

Exposure Draft

Accounting Standard (AS) 7 (Revised 20XX)

(Corresponding to IAS 11)

Construction Contracts

(Last date for Comments: April 30, 2010)



Issued by
Accounting Standards Board

The Institute of Chartered Accountants of India

Exposure Draft

Accounting Standard 7 (Revised 20XX)
(Corresponding to IAS 11)

Construction Contracts

Contents

	Paragraphs
OBJECTIVE	
SCOPE	1–2
DEFINITIONS	3–6
COMBINING AND SEGMENTING CONSTRUCTION CONTRACTS	7–10
CONTRACT REVENUE	11–15
CONTRACT COSTS	16–21
RECOGNITION OF CONTRACT REVENUE AND EXPENSES	22–35
RECOGNITION OF EXPECTED LOSSES	36–37
CHANGES IN ESTIMATES	38
DISCLOSURE	39–45
EFFECTIVE DATE	46
APPENDICES	
A Service Concession Arrangements (Corresponding to IFRIC 12)	
B Service Concession Arrangements: Disclosures (Corresponding to SIC 29)	
C References to matters contained in other Accounting Standards	
D Illustrative examples	
• Disclosure of accounting policies	
• The determination of contract revenue and expenses	

- Contract disclosures

E **Comparison with IAS 11, *Construction Contracts*, IFRIC 12, *Service Concession Arrangements* and SIC 29, *Service Concession Arrangements; Disclosures***

F **Major differences between the Exposure Draft of AS 7 (Revised 20XX), *Construction Contracts*, and existing AS 7 (Revised 2002)**

Exposure Draft

Accounting Standard 7 (Revised 20XX)¹ (Corresponding to IAS 11)

Construction Contracts

The following is the Exposure Draft of the Accounting Standard (AS) 7 (Revised 20XX), Construction Contracts, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comments. The Board invites comments on any aspect of this Exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than April 30, 2010. Comments can also be sent by e-mail at edcommentsasb@icai.org or asb@icai.org.

*(This Exposure Draft of the revised Accounting Standard includes paragraphs set in **bold** type and plain type, which have equal authority. Paragraphs in bold type indicate the main principles. This Exposure Draft of the revised Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards²).*

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the *Framework for the Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India to determine when contract revenue and contract costs

¹ This Exposure Draft is issued pursuant to the decision to converge with IFRSs in respect of accounting periods commencing on or after April 1, 2011. All existing Accounting Standards and new Accounting Standards which are referred to in this Exposure Draft are also being revised or formulated, as the case may be, to converge with IFRSs from the aforesaid date. References to the other standards may be viewed accordingly.

² Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to items which are material.

should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

Scope

1. **This Standard shall be applied in accounting for construction contracts in the financial statements of contractors.**
2. This Standard supersedes Accounting Standard (AS) 7, (Revised 2002) *Construction Contracts* in respect of the entities to which this Accounting Standard is applicable.

Definitions

3. **The following terms are used in this Standard with the meanings specified:**

A *construction contract* is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A *fixed price contract* is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A *cost plus contract* is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

4. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.
5. For the purposes of this Standard, construction contracts include:
 - (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
 - (b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.
6. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example in the case of a cost plus

contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 23 and 24 in order to determine when to recognise contract revenue and expenses.

Combining and segmenting construction contracts

7. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.
8. **When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:**
 - (a) **separate proposals have been submitted for each asset;**
 - (b) **each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and**
 - (c) **the costs and revenues of each asset can be identified.**
9. **A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:**
 - (a) **the group of contracts is negotiated as a single package;**
 - (b) **the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and**
 - (c) **the contracts are performed concurrently or in a continuous sequence.**
10. **A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset shall be treated as a separate construction contract when:**
 - (a) **the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or**
 - (b) **the price of the asset is negotiated without regard to the original contract price.**

Contract revenue

11. **Contract revenue shall comprise:**

- (a) the initial amount of revenue agreed in the contract; and**
- (b) variations in contract work, claims and incentive payments:**
 - (i) to the extent that it is probable that they will result in revenue; and**
 - (ii) they are capable of being reliably measured.**

12. Contract revenue is measured at the fair value of the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

- (a) a contractor and a customer may agree variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;
- (b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;
- (c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or
- (d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

13. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

- (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and
- (b) the amount of revenue can be reliably measured.

14. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are included in contract revenue only when:

- (a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and

- (b) the amount that it is probable will be accepted by the customer can be measured reliably.
15. Incentive payments are additional amounts paid to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:
- (a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
 - (b) the amount of the incentive payment can be measured reliably.

Contract costs

16. Contract costs shall comprise:

- (a) costs that relate directly to the specific contract;**
- (b) costs that are attributable to contract activity in general and can be allocated to the contract; and**
- (c) such other costs as are specifically chargeable to the customer under the terms of the contract.**

17. Costs that relate directly to a specific contract include:

- (a) site labour costs, including site supervision;
- (b) costs of materials used in construction;
- (c) depreciation of plant and equipment used on the contract;
- (d) costs of moving plant, equipment and materials to and from the contract site;
- (e) costs of hiring plant and equipment;
- (f) costs of design and technical assistance that is directly related to the contract;
- (g) the estimated costs of rectification and guarantee work, including expected warranty costs; and
- (h) claims from third parties.

These costs may be reduced by any incidental income that is not included in contract revenue, for example income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

18. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:
- (a) insurance;
 - (b) costs of design and technical assistance that are not directly related to a specific contract; and
 - (c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs.

19. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.
20. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:
- (a) general administration costs for which reimbursement is not specified in the contract;
 - (b) selling costs;
 - (c) research and development costs for which reimbursement is not specified in the contract; and
 - (d) depreciation of idle plant and equipment that is not used on a particular contract.
21. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of contract revenue and expenses

22. **When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract**

shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

- 23. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:**
- (a) total contract revenue can be measured reliably;**
 - (b) it is probable that the economic benefits associated with the contract will flow to the entity;**
 - (c) both the contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably; and**
 - (d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.**
- 24. In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:**
- (a) it is probable that the economic benefits associated with the contract will flow to the entity; and**
 - (b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.**
25. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.
26. Under the percentage of completion method, contract revenue is recognised as revenue in profit or loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in profit or loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.
27. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable

that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

28. The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits associated with the contract will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in contract revenue, and already recognised in profit or loss, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.
29. An entity is generally able to make reliable estimates after it has agreed to a contract which establishes:
- (a) each party's enforceable rights regarding the asset to be constructed;
 - (b) the consideration to be exchanged; and
 - (c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

30. The stage of completion of a contract may be determined in a variety of ways. The entity uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:
- (a) the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;
 - (b) surveys of work performed; or
 - (c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers often do not reflect the work performed.

31. When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in costs incurred to date. Examples of contract costs which are excluded are:
- (a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

- (b) payments made to subcontractors in advance of work performed under the subcontract.

32. When the outcome of a construction contract cannot be estimated reliably:

- (a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and
- (b) contract costs shall be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

33. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenues. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.

34. Contract costs that are not probable of being recovered are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may need to be recognised as an expense immediately include contracts:

- (a) that are not fully enforceable, ie their validity is seriously in question;
- (b) the completion of which is subject to the outcome of pending litigation or legislation;
- (c) relating to properties that are likely to be condemned or expropriated;
- (d) where the customer is unable to meet its obligations; or
- (e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

35. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract shall be recognised in accordance with paragraph 22 rather than in accordance with paragraph 32.

Recognition of expected losses

- 36. When it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.**
37. The amount of such a loss is determined irrespective of:
- (a) whether work has commenced on the contract;
 - (b) the stage of completion of contract activity; or
 - (c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 9.

Changes in estimates

38. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see AS 5 (Revised 20XX) *Accounting Policies, Changes in Accounting Estimates and Errors*). The changed estimates are used in the determination of the amount of revenue and expenses recognised in profit or loss in the period in which the change is made and in subsequent periods.

Disclosure

- 39. An entity shall disclose:**
- (a) the amount of contract revenue recognised as revenue in the period;**
 - (b) the methods used to determine the contract revenue recognised in the period; and**
 - (c) the methods used to determine the stage of completion of contracts in progress.**
- 40. An entity shall disclose each of the following for contracts in progress at the end of the reporting period:**
- (a) the aggregate amount of costs incurred and recognised profits (less recognised losses) to date;**
 - (b) the amount of advances received; and**
 - (c) the amount of retentions.**

41. Retentions are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.
42. **An entity shall present:**
- (a) **the gross amount due from customers for contract work as an asset; and**
 - (b) **the gross amount due to customers for contract work as a liability.**
43. The gross amount due from customers for contract work is the net amount of:
- (a) costs incurred plus recognised profits; less
 - (b) the sum of recognised losses and progress billings
- for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.
44. The gross amount due to customers for contract work is the net amount of:
- (a) costs incurred plus recognised profits; less
 - (b) the sum of recognised losses and progress billings
- for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).
45. An entity discloses any contingent liabilities and contingent assets in accordance with AS 29 (Revised 20XX) *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses.

Effective date

46. An entity to which this Accounting Standard is applicable shall apply it for accounting periods commencing on or after the date (to be announced separately) 1st April 2011 and will be mandatory in nature³ from that date.

³ This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

Appendix A

Service Concession Arrangements⁴ (Corresponding to IFRIC 12)

This Appendix is an integral part of Accounting Standard 7(Revised 20XX).

Background

- 1 Infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.
- 2 In recent times, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructure. The infrastructure may already exist, or may be constructed during the period of the service arrangement. An arrangement within the scope of this Appendix typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a ‘build-operate-transfer’, a ‘rehabilitate-operate-transfer’ or a ‘public-to-private’ service concession arrangement.
- 3 A feature of these service arrangements is the public service nature of the obligation undertaken by the operator. Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:
 - (a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.
 - (b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.
 - (c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.

⁴ This Appendix refers to AS 7 (Revised 20XX) in respect of recognition of contract revenue where the operator under a service concession arrangement acts as a contractor.

- (d) the operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

Scope

- 4 This Appendix gives guidance on the accounting by operators for public-to-private service concession arrangements
- 5 This Appendix applies to public-to-private service concession arrangements if:
 - (a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
 - (b) the grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.
- 6. Infrastructure used in a public-to-private service concession arrangement for its entire useful life (whole of life assets) is within the scope of this Appendix if the conditions in paragraph 5(a) of this Appendix are met. Paragraphs AG1–AG8 of the Application Guidance of this Appendix provide guidance on determining whether, and to what extent, public-to-private service concession arrangements are within the scope of this Appendix.
- 7 This Appendix applies to both:
 - (a) infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and
 - (b) existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement.
- 8 This Appendix does not specify the accounting for infrastructure that was held and recognised as property, plant and equipment by the operator before entering the service arrangement. The derecognition requirements of Accounting Standards (as set out in AS 10 (Revised 20XX)) apply to such infrastructure.
- 9 This Appendix does not specify the accounting by grantors.

Issues

- 10 This Appendix sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements. Requirements for disclosing information about service concession arrangements are in

Appendix B to this Accounting Standard. The issues addressed in this Appendix are:

- (a) treatment of the operator's rights over the infrastructure;
- (b) recognition and measurement of arrangement consideration;
- (c) construction or upgrade services;
- (d) operation services;
- (e) borrowing costs;
- (f) subsequent accounting treatment of a financial asset and an intangible asset; and
- (g) items provided to the operator by the grantor.

