Query No. 26

Subject: ***Accounting treatment of liquidated damages on unexecuted portion of contract.***[1]

A. Facts of the Case

1. A central public sector enterprise, registered under the Companies Act, 1956, was established for manufacturing of weapon systems required for Armed Forces.

2. *Existing practice:*

> "The customers of the company recover liquidated damages for delayed delivery of goods, i.e., when goods are delivered after due date. The company makes provision for liquidated damages for the unexecuted portion of contract for the period of delay from due date of delivery till the date of the accounts. The company is following this practice as a prudent policy and liquidated damages amount is quantifiable and is a definite known liability. In most of the cases, the customer extends the due date, however, with levy of full liquidated damages. At the time of payment, the customer recovers the liquidated damages amount and pays the balance amount only. Then, the company reverses the liquidated damages provision and debits to liquidated damages recovered account (expense account)."

The querist has also stated that the company is following Accounting Standard (AS) 9, 'Revenue Recognition', with regard to main products of the company and the present query has been raised in the context of contract for supply of goods in respect of which principles of AS 9 apply.

3. *Opinion of the Government auditors:*

Provision for liquidated damages is to be made for delay in supply to the extent of executed portion of sales only. Making liquidated damages provision for unexecuted part of contract merely for the delayed time beyond due date is not correct due to matching principle not being satisfied.

4. *Rationale for the existing practice:*

After considering Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, as well as General Accounting Pronouncements and Accepted Accounting Practices, the company is of the opinion that liquidated damages is to be provided for unexecuted

[1]Opinion finalised by the Committee on 22.1.2014 and 23.1.2014.

portion of the contract for the delayed period from the due date of delivery till the date of the accounts for the following reasons:

(1) Customers are recovering liquidated damages for delayed delivery of goods as per the contractual terms.

(2) Amount of liquidated damages is quantifiable and is generally recovered by the customer.

(3) Customer in all cases recovers liquidated damages as per the terms of the contract, and makes the balance payment. There is no clause for the waiver or refund of the liquidated damages by the customer. There is also no clause in the contract to exit from the contract entered with the customer, with or without penalty.

(4) Reference may be made to AS 29 wherein paragraph 14 mentions that ***"a provision should be recognised when: (a) an enterprise has a present obligation as a result of 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."***

(5) In AS 29, 'present obligation' has been defined as follows:
"<u>Present obligation</u> - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."

(6) Paragraph 16 of AS 29 provides that "a past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event."

(7) The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India (ICAI) defines 'liability' as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. 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.

(8) The Framework further mandates that a liability is to be recognised in the balance sheet when it is probable that an outflow of resources embodying

economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

(9) *The key aspect which needs to be addressed is therefore - what is the past event? Whether the sales affected is a past event or slippage of delivery schedule as per the contract which is binding is the past event.* (Emphasis supplied by the querist.)

(10) A distinction ought to be made between a 'past event' and a 'past transaction'. While a past transaction, in the opinion of the company, will be restricted in the instant case to the sales made and recognised as revenue, the past event may include the delivery schedule and other terms of the contract which are binding in nature and enforceable in law.

(11) Therefore, as the company has not adhered to the delivery schedule, there is a present obligation of paying the liquidated damages which is recovered by the customer from the sales invoices raised subsequently.

(12) The principle of prudence is one of the qualitative characteristics of a financial statement. Prudence demands that the liabilities are not understated.

(13) With regard to the matching principle of costs with revenue, the expenses that result directly and jointly from the same transaction, for example - cost of goods sold are to be matched with the income derived from the sale of goods. The liquidated damages being recovered by the customer is, in the opinion of the company, in the nature of compensatory payment made for the delay in delivery of goods and accrues from the due date of delivery as per the delivery schedule in the contract.

(14) Accordingly, the company feels that it need not revise its accounting treatment with regard to the provision made for liquidated damages recovered by the customers as the present accounting treatment is in order.

5. For better understanding of the facts, the querist has also explained the accounting followed by it with the help of the following example:

Example:

The delivery schedule of an item to be supplied and details of sales to the customer are as follows:

S. No.	Due date of supply	Qty (Nos.)	Value in Rs. Lakh	Actual date of Supply	Qty	Remarks
1.	31st Dec., 2010 (2010-11)	6000	6000	31st Dec., 2010	5000	Slippage of Delivery – 1000 Nos.
2.	28th Feb., 2012 (2011-12)	2000	2000	30th June, 2011 31st Dec., 2011	1000 500	Slippage of Delivery – 1500 Nos.
3.	30th Sep., 2012 (2012-13)	1000	1000	31st May, 2012 31st Dec., 2012	1500 1000	-
4.	31st Mar., 2013 (2012-13)	1000	1000	Yet to be supplied		
	TOTAL	**10000**	**10000**			

Liquidated damage (LD) is @ 0.5% per week or part thereof, Maximum LD is 5%.

At the time of slippage (not yet sold), LD provision is made. At the time of delayed sales, LD provision is reversed and LD liability is created. Debtor's balance is reduced if customer recovers subsequently.

<u>In the year 2010-11, entries to be passed:</u>

I. 1000 Nos. are not sold in the year 2010-11:

Profit & Loss A/c Dr. 50 Lakh
To Provision for LD 50 Lakh

Being LD provision created for 1000 Nos. (Rs. 10,00,00,000 * 5%) not sold as per delivery schedule. 1000 Nos supplied on 30 Jun 2011. Delay from 01 Jan 2011 to 31st March, 2011 is 3 months (12 weeks). LD at the rate of 0.5% per week subject to a maximum of 5% works out to Rs 50 lakhs.

<u>In the year 2011-12, entries to be passed:</u>

A. 1000 Nos. pertaining to the year 2010-11 are sold in the year 2011-12:

I. Provision for LD Dr. 50 Lakh
To provision no longer required written back
(Profit & Loss A/c – income) 50 Lakh

