

Query No. 11

Subject: Recognition of free of cost equipment provided by a contractee to the contract.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’) is a defence public sector undertaking under the Ministry of Defence and is engaged in the construction of Warships and Submarines. For a particular class of ship construction, the company entered into an agreement with the buyer for the construction and delivery of 3 ships.

2. The company has agreed for construction of 3 ships on ‘Fixed Price’ basis with variable component in respect to certain items.

(i) The break-up of the contract price is as under:

Sr No	Cost Element	1st ship	2nd ship	3rd ship	Total
1	Material	xx	xx	xx	xxx
2	Yard efforts	xx	xx	xx	xxx
(A)	Fixed cost element on not exceeding basis (1+2)	xxx	xxx	xxx	xxx
(B)	Variable cost items on not exceeding basis	xxx	xxx	xxx	xxxx
(C)	Base and Depot (B & D) spares (Budgetary) (With FE Content xx crore) on not exceeding basis				xxxx
(D)	Grand Total (a+b+c)				xxxxx

Note: The above cost is exclusive of duties and other statutory levies applicable at the time of delivery of the vessel(s) and will be paid at actual.

(ii) Payment Terms:

(a) Fixed price element:

The payment will be made by the buyer against the completion of particular stage.

(b) Variable price element:

The payment will be made at actual with % of profit against the documentary evidence.

¹ Opinion finalised by the Committee on 21.5.2013 and 22.5.2013

3. Base and depot (B&D) spares for all 3 ships of this class shall be procured through the company and X % remuneration will be paid on the cost of the item.

4. The contract states that variable cost items indicated as a part of contract price are budgetary and will be paid based on finalised specifications and source of supply nominated by the buyer at actual. Later, the buyer intimated to the querist that certain equipments out of variable cost items, will be supplied by him at 'free of cost' for installation on board of ship. It is, therefore, to be noted that the variable cost items mentioned at paragraph 2(i) (B) in the table above consists of 2 parts as under:

- (i) The purchase orders of some equipments are placed by the company in the presence of the buyer's representative for technical scrutiny as well as negotiating the prices. The vendors of the equipment are paid by the company. The cost of the equipment alongwith the cost of installation and profit thereon is claimed and reimbursed by the buyer to the company.
- (ii) There are certain equipments for which orders are directly placed and also paid by the buyer. These equipments are known as 'Buyer Furnished Equipment (BFE)' and are delivered to the company 'free of cost' for installing in the ship. The labour cost of installation is included in the fixed price component of the contract.

5. Sale on delivery of the ship to customer is reflected in that financial year. During the construction period, work-in-progress (WIP) is valued as under:

a. Where profits can be reliably measured:

“At costs incurred upto the reporting date plus profits recognised under the percentage of completion method in the proportion of the actual costs incurred bear to the estimated total cost to completion as on that date.”

b. Where loss is anticipated:

“When it is probable that total contract costs will exceed the total contract revenue, the expected loss is fully recognised as an expense immediately, irrespective of physical progress achieved on the reporting date.”

(A copy of annual accounts for the financial year (F.Y) 2011-12 has been supplied by the querist for the perusal of the Committee.)

B. Query

6. From the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the Buyer Furnished Equipment's (BFE's) cost can be considered as inventory (simultaneously creating liability to the buyer) and then on issue to ship can be taken in WIP, so that accretion to WIP will be recognised as revenue.
- (ii) Whether BFE's value can be considered as a part of sale value in the year of delivery.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to whether the Buyer Furnished Equipment (BFE) can be considered as inventory/WIP by the contractor and whether that value can be considered as part of sales value in the year of delivery. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of equipments purchased by the company whose value is reimbursed by the buyer, accounting treatment of installation cost on BFE, recognition of contract costs and revenue, method of valuing work-in-progress during the construction period, etc. Further, it is also presumed by the Committee that the risks and rewards of ownership relating to BFEs do not vest with the company.

8. The Committee notes that before any item can be recognised as an inventory, it should meet the definition of 'asset' as given in paragraph 49 of the Framework for the Preparation and Presentation of Financial Statements (hereinafter referred to as 'the Framework'), issued by the Institute of Chartered Accountants of India as follows:

“(a) An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.”

The Committee notes from the Facts of the Case that orders in respect of BFEs are directly placed by the buyer and also payment in respect of them is made by the buyer. These are then supplied to the company for installing in the ship and the buyer pays installation charges which are included in the contract price. Thus, the company has neither incurred any cost on BFEs nor any amount is recoverable on account of such equipments except installation charges. Accordingly, the Committee is of the view that such equipments are not 'assets' that may be considered as a part of its contract work-in progress. In fact, after installation in the ship, BFEs are returned to the buyer after completion of the ship. Thus, these are only held by the company in the capacity of a bailee. Since, these cannot be considered as 'asset', therefore, these can neither be considered as 'inventory' nor as work-in-progress.

Accordingly, these cannot also be considered as a part of sale value or revenue of the company as no consideration would be receivable in respect of the cost of such equipments.

D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 6 above:

- (i) No, the BFEs cannot be considered as inventories/WIP, as discussed in paragraph 8 above.
- (ii) No, the BFE's cost cannot be considered as part of sales value/contract revenue, as discussed in paragraph 8 above.