



ASSURANCE GAZETTE

December, 2024

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Foreword

We are thrilled to present the December 2024 edition of the Assurance Gazette. This edition offers insights for professionals in financial reporting, auditing, and compliance.

This edition focuses on Energy Service Companies (ESCOs), emphasizing their role in energy efficiency and sustainability. It covers key accounting treatments under Indian Accounting Standards (Ind AS), including Ind AS 115, 116, and 16. Our goal is to guide professionals in adopting sustainable financial practices while addressing ESCO-related challenges.

Additionally, this edition also captures the examination of the accounting treatment of interest payable and depreciation in the context of a joint venture's termination dispute. It highlights the necessity for proper classification and disclosure in financial statements, ensuring compliance with Ind AS standards and providing clarity to users on exceptional items and routine expenses.



Accounting Treatment for ESCO Projects

An Energy Service Company (ESCO) offers energy solutions aimed at optimizing energy usage, improving efficiency, and reducing costs. Through services such as energy audits, efficiency upgrades, renewable energy installations, and ongoing energy management, ESCOs help clients achieve significant savings, reduce environmental impact, and promote sustainability. These services are tailored to meet the specific energy needs of different sectors, including commercial, industrial, governmental, and institutional.

ESCOs operate under three main business models:



Performance-Based Contracts:
Compensation is tied to actual energy savings achieved.



Shared Savings Contracts: The ESCO and client share the energy savings, with the ESCO receiving a portion.



Energy Performance Contracts (EPC): The ESCO finances, installs, and designs energy-efficient systems, with repayments based on the savings generated.

Revenue streams for ESCOs are primarily categorized into two types. The first is upfront revenue, which includes income earned at the start of the project, such as equipment sales and consulting fees. The second is ongoing revenue, which refers to continuous income tied to the performance of energy-saving measures, including payments for energy management and maintenance services.

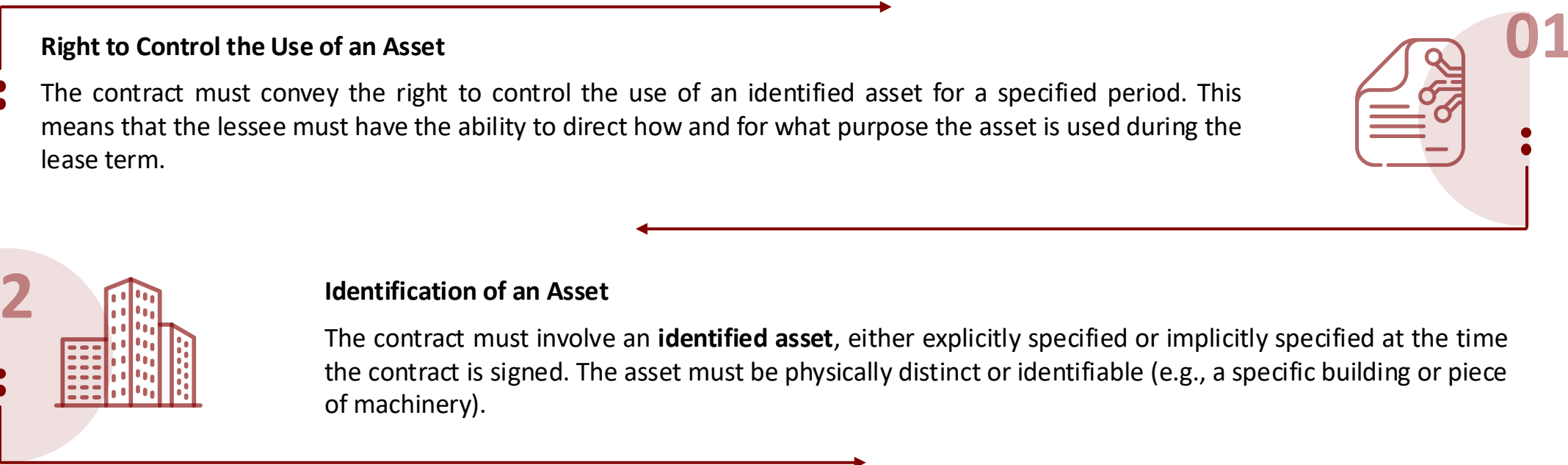
Accounting Treatment under Indian Accounting Standards (Ind AS)

Applicable IND AS are IND AS 115 “Revenue from contacts with customers”, IND AS 116 “Leases”, IND AS 16 “Property, Plant and Equipment”.