Accounting Principles

Treatment of the operator's rights over the infrastructure

- 11 Infrastructure within the scope of this Appendix shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

Recognition and measurement of arrangement consideration

- 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 AS 7 (Revised 20XX) and AS 9 (Revised 20XX) for the services it performs. If the operator performs more than one service (ie construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable. The nature of the consideration determines its subsequent accounting treatment. The subsequent accounting for consideration received as a financial asset and as an intangible asset is detailed in paragraphs 23–26 below.

Construction or upgrade services

- 14 The operator shall account for revenue and costs relating to construction or upgrade services in accordance with AS 7 (Revised 20XX).

| 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 at its fair value. 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.
- 18 If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognised initially at the fair value of the consideration received or receivable.
- 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.

| Operation services

- 20 The operator shall account for revenue and costs relating to operation services in accordance with AS 9 (Revised 20XX).

| Contractual obligations to restore the infrastructure to a specified level of serviceability

- 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 AS 29

(Revised 20XX), ie at the best estimate of the expenditure that would be required to settle the present obligation at the end of the reporting period.

Borrowing costs incurred by the operator

- 22 In accordance with AS 16 (Revised 20XX), 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 AS 30 (Revised 20XX), AS 31 (Revised 20XX) and AS 32 (Revised 20XX) 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 AS 30 (Revised 20XX) as:
- (a) a loan or receivable;
 - (b) an available-for-sale financial asset; or
 - (c) if so designated upon initial recognition, a financial asset at fair value through profit or loss, if the conditions for that classification are met.
- 25 If the amount due from the grantor is accounted for either as a loan or receivable or as an available-for-sale financial asset, AS 30 (Revised 20XX) requires interest calculated using the effective interest method to be recognised in profit or loss.

Intangible asset

- 26 AS 26 (Revised 20XX) applies to the intangible asset recognised in accordance with paragraphs 17 and 18 of this Appendix . Paragraphs 45–47 of AS 26 (Revised 20XX) 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.

Items provided to the operator by the grantor

- 27 In accordance with paragraph 11 of this Appendix, infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognised as property, plant and equipment of the operator. The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are not government grants as defined in AS 12 (Revised 20XX). They are recognised as assets of the operator,

measured at fair value on initial recognition. The operator shall recognise a liability in respect of unfulfilled obligations it has assumed in exchange for the assets.

Effective date

28 (Deleted)

Transition

29. (Deleted)

30. (Deleted)

Application Guidance on Appendix A

This Application Guidance is an integral part of Appendix A

Scope (paragraph 5 of Appendix of A)

- AG1 Paragraph 5 of Appendix A specifies that infrastructure is within the scope of the Appendix when the following conditions apply:
- (a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
 - (b) the grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.
- AG2 The control or regulation referred to in condition (a) could be by contract or otherwise (such as through a regulator), and includes circumstances in which the grantor buys all of the output as well as those in which some or all of the output is bought by other users. In applying this condition, the grantor and any related parties shall be considered together. If the grantor is a public sector entity, the public sector as a whole, together with any regulators acting in the public interest, shall be regarded as related to the grantor for the purposes of this Appendix A.
- AG3 For the purpose of condition (a), the grantor does not need to have complete control of the price: it is sufficient for the price to be regulated by the grantor, contract or regulator, for example by a capping mechanism. However, the condition shall be applied to the substance of the agreement. Non-substantive features, such as a cap that will apply only in remote circumstances, shall be ignored. Conversely, if for example, a contract purports to give the operator freedom to set prices, but any excess profit is returned to the grantor, the operator's return is capped and the price element of the control test is met.
- AG4 For the purpose of condition (b), the grantor's control over any significant residual interest should both restrict the operator's practical ability to sell or pledge the infrastructure and give the grantor a continuing right of use throughout the period of the arrangement. The residual interest in the infrastructure is the estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement.
- AG5 Control should be distinguished from management. If the grantor retains both the degree of control described in paragraph 5(a) of Appendix A and any significant

residual interest in the infrastructure, the operator is only managing the infrastructure on the grantor's behalf—even though, in many cases, it may have wide managerial discretion.

AG6 Conditions (a) and (b) together identify when the infrastructure, including any replacements required (see paragraph 21 of Appendix A), is controlled by the grantor for the whole of its economic life. For example, if the operator has to replace part of an item of infrastructure during the period of the arrangement (eg the top layer of a road or the roof of a building), the item of infrastructure shall be considered as a whole. Thus condition (b) is met for the whole of the infrastructure, including the part that is replaced, if the grantor controls any significant residual interest in the final replacement of that part.

AG7 Sometimes the use of infrastructure is partly regulated in the manner described in paragraph 5(a) of Appendix A and partly unregulated. However, these arrangements take a variety of forms:

(a) any infrastructure that is physically separable and capable of being operated independently and meets the definition of a cash-generating unit as defined in AS 28 (Revised 20XX) shall be analysed separately if it is used wholly for unregulated purposes. For example, this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients.

(b) when purely ancillary activities (such as a hospital shop) are unregulated, the control tests shall be applied as if those services did not exist, because in cases in which the grantor controls the services in the manner described in paragraph 5 of Appendix A, the existence of ancillary activities does not detract from the grantor's control of the infrastructure.

