrangement, fair value estimation, treatment of pre-operative expenses, estimation of margins, etc. The Committee has examined the issue only from the accounting perspective and has not examined the regulatory or legal requirements and commercial implications. Further, the opinion hereinafter has been expressed in the context of Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time.

The Committee notes that the querist has submitted an illustrative example of the accounting with two alternative options. It seems to the Committee that under both the options illustrated by the querist, revenue from the concession agreement, consists of construction phase and operating & maintenance phase. Further, the querist appears to have used the input method as the basis for estimating the measurement of progress over time. Under Option 1, the interest cost incurred by the Company is considered in the cost incurred till date as well as total estimated cost, whereas under Option 2, the same is not considered in the cost incurred till date or in total estimated cost.

10. The Committee notes that the service concession arrangement of the Company under the hybrid annuity model contains following key features:

- The project is awarded to the sponsor company through a bidding process by NHAI. Under the bidding requirements, the sponsor company has formed an SPV, i.e., the concessionaire.
- The Project is for a period of 17 years (2 years (construction) + 15 years (O&M)), after which the project shall be transferred to the grantor (NHAI).
- Total Bid Project Cost (Contract Value) consists of the following expenses:
 - EPC civil road construction cost
 - Interest during construction (IDC) as loan is taken for arrangement of 60% remaining amount.
 - Other pre-operative expenses, i.e., loan processing fees, independent engineer fees, audit fees, insurance, salary of SPV employees, BG commission, secretarial compliance cost and other administration cost.
- As per the Concession Agreement provisions, SPV (the Concessionaire) receives 40% of contract value during construction (COD) period as construction grant. Remaining 60% amount is received during the operation & maintenance period of 15 years as annuity along with interest on it.
- The Company has no right in the road's ownership or toll collection.
- During maintenance period, there will be receipt and expenses towards O&M which is separate from EPC. There is no toll collection right for the Company. Revenue collection would be the responsibility of NHAI.
- Total project cost and estimates are considered for entire duration of the project, i.e., till COD + O&M period (2+15=17 years).

- There is no other project or business for the SPV company and post completion of period, SPV will get dissolved.
- Margin for the SPV company will be at a very minimum level as the project has been awarded based on the Company's cost estimates for the above-mentioned cost components.

11. The Committee notes that the Company has applied Appendix D 'Service Concession Arrangements' to Ind AS 115 in respect of the contract with the NHAI. Therefore, presuming that the Company has correctly applied the same, the Committee notes the following requirements of Appendix D to Ind AS 115:

“14 The operator shall account for construction or upgrade services in accordance with Ind AS 115.

Consideration given by the grantor to the operator

15 If the operator provides construction or upgrade services the consideration received or receivable by the operator shall be recognised in accordance with Ind AS 115. The consideration may be rights to:

- (a) a financial asset, or
- (b) an intangible asset.

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

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.”

“19 The nature of the consideration given by the grantor to the operator shall be determined by reference to the contract terms and, when it exists, relevant contract law. The nature of the consideration determines the subsequent accounting as described in paragraphs 23–26 of this Appendix. However, both types of consideration are classified as a contract asset during the construction or upgrade period in accordance with Ind AS 115.

Operation services

20 The operator shall account for operation services in accordance with Ind AS 115.”

“22 In accordance with Ind AS 23, borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service). In this case borrowing costs attributable to the arrangement shall be capitalised during the construction phase of the arrangement in accordance with that Standard.

Financial asset

23 Ind ASs 32, 107 and 109 apply to the financial asset recognised under paragraphs 16 and 18 of this Appendix.

24 The amount due from or at the direction of the grantor is accounted for in accordance with Ind AS 109 as measured at:

(a) amortised cost;

(b) fair value through other comprehensive income; or

(c) fair value through profit or loss.

25 If the amount due from the grantor is measured at amortised cost or fair value through other comprehensive income, Ind AS 109 requires interest calculated using the effective interest method to be recognised in profit or loss.”