IND AS 116 “Leases”

ESCO shall check the contract for classification under IND AS 116 “leases”. IND AS 116 defines lease as, ***“A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.”***

Further it provides some conditions to be fulfilled by a contract to be identified as a lease contract. These conditions are listed below:



Most ESCO projects are more focused on providing a service (energy savings, efficiency, etc.) than transferring the control or use of an asset, which is why they do not qualify as leases under IND AS 116. Instead, these projects are often accounted for under IND AS 115 (Revenue from Contracts with Customers), where the focus is on revenue recognition based on the delivery of services rather than the transfer of an asset.

IND AS 115 “Revenue from Contracts with Customers”

IND AS 115 provides 5 step models to recognize the revenue 1. **Identify the Contract**, 2. **Identify Performance Obligations**, 3. **Determine the Transaction Price**, 4. **Allocate the Price** and 5. **Recognize Revenue**.

Revenue streams are broadly categorized into two main types based on their sources:

Revenue generated directly from the public, such as collections from tolls or charging stations.

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Revenue generated from government authorities, including income from streetlight projects and energy-saving initiatives for buildings.

IND AS 115 applies to ESCO projects that are structured as service contracts rather than leases. In such cases, the revenue recognition is driven by the provision of energy services, such as energy savings, monitoring, and maintenance. The revenue is recognized as the performance obligations are satisfied over time, aligning with the principle that revenue should reflect the transfer of services to the customer. The specifics of each ESCO agreement, including performance guarantees and the timing of revenue recognition, must be carefully considered to apply IND AS 115 correctly.



IND AS 16 “Property, Plant And Equipment”

IND AS 16 specifies following two conditions to be fulfilled by an asset to be classified as PPE:

It is expected to bring future economic benefits to the entity (such as revenue generation or cost savings).



The cost of the asset can be reliably measured, including all costs incurred to bring the asset to its current condition and location for use.

It further states that cost of PPE includes purchase price of the assets, cost directly attributable to the assets and expected dismantling cost, if any.

The asset or infrastructure developed by ESCO vest with the client but, the ESCO has right on the future economic benefits of the asset and the same should be accounted for as per IND AS 16 so, the cost of the infrastructure should be capitalized and to be depreciated over the useful life of the project or agreement, as ESCO normally transfer the assets to the user at the end of the agreement.



Nangia's Take

ESCOs represent a transformative approach to sustainable development, seamlessly integrating economic incentives with environmental solutions. Their innovative revenue models, spanning government partnerships and direct consumer services, showcase a sophisticated approach to energy infrastructure. The intricate financial mechanisms underlying these projects highlight the complex yet promising landscape of sustainable technology investments. As the energy sector continues to evolve, ESCOs stand at the forefront of driving meaningful ecological and economic progress.

Presentation of interest payable and depreciation for earlier years in the Statement of Profit and Loss.

Facts of the case presented before EAC

A joint venture between the Government of India and the Government of the National Capital Territory of Delhi proposed the Airport Line project as a Public-Private Partnership (PPP). The Concession Agreement was signed on August 25, 2008, and a Special Purpose Vehicle (SPV), D Ltd., was formed to operate the Airport Line for 30 years before handing it over to the Corporation.

On May 23, 2012, D Ltd. identified defects in the Corporation's work and ceased operations by July 8, 2012. D Ltd. issued a notice on July 9, 2012, giving 90 days to rectify defects or face termination under the agreement. Despite repairs by the Corporation, D Ltd. claimed the defects were not resolved within the stipulated period, issuing a termination notice effective January 7, 2013. The dispute escalated to arbitration. On May 11, 2017, the Arbitral Tribunal upheld D Ltd.'s termination claim, awarding Rs. 2,992.49 crores (including Rs. 2,782.33 crores as Termination Payment) with interest. The Supreme Court affirmed this decision in September 2021.

For FY 2021-22, the Corporation capitalized the termination payment as of the termination date, charging associated interest and depreciation as exceptional items in its financial statements. Earlier, it had disclosed the liability as contingent for FY 2020-21.

Queries Posed before the EAC

Whether aforesaid accounting treatment given by the Company was correct.

If not, what was the correct accounting treatment?

