**Query No. 21**

Subject: Provision for warranty under construction contract and corresponding revenue recognition.[1]

## A. Facts of the Case

1. A public sector company (hereinafter referred to as 'the company') is engaged in the field of engineering, manufacture of equipment, erection and commissioning of power projects. In addition, the company is also in the business of transportation, transmission, defence, etc. The normal execution period of a contract ranges between 3 to 5 years. The normal warrantee/guarantee period of a contract is between 18 to 24 months, which starts from the date of completion of trial operation of the project. The company has 15 manufacturing units, 4 power sector regions, service centers and regional offices besides project sites spread all over India and abroad. The company is listed with NSE and BSE. The turnover of the company was Rs. 43,337 crore in the year 2010-11.

2. The querist has stated that revenue recognition in respect of long term construction contracts is done based on percentage of completion method in line with the requirements of Accounting Standard (AS) 7, 'Construction Contracts', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'Rules'). The accounting policies in respect of revenue recognition and provision for contractual obligation (warranty/guarantee) are as under. The warranty obligation is created at 2.5% of the contract value based on past trends.

**Revenue recognition**

"Revenue is recognised on percentage completion method based on the percentage of actual cost incurred upto the reporting date to the total estimated cost of the contract."

**Provision for warranties**

*From 01.04.2010*

"The company provides warranty cost at 2.5% of the revenue progressively as and when it recognises the revenue and maintain the same throughout the warranty period."

*Earlier policy (upto 31.03.2010)*

[1] Opinion finalised by the Expert Advisory Committee on 6.2.2012.

"Provision for contractual obligations is maintained at 2.5% of the contract value on completion of trial operation."

3. The querist has stated that the accounting practice in respect of provision for warranty obligation while working out percentage of completion for revenue recognition is as follows:

*From 01.04.2010*

Provision is created towards warranty obligation at 2.5% of the revenue progressively as and when the revenue is recognised and the same is added to 'actual cost incurred' upto reporting period for working out percentage of completion under AS 7 contracts. 2.5% of the contract value is also added towards warranty obligation to the 'total estimated cost' to complete the work for percentage completion method.

*Earlier Practice*

While working out the total cost to complete the contract, contractual obligation at 2.5% of the value of the contract was added, to work out the percentage of completion and to recognise the revenue. On completion of trial operation, 2.5% of contract value is added in the actual cost incurred to bring the cost incurred to 100% and also to recognise 100% revenue. Provision for warranty obligation is also created for the same amount.

4. The querist has further stated the following issues and grounds for change of accounting policy:

(i) The recognition of turnover of 2.5% value of each despatch/activity completion was deferred till the completion of trial operation by adding 2.5% of the contract value to 'estimated cost to complete' but not in 'actual cost incurred' upto the reporting period in ascertaining the percentage completion.

(ii) Further, there was a mismatch in recognition of turnover and creation of provision for contractual obligation in the year of completion of trial operation. In case of profitable projects, revenue recognised before the trial operation was lower than 97.5% of the contract revenue and in case of loss making projects, it was more than 97.5%.

(iii) There was a deferment of revenue till completion of trial operation and recognising revenue on trial operation without any despatch/activity completion was against the spirit of revenue recognition and AS 7 . This may be construed against the revenue recognition principle as per which,

the revenue has to be recognised at 100% of the value of the activities completed or services rendered in line with AS 7.

(iv) Paragraph 11 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the 'Rules' states, "An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner." From this, it is very clear that the obligation could be a statutory requirement from a binding contract or normal business practice, custom and desire to maintain good business relations etc. In all the contracts of the company, the contract provides for warranty for periods ranging between 12 months to 24 months which is a binding contract. However, while executing the contract ranging over a period of 3 to 4 years, the company is always bound to rectify, rework, compensate any defects, short supplies, operational problems of the individual equipment already supplied in respect of which turnover has been recognised even before the warranty period. In fact, it can be concluded that the contractual obligation coexists right from the date the first supply is made irrespective of the fact whether the trial operation has been completed or not. The company is always to incur additional expenditure to rectify the problem with equipment supplied, work performed etc. and in respect of which turnover has been recognised.

(v) Further, as per AS 7, the normal principle of revenue recognition is substituted by the percentage of completion method and the revenue itself is progressively recognised on consideration of the substance of the transaction. It is, therefore, appropriate that to the extent the revenue has been recognised, the related warranty cost should also be recognised. Whatever has been recognised as contract revenue under percentage of completion method (PoCM) is subject matter of warranty and to that extent, warranty has become a present obligation even though period of warranty may commence at a later date.

(vi) As per revenue recognition principle, 100% revenue needs to be recognised on completion of corresponding supplies/work performed with matching cost.

(vii) This issue was also referred for opinion to an accounting expert and to a leading Chartered Accountant firm who is assisting the company in IFRS implementation. The changed policy is in line with the opinion given by them.

(viii) Further, the company has also reviewed the practices of similar companies in the industry which are reproduced below:

X Ltd.