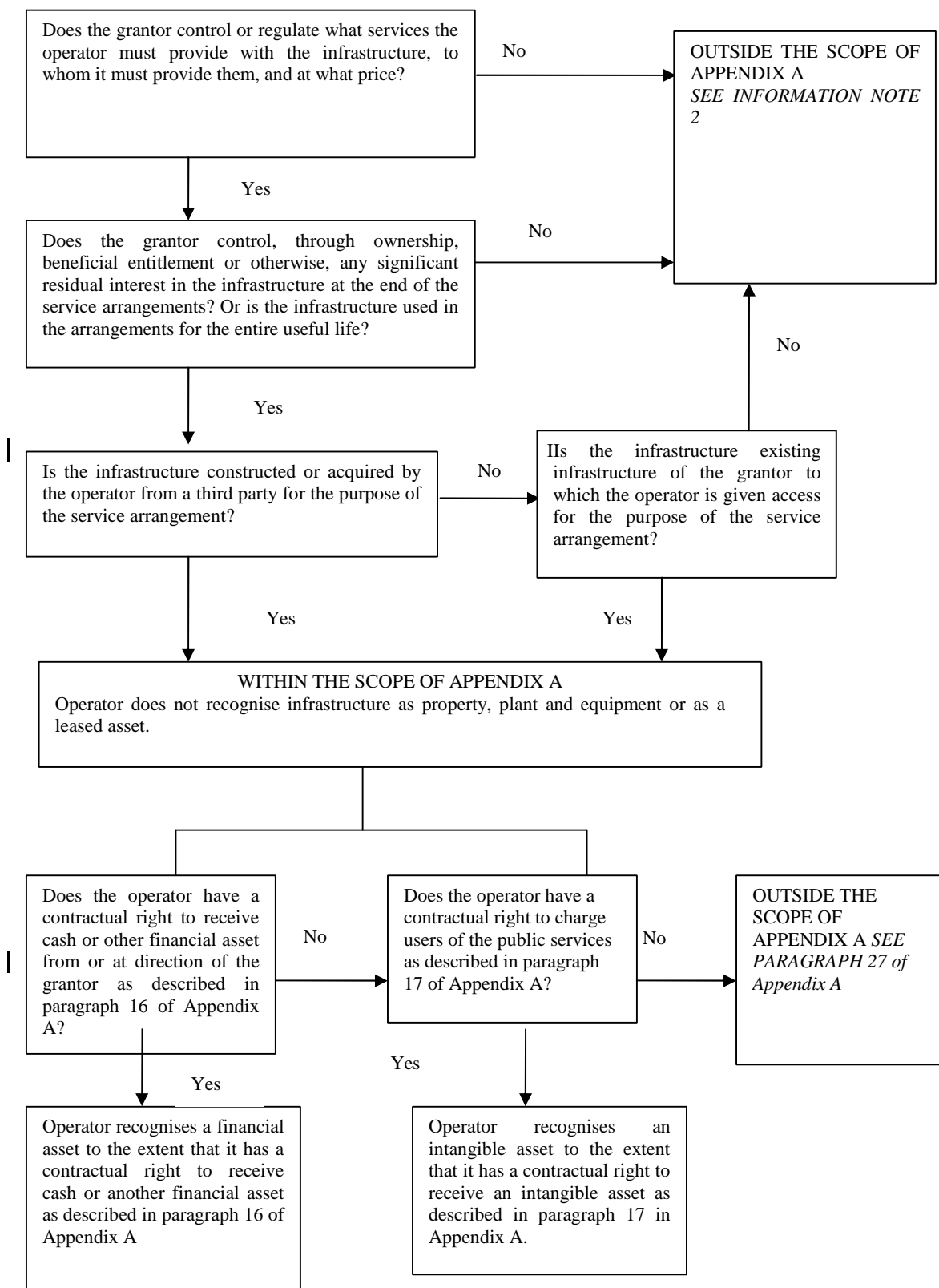
AG8 The operator may have a right to use the separable infrastructure described in paragraph AG7 (a), or the facilities used to provide ancillary unregulated services described in paragraph AG7 (b). In either case, there may in substance be a lease from the grantor to the operator; if so, it shall be accounted for in accordance with AS 19 (Revised 20XX).

Information note 1

Accounting framework for public-to-private service arrangements

This note accompanies, but is not part of, Appendix A

The diagram below summarises the accounting for service arrangements established by Appendix A



Information note 2

References to Accounting Standards that apply to typical types of public-to-private arrangements

This note accompanies, but is not part of, Appendix A.

The table sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to Accounting Standards that apply to those arrangements. The list of arrangements types is not exhaustive. The purpose of the table is to highlight the continuum of arrangements. It is not Appendix A's intention to convey the impression that bright lines exist between the accounting requirements for public-to-private arrangements

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (eg Operator leases asset from grantor)	Service and/or maintenance contract (specific tasks eg debt collection)	Rehabilitate – operate - transfer	Build - operate - transfer	Build - own - operate	100% Divestment/ Privatisation/ Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or Grantor		Operator	
Typical duration	8–20 years	1–5 years	25–30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor				Operator	
Relevant Accounting Standards	AS 19 (Revised 20XX)	AS 9 (Revised 20XX)	This Appendix A		AS 10 (Revised 20XX)	

Illustrative examples

These examples accompany, but are not part of, Appendix A

Example 1: The grantor gives the operator a financial asset

Arrangement terms

- IE1 The terms of the arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (ie years 3–10). The terms of the arrangement also require the operator to resurface the road at the end of year 8—the resurfacing activity is revenue-generating. At the end of year 10, the arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1.1 *Contract costs*

	Year	Rs
Construction services	1	500
	2	500
Operation services (per year)	3–10	10
Road resurfacing	8	100

- IE2 The terms of the arrangement require the grantor to pay the operator Rs 200 per year in years 3–10 for making the road available to the public.
- IE3 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Contract revenue

- IE4 The operator recognises contract revenue and costs in accordance with AS 7 (Revised 20XX) *Construction Contracts* and AS 9 (Revised 20XX) *Revenue*. The costs of each activity—construction, operation and resurfacing—are recognised as expenses by reference to the stage of completion of that activity. Contract revenue—the fair value of the amount due from the grantor for the activity undertaken—is recognised at the same time. Under the terms of the arrangement the operator is obliged to resurface the road at the end of year 8. In year 8 the operator will be reimbursed by the grantor for resurfacing the road. The obligation to resurface the road is measured at zero in the balance sheet and the revenue and expense are not recognised in profit or loss until the resurfacing work is performed.
- IE5 The total consideration (Rs 200 in each of years 3–8) reflects the fair values for each of the services, which are:

Table 1.2 Fair values of the consideration received or receivable

	Fair value
Construction services	Forecast cost + 5%
Operation services	" " + 20%
Road resurfacing	" " + 10%
Effective interest rate	6.18% per year

IE6 In year 1, for example, construction costs of Rs 500, construction revenue of Rs 525 (cost plus 5 per cent), and hence construction profit of Rs 25 are recognised in profit or loss.