Company's Contention:

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Asset Allocation: The Arbitration Award did not provide a detailed asset-wise break-up of Rs. 2,782.33 crores. As per Ind AS 103 ('Business Combinations'), this amount was allocated to individual identifiable assets on a pro-rata basis, based on their relative values as per I Ltd.'s report.

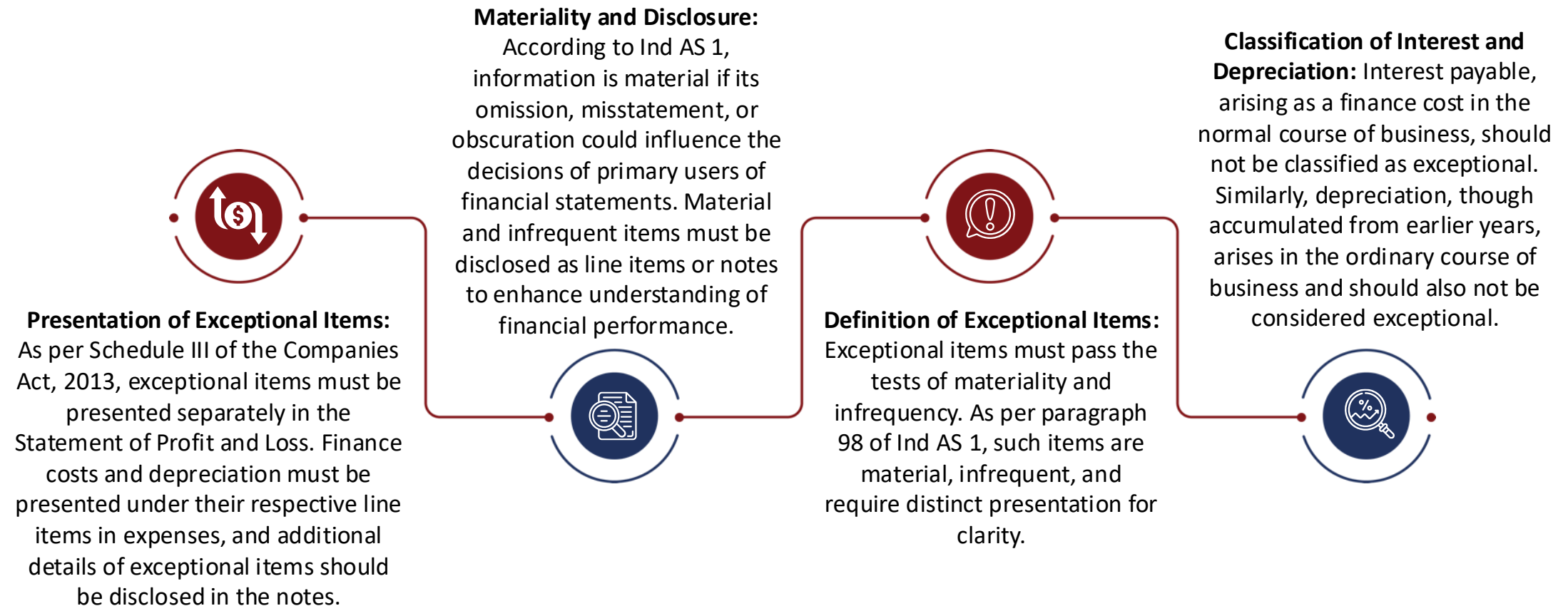
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Execution Petition: D Ltd. filed an Execution Petition with the Hon'ble Delhi High Court on 10.09.2021 for Rs. 7,045.41 crores. Hearings are ongoing, which challenges the assertion that the capital cost for creating various classes of Airport Line assets is limited to Rs. 2,992.49 crores.

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Provision under Ind AS 37: Since the capitalisation amount for the Airport Line remains unascertainable, the company cannot recognise various asset classes corresponding to the liability of Rs. 2,992.49 crores, contrary to the Audit's suggestion.

Synopsis of EAC considerations



Conclusion

The presentation of interest payable to D Ltd. and depreciation under "exceptional items" in the Statement of Profit and Loss for FY 2021-22 was inappropriate. Instead, these items should be presented under their respective heads, "finance cost" and "depreciation," with disaggregated headings or subtotals if their magnitude or frequency warrants it, along with suitable disclosure in the notes for better clarity on financial performance.

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