In the extant case, the Committee notes that under the service concession arrangement, the Company receives 40% of contract value during construction (COD) period and remaining 60% amount is received during the operation & maintenance period of 15 years as annuity along with interest on it. Thus, the Company has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services and the grantor (NHAI) has little, if any, discretion to avoid the payment. Further, the Company does not have any right to charge users of the public services (toll). Therefore, the Company’s right under the arrangement constitutes a financial asset. As per the requirements of paragraphs 14 and 19 of Appendix D, the Company should account for revenue from construction and operating services as per the requirements of Ind AS 115. Further, as per the requirements of paragraphs 23 to 25 of Appendix D, the financial asset so recognised should be accounted for in accordance with Ind AS 109.

12. With regard to the issue raised by the querist relating to inclusion of borrowing costs in the costs incurred during construction activities, the Committee notes that as per the requirements of paragraph 22 of Appendix D to Ind AS 115, as reproduced above, borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service), in which case, borrowing costs attributable to the arrangement shall be capitalised during the construction phase. Since, in the extant case, as discussed above, the Company does not have any right to charge users of the public services (toll) resulting in to recognition of any intangible asset, therefore, the borrowing costs incurred by the Company in the extant case shall be charged to the Statement of Profit and Loss, as and when incurred and shall not be capitalised as part of the contract asset/financial asset being recognised under the arrangement.

13. The Committee further notes that in the extant case, the Company appears to be including the borrowing costs incurred as part of actual costs incurred and estimated total cost for the purpose of determining the progress of measure under inputs method while recognising revenue from its construction activity over time under Ind AS 115. Without examining the issues of pattern of recognition of revenue, appropriateness of inputs method as a measure of progress, etc. (as these issues have not been raised by the querist), the Committee notes the following requirements of Ind AS 115 with respect to measure of progress of revenue for the purpose of recognition:

“B18 Input methods recognise revenue on the basis of the entity’s efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. ...

B19 A shortcoming of input methods is that there may not be a direct relationship between an entity’s inputs and the transfer of control of goods or services to a customer. Therefore, an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity’s performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

- (a) When a cost incurred does not contribute to an entity’s progress in satisfying the performance obligation. For example, an entity would not recognise revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity’s performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labour or other resources that were incurred to satisfy the performance obligation).
- (b) When a cost incurred is not proportionate to the entity’s progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity’s performance may be to adjust the input method to recognise revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity’s performance might be to recognise revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met ...”

The Committee notes from the above that the method used by the Company to measure progress of contract to determine and recognise revenue under Ind AS 115 should reflect its performance in transferring goods or services to the customer. Further, a cost incurred, which does not contribute to an entity’s progress in satisfying the performance obligation is to be excluded while measuring progress.

Therefore, the Committee is of the view that borrowing costs incurred by an entity, which are incurred to fund its activities rather than to fulfil its performance obligations, would not be an input that reflects the progress of contract for the purpose of Ind AS 115 since borrowing costs would not represent entity’s efforts / inputs to satisfy the performance obligation.

14. The Committee also wishes to point out that the Company shall apply the guidance in Ind AS 115 for separation of distinct performance obligations within a contract and allocation of the total consideration amongst the distinct performance obligations.

D. Opinion

15. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 8 above:

- (i) The borrowing costs shall be charged to the Statement of Profit and Loss, as and when incurred, as discussed in paragraph 12 above. These costs shall not be included in the total cost for the purpose of determining the measure of progress of the contract under Ind AS 115, as discussed in paragraph 13 above. Further, the points mentioned in paragraphs 12, 13 and 14 above shall be referred.
 - (ii) The borrowing costs incurred shall not be capitalised as part of the financial asset being recognised under the arrangement, as discussed in paragraph 12 above.
 - (iii) Refer (i) above.
 - (iv) Refer (i) and (ii) above.
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