Financial asset

IE7 The amounts due from the grantor meet the definition of a receivable in AS 30 (Revised 20XX) *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments.

IE8 If the cash flows and fair values remain the same as those forecast, the effective interest rate is 6.18 per cent per year and the receivable recognised at the end of years 1–3 will be:

Table 1.3 Measurement of receivable

	Rs
Amount due for construction in year 1	525
Receivable at end of year 1⁵	525
Effective interest in year 2 on receivable at the end of year 1 (6.18% × Rs 525)	32
Amount due for construction in year 2	525
Receivable at end of year 2	1,082
Effective interest in year 3 on receivable at the end of year 2 (6.18% × Rs1, 082)	67
Amount due for operation in year 3 (Rs 10 × (1 + 20%))	12
Cash receipts in year 3	(200)
Receivable at end of year 3	961

⁵ No effective interest arises in year 1 because the cash flows are assumed to take place at the end of the year

Overview of cash flows, statement of profit and loss and balance sheet

IE9 For the purpose of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of profit and loss and balance sheet over the duration of the arrangement will be:

Table 1.4 Cash flows (Rupees)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs ⁶	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs ⁷	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

Table 1.5 Statement of profit and loss (Rupees)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	12	12	12	12	12	122	12	12	1,256
Contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Finance income ⁸	-	32	67	59	51	43	34	25	22	11	344
Borrowing costs ⁹	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net profit	25	23	-	-	-	2	3	14	5	6	78

Table 1.6 Balance sheet (Rupees)

End of year	1	2	3	4	5	6	7	8	9	10
Amount due from grantor ¹⁰	525	1,082	961	832	695	550	396	343	177	-

⁶ Table 1.1

⁷ Debt at start of year (table 1.6) x 6.7%

⁸ Amount due from grantor at start of year (table 1.6) x 6.18%

⁹ Cash/(debt) (table 1.6) x 6.7%

¹⁰ Amount due from grantor at start of year, plus revenue and finance income earned in year (table 1.4), less receipts in year (table 1.4).

Cash/(debt) ¹¹	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Net assets	25	48	48	48	48	50	53	67	72	78

IE10 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

Example 2: The grantor gives the operator an intangible asset (a licence to charge users)

Arrangement terms

IE11 The terms of a service arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (ie years 3–10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of the year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 2.1 Contract costs

	Year	Rs
Construction services	1	500
	2	500
Operation services (per year)	3–10	10
Road resurfacing	8	100

IE12 The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of Rs 200 in each of years 3–10.

IE13 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

¹¹ Debt at start of year plus net cash flow in year (table 1.4).

Intangible asset

IE14 The operator provides construction services to the grantor in exchange for an intangible asset, ie a right to collect tolls from road users in years 3–10. In accordance with AS 26 (Revised 20XX) *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of consideration transferred to acquire the asset, which is the fair value of the consideration received or receivable for the construction services delivered.

IE15 During the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) is classified as an intangible asset (licence to charge users of the infrastructure). The operator estimates the fair value of its consideration received to be equal to the forecast construction costs plus 5 per cent margin. It is also assumed that, in accordance with AS 16 (Revised 20XX) *Borrowing Costs*, the operator capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase of the arrangement:

Table 2.2 Initial measurement of intangible asset

	Rs
Construction services in year 1 (Rs 500 × (1 + 5%))	525
Capitalisation of borrowing costs (table 2.4)	34
Construction services in year 2 (Rs 500 × (1 + 5%))	525
Intangible asset at end of year 2	1,084

IE16 In accordance with AS 26 (Revised 20XX), the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3–10. The depreciable amount of the intangible asset (Rs 1, 084) is allocated using a straight-line method. The annual amortisation charge is therefore Rs1,084 divided by 8 years, ie Rs 135 per year.

Construction costs and revenue

IE17 The operator recognises the revenue and costs in accordance with AS 7 (Revised 20XX) *Construction Contracts*, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration received or receivable. Thus in each of years 1 and 2 it recognises in its profit or loss construction costs of Rs 500, construction revenue of Rs 525 (cost plus 5 per cent) and, hence, construction profit of Rs 25.

Toll revenue

IE18 The road users pay for the public services at the same time as they receive them, ie when they use the road. The operator therefore recognises toll revenue when it collects the tolls.

Resurfacing obligations

IE19 The operator's resurfacing obligation arises as a consequence of use of the road during the operating phase. It is recognised and measured in accordance with AS 29 (Revised 20XX) *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period

IE20 For the purpose of this illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by Rs 17 (discounted to a current value) each year. The operator discounts the provision to its present value in accordance with AS 29 (Revised 20XX). The charge recognised each period in profit or loss is:

Table 2.3 Resurfacing obligation (Rupees)

Year	3	4	5	6	7	8	Total
Obligation arising in year (Rs17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in profit or loss	12	14	15	17	20	22	100

Overview of cash flows, statement of profit and loss and balance sheet

IE21 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of profit and loss and balance sheet over the duration of the arrangement will be:

Table 2.4 Cash flows (Rupees)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs ¹²	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs ¹³	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

¹² Table 2.1

¹³ Debt at start of year (table 2.6) × 6.7%

Table 2.5 Statement of profit and loss (Rupees)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	200	200	200	200	200	200	200	200	2,650
Amortisation	-	-	(135)	(135)	(136)	(136)	(136)	(136)	(135)	(135)	(1,084)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Other contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(1,080)
Borrowing costs ^{14 15}	-	-	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(308)
Net profit	25	25	(26)	(20)	(14)	(6)	1	9	36	48	78

Table 2.6 Balance sheet (Rupees)

End of Year	1	2	3	4	5	6	7	8	9	10
Intangible asset	525	1,084	949	814	678	542	406	270	135	-
Cash/(debt) ¹⁶	(500)	(1034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	50	24	4	(10)	(16)	(15)	(6)	30	78

IE22 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

¹⁴ Borrowing costs are capitalised during the construction phase.

¹⁵ Table 2.4

¹⁶ Debt at start of year plus net cash flow in year (table 2.4)

Example 3: The grantor gives the operator a financial asset and an intangible asset

Arrangement terms

IE23 The terms of a service arrangement require an operator to construct a road—completing construction within two years—and to operate the road and maintain it to a specified standard for eight years (i.e., years 3–10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the arrangement will end. The operator estimates that the costs it will incur to fulfill its obligations will be:

Table 3.1 Contract costs

	Year	Rs
Construction services	1	500
	2	500
Operation services (per year)	3–10	10
Road resurfacing	8	100

IE24 The operator estimates the consideration in respect of construction services to be cost plus 5 per cent.

IE25 The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of Rs 700 and interest at a specified rate of 6.18 per cent to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of Rs 200 in each of years 3–10.

IE26 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Dividing the arrangement

IE27 The contractual right to receive cash from the grantor for the services and the right to charge users for the public services should be regarded as two separate assets under Accounting Standards. Therefore in this arrangement it is necessary to divide the operator's consideration into two components—a financial asset component based on the guaranteed amount and an intangible asset for the remainder.

Table 3.2 Dividing the operator's consideration

Year	Total	Financial asset	Intangible asset
Construction services in year 1 (Rs 500 × (1 + 5%))	525	350	175
Construction services in year 2 (Rs 500 × (1 + 5%))	525	350	175
Total construction services	1,050	700	350
	100%	67% ¹⁷	33%
Finance income, at specified rate of 6.18% on receivable (see table 3.3)	22	22	-
Borrowing costs capitalised (interest paid in years 1 and 2 × 33%) (see table 3.7)	11	-	11
Total fair value of the operator's consideration	1,083	722	361

Financial asset

IE28 The amount due from or at the direction of the grantor in exchange for the construction services meets the definition of a receivable in AS 30 (Revised 20XX) *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount minus repayments.

IE29 On this basis the receivable recognised at the end of years 2 and 3 will be:

Table 3.3 Measurement of receivable

Construction services in year 1 allocated to the financial asset	350
Receivable at end of year 1	350
Construction services in year 2 allocated to the financial asset	350
Interest in year 2 on receivable at end of year 1 (6.18% × Rs 350)	22
Receivable at end of year 2	722
Interest in year 3 on receivable at end of year 2 (6.18% × Rs 722)	45
Cash receipts in year 3 (see table 3.5)	(117)
Receivable at end of year 3	650

¹⁷ Amount guaranteed by the grantor as a proportion of the construction services

Intangible asset

IE30 In accordance with AS 26 (Revised 20XX) *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of the consideration received or receivable.

IE31 During the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction Services) is classified as a right to receive a licence to charge users of the infrastructure. The operator estimates the fair value of its consideration received or receivable as equal to the forecast construction costs plus 5 percent. It is also assumed that, in accordance with AS 16 (Revised 20XX) *Borrowing Costs*, the operator capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase:

Table 3.4 Initial measurement of intangible asset

	Rs
Construction services in year 1 (Rs 500 x (1 + 5%) × 33%)	175
Borrowing costs (interest paid in years 1 and 2 × 33%) (see table 3.7)	11
Construction services in year 2 (Rs500 x (1 + 5%) × 33%)	175
Intangible asset at the end of year 2	361

IE32 In accordance with AS 26 (Revised 20XX), the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3–10. The depreciable amount of the intangible asset (Rs 361 including borrowing costs) is allocated using a straight-line method. The annual amortisation charge is therefore Rs 361 divided by 8 years, ie Rs 45 per year.

Contract revenue and costs

IE33 The operator provides construction services to the grantor in exchange for a financial asset and an intangible asset. Under both the financial asset model and intangible asset model, the operator recognises contract revenue and costs in accordance with AS 7 (Revised 20XX) *Construction Contracts*, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration receivable. Thus in each of years 1 and 2 it recognises in profit or loss construction costs of Rs 500 and construction revenue of Rs 525 (cost plus 5 per cent).

Toll revenue

IE34 The road users pay for the public services at the same time as they receive them, ie when they use the road. Under the terms of this arrangement the cash flows are allocated to the financial asset and intangible asset in proportion, so the operator allocates the receipts from tolls between repayment of the financial asset and revenue earned from the intangible asset:

Table 3.5 Allocation of toll receipts

Year	Rs
Guaranteed receipt from grantor	700
Finance income (see table 3.8)	237
Total	937
Cash allocated to realisation of the financial asset per year (Rs 937/8 years)	117
Receipts attributable to intangible asset (Rs 200 x 8 years – Rs937)	663
Annual receipt from intangible asset (Rs663/8 years)	83

Resurfacing obligations

IE35 The operator’s resurfacing obligation arises as a consequence of use of the road during the operation phase. It is recognised and measured in accordance with AS 29 (Revised 20XX) *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

IE36 For the purpose of this illustration, it is assumed that the terms of the operator’s contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by Rs 17 each year. The operator discounts the provision to its present value in accordance with AS 29 (Revised 20XX). The charge recognised each period in profit or loss is:

Table 3.6 Resurfacing obligation (Rupees)

Year	3	4	5	6	7	8	Total
Obligation arising in year (Rs17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years’ provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in profit or loss	12	14	15	17	20	22	100

Overview of cash flows, statement of profit and loss and balance sheet

IE37 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as

those forecast, the operator's cash flows, statement of comprehensive income profit and loss and balance sheet over the duration of the arrangement will be:

Table 3.7 Cash flows (Rupees)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs ¹⁸	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs ¹⁹	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

Table 3.8 Statement of profit and loss (Rupees)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue on construction	525	525	-	-	-	-	-	-	-	-	1,050
Revenue from intangible asset	-	-	83	83	83	83	83	83	83	83	663
Finance income ²⁰	-	22	45	40	35	30	25	19	13	7	237
Amortisation	-	-	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(46)	(361)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Construction costs	(500)	(500)									(1,000)
Other contract costs ²¹			(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(80)
Borrowing costs (table 3.7) ²²	-	(23)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(331)
Net profit	25	24	(8)	(7)	(5)	(2)	0	2	22	27	78

Table 3.9 Balance sheet (Rupees)

End of year	1	2	3	4	5	6	7	8	9	10
Receivable	350	722	650	573	491	404	312	214	110	-

¹⁸ Table 3.1

¹⁹ Debt at start of year (table 3.9) × 6.7%

²⁰ Interest on receivable

²¹ Table 3.1

²² In year 2, borrowing costs are stated net of amount capitalised in the intangible (see table 3.4).

Intangible asset	175	361	316	271	226	181	136	91	46	-
Cash/(debt) ²³	(500)	(1034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	49	41	34	29	27	27	29	51	78

IE38 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

²³ Debt at start of year plus net cash flow in year (table 3.7)

Appendix B

Service Concession Arrangements: Disclosures (Corresponding to SIC 29)

This Appendix is an integral part of Accounting Standard 7(Revised 20XX).

Issues

1. An entity (the operator) may enter into an arrangement with another entity (the grantor) to provide services that give the public access to major economic and social facilities. The grantor may be a public or private sector entity, including a governmental body. Examples of service concession arrangements involve water treatment and supply facilities, motorways, car parks, tunnels, bridges, airports and telecommunication networks. Examples of arrangements that are not service concession arrangements include an entity outsourcing the operation of its internal services (eg employee cafeteria, building maintenance, and accounting or information technology functions).
2. A service concession arrangement generally involves the grantor conveying for the period of the concession to the operator:
 - (a) the right to provide services that give the public access to major economic and social facilities, and
 - (b) in some cases, the right to use specified tangible assets, intangible assets, or financial assets, in exchange for the operator:
 - (c) committing to provide the services according to certain terms and conditions during the concession period, and
 - (d) when applicable, committing to return at the end of the concession period the rights received at the beginning of the concession period and/or acquired during the concession period.
3. The common characteristic of all service concession arrangements is that the operator both receives a right and incurs an obligation to provide public services.
4. The issue is what information should be disclosed in the notes in the financial statements of an operator and a grantor.
5. Certain aspects and disclosures relating to some service concession arrangements are addressed by Accounting Standards (eg AS 10 (Revised 20XX) applies to acquisitions of items of property, plant and equipment, AS 19 (Revised 20XX) applies to leases of assets, and AS 26 (Revised 20XX) applies to acquisitions of intangible assets). However, a service concession arrangement may involve executory contracts that are not addressed in Accounting Standards, unless the contracts are onerous, in which case AS 29 (Revised 20XX) applies. Therefore,

this Appendix addresses additional disclosures of service concession arrangements.

Accounting Principles

6. All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. An operator and a grantor shall disclose the following in each period:
 - (a) a description of the arrangement;
 - (b) significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows (eg the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined);
 - (c) the nature and extent (eg quantity, time period or amount as appropriate) of:
 - (i) rights to use specified assets;
 - (ii) obligations to provide or rights to expect provision of services;
 - (iii) obligations to acquire or build items of property, plant and equipment;
 - (iv) obligations to deliver or rights to receive specified assets at the end of the concession period;
 - (v) renewal and termination options; and
 - (vi) other rights and obligations (eg major overhauls);
 - (d) changes in the arrangement occurring during the period; and
 - (d) how the service arrangement has been classified.
- 6A An operator shall disclose the amount of revenue and profits or losses recognized in the period on exchanging construction services for a financial asset or an intangible asset.
- 7 The disclosures required in accordance with paragraph 6 of this Appendix shall be provided individually for each service concession arrangement or in aggregate for each class of service concession arrangements. A class is a grouping of service concession arrangements involving services of a similar nature (eg toll collections, telecommunications and water treatment services).

Appendix C

References to matters contained in other Accounting Standards

This Appendix is an integral part of Accounting Standard 7 (Revised 20XX).

This appendix lists the appendices which are part of other Accounting Standards and makes reference to AS 7 (Revised 20XX), *Construction Contracts*.

1. Appendix B *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (Corresponding to SIC 27) contained in AS 19 *Leases* (Revised 20XX).
2. Appendix __ *Intangible Assets—Web Site Costs* (Corresponding to SIC 32) contained in AS 26 *Intangible Assets* (Revised 20XX).
3. Appendix __ *Agreements for the Construction of Real Estate* (Corresponding to IFRIC 15) contained in AS 9, *Revenue* (Revised 20XX).

Appendix D

Illustrative examples

This Appendix accompanies, but is not part of, AS 7 (Revised 20XX).

Disclosure of accounting policies

The following are examples of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred to date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred to date bear to the estimated total costs of the contract.

The determination of contract revenue and expenses

The following example illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 22-35 of the Standard). (Amounts shown hereinbelow are in Rs. Lakhs)

A construction contractor has a fixed price contract for Rs 9,000 to build a bridge. The initial amount of revenue agreed in the contract is Rs 9,000. The contractor's initial estimate of contract costs is Rs 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to Rs 8,050.

In year 2, the customer approves a variation resulting in an increase in contract revenue of Rs 200 and estimated additional contract costs of Rs 150. At the end of year 2, costs incurred include Rs 100 for standard materials stored at the site to be used in year 3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

(amount in Rs. Lakhs)

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	—	200	200

Total contract revenue	9,000	9,200	9,200
Contract costs incurred to date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	–
Total estimated contract costs	8,050	8,200	8,200
Estimated profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed to date the Rs 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the statement of profit and loss in the three years are as follows:

	To date	Recognised in prior years	Recognised in current year
Year 1			
Revenue (9,000 × .26)	2,340	–	2,340
Expenses (8,050 × .26)	2,093	–	2,093
Profit	247	–	247
Year 2			
Revenue (9,200 × .74)	6,808	2,340	4,468
Expenses (8,200 × .74)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 × 1.00)	9,200	6,808	2,392
Expenses	8,200	6,068	2,132
Profit	1,000	740	260

Contract disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

(amount in Rs. Lakhs)

	A	B	C	D	E	Total
Contract revenue recognised in accordance with paragraph 22	145	520	380	200	55	1,300
Contract expenses recognised in accordance with paragraph 22	110	450	350	250	55	1,215
Expected losses recognised in accordance with paragraph 36	–	–	–	40	30	70
Recognised profits less recognised losses	<u>35</u>	<u>70</u>	<u>30</u>	<u>(90)</u>	<u>(30)</u>	<u>15</u>
Contract costs incurred in the period	110	510	450	250	100	1,420
Contract costs incurred recognised as contract expenses in the period in accordance with paragraph 22	<u>110</u>	<u>450</u>	<u>350</u>	<u>250</u>	<u>55</u>	<u>1,215</u>
Contract costs that relate to future activity recognised as an asset in accordance with paragraph 27	–	60	100	–	45	205
Contract revenue (see above)	145	520	380	200	55	1,300
Progress billings (paragraph 41)	100	520	380	180	55	1,235
Unbilled contract revenue	<u>45</u>	<u>–</u>	<u>–</u>	<u>20</u>	<u>–</u>	<u>65</u>
Advances (paragraph 41)	<u>–</u>	<u>80</u>	<u>20</u>	<u>–</u>	<u>25</u>	<u>125</u>

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period (paragraph 39 (a))	1,300
Contract costs incurred and recognised profits (less recognised losses) to date (paragraph 40(a))	1,435
Advances received (paragraph 40(b))	125
Gross amount due from customers for contract work – presented as an asset in accordance with paragraph 42(a)	220
Gross amount due to customers for contract work – presented as a liability in accordance with paragraph 42(b)	(20)

The amounts to be disclosed in accordance with paragraphs 40(a), 42(a) and 42(b) are calculated as follows:

	Contract					Total
	A	B	C	D	E	Total
Contract costs incurred	110	510	450	250	100	1,420

Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	<u>145</u>	<u>580</u>	<u>480</u>	<u>160</u>	<u>70</u>	<u>1,435</u>
Progress billings	100	520	380	180	55	1,235
	<u>45</u>	<u>60</u>	<u>100</u>	<u>–</u>	<u>15</u>	<u>220</u>
Due from customers	–	–	–	(20)	–	(20)
Due to customers						

The amount disclosed in accordance with paragraph 40(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

Appendix E

Note: This Appendix is not a part of the Accounting Standard. The purpose of this Appendix is only to bring out the major differences, if any, between Accounting Standard (AS) 7 (Revised 20XX) and the corresponding International Accounting Standard (IAS) 11, Construction Contracts, IFRIC 12, Service Concession Arrangements and SIC 29, Service Concession Arrangements: Disclosures

Comparison with IAS 11, Construction Contracts, IFRIC 12, Service Concession Arrangements and SIC 29, Service Concession Arrangements: Disclosures

There is no major difference between the Exposure Draft of AS 7 (Revised 20XX), *Construction Contracts* and International Accounting Standard (IAS) 11, *Construction Contracts*, IFRIC 12, *Service Concession Arrangements* and SIC 29, *Service Concession Arrangements: Disclosures*, except that the transitional provisions given in IFRIC 12 have not been given in the Exposure Draft of AS 7 (Revised 20XX), keeping in view that Accounting Standard corresponding to IFRS 1, *First-time Adoption of International Financial Reporting Standards*, will deal with the same.

Appendix F

Note: This Appendix is provided to bring out the major differences between the Exposure Draft of AS 7 (Revised 20XX) and existing AS 7 (revised 2002) with a view to facilitate commentators in sending their comments on the Exposure Draft of AS 7 (Revised 20XX).

Major Differences between the Exposure Draft of AS 7 (Revised 20XX) Construction Contracts, and existing AS 7 (revised 2002)

1. Existing AS 7 includes borrowing costs as per AS 16, *Borrowing Costs*, in the costs that may be attributable to contract activity in general and can be allocated to specific contracts, whereas the Exposure Draft of AS 7 ((Revised 20XX) does not do so on the lines of IAS 11, *Construction Contracts*.
2. Existing AS 7 does not recognise fair value concept as contract revenue is measured at consideration received/receivable, whereas the Exposure Draft of AS 7 (Revised 20XX) requires that contract revenue shall be measured at fair value of consideration received/receivable.
3. Existing AS 7 does not deal with accounting for Service Concession Arrangements, i.e., the arrangement where private sector entity (an operator) constructs or upgrades the infrastructure to be used to provide the public service and operates and maintains that infrastructure for a specified period of time, whereas Appendix A and Appendix B of the Exposure Draft of AS 7 (Revised 20XX) deal with accounting and disclosure aspects involved in such arrangements.