"The company provides for anticipated costs for warranties when it recognises revenue on the related products or contracts. Warranty costs include calculated costs arising from imperfections in design, material and workmanship in the company's products. …"

Y Ltd.

"Product-related expenses and losses from onerous contracts, provisions for estimated costs related to product warranties are recorded in cost of goods sold and services rendered at the time the related sale is recognised. …"

Z Ltd.

"Production costs include direct costs (such as material, labour and warranty costs) and indirect costs. Warranty costs are estimated on the basis of contractual agreement, available statistical data and weighting of all possible outcomes against their associated probabilities. Warranty periods may extend upto five years. …"

(ix) According to the querist, the change has definitely resulted in better presentation of the financial statements and it is well within the principles of conservatism and prudence. The present change in accounting policy is exactly in line with the revenue recognition requirements of AS 7 and at the same time improves the presentation of financial statements.

## B. Query

5. Considering the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the present policy and practice of the company on 'provision for warranties', viz., creation of provision towards warranty obligation progressively during construction period and considering the same as "cost incurred" to determine the percentage of completion for revenue recognition under AS 7 is in line with the requirements of accounting standards.

## C. Points considered by the Committee

6. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to recognition of provision for warranty costs under a construction contract and its treatment for determining the percentage of completion for recognition of contract revenue. 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, measurement of amount of provision for warranty obligation, accounting for construction costs and revenue in general, appropriateness of method selected for determination of stage of completion of a contract, accounting for change in accounting policy, etc. The opinion expressed hereinafter only lays down the general principles to be followed in the extant case and has not gone into calculations of contract costs and contract revenue during various accounting periods. Further, the Committee has presumed from the Facts of the Case that the warranty service in the extant case is the normal quality-assurance type warranty, which is neither separately priced nor separately sold as per the business practice in case of construction contracts.

7. As regards recognition of provision for warranty costs, the Committee notes paragraphs 11 and 14 of AS 29, notified under the 'Rules' as follows:

> "11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."
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> "***14. A provision should be recognised when:***
> ***(a) an enterprise has a present obligation as a result of a past event;***
> ***(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
> ***(c) a reliable estimate can be made of the amount of the obligation.***
> ***If these conditions are not met, no provision should be recognised."***

From the above, the Committee is of the view that a provision should be recognised when there exists present obligation to act or perform in a certain way and other conditions for its recognition under AS 29 are satisfied. Obligations may arise from a binding contract or statutory requirement and may also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. The Committee notes from the Facts of the Case that all the contracts of the company provide for warranty for periods ranging between 12 to 24 months and while executing the contract over a period of 3 to 4 years, the company is always bound to rectify, rework and compensate any defects, short supplies, operational problems of the individual equipment *already supplied* under construction contracts. Thus, there exists a contractual/customary present obligation in respect of warranty service which will require outflow of resources

embodying economic benefits to settle the obligation. Further, the Committee notes that, in the extant case, the company can reliably estimate the amount of obligation on the basis of past trend. Accordingly, the Committee is of the view that a provision in respect of warranty service should be recognised in the extant case.

8. As far as timing of recognition of provision is concerned, the Committee notes paragraphs 15, 16 and 21 of AS 7, as reproduced below:

> ***"15. Contract costs should comprise:***
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> ***(a) costs that relate directly to the specific contract;***
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> **…**
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> 16. Costs that relate directly to a specific contract include:
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> …
>
> (g) the estimated costs of rectification and guarantee work, including *expected warranty costs*; and
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> …" (Emphasis supplied by the Committee.)

> ***"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. …"***

From the above, the Committee is of the view that the expected warranty cost is a contract cost which is directly related to a specific contract. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. In the instant case, the company follows the percentage of completion method for recognising its revenue which indicates that the outcome of a construction contract can be estimated reliably. Accordingly, following the percentage of completion method, the contract costs, including provision for expected warranty costs, should be recognised by reference to stage of completion of the contract activity at the reporting date. In this regard, the Committee also notes from the Facts of the Case that the querist has stated that even during the execution of the projects, the company is bound to rectify, rework and compensate any defects, short supplies, operational problems of the individual equipment already supplied and that the contractual obligation in respect of warranty coexists from the date of first supply. Thus, the Committee is of the view that in the extant case, present obligation in respect of contractual warranty as per the provisions of AS 29 arises from the performance of a contract activity in respect of which contract cost is recognised even during the progress of the contract and as such, the proportionate warranty cost should be provided for during the contract period. The Committee is of the view that such provision for expected warranty costs would also be 'contract cost

incurred' and therefore, should be considered for determining the stage of completion for recognition of revenue as per the principles of AS 7.

## D. Opinion

9. On the basis of the above and subject to paragraph 6 above, the Committee is of the opinion that the provision for warranty costs should be recognised progressively during the construction on performance of contract activity and in respect of which contract cost is recognised. Since such provision for expected warranty costs would also be 'contract cost incurred', the proportionate warranty cost should be considered for determining the stage of completion for recognition of revenue as per the principles of AS 7, as discussed in paragraphs 7 and 8 above.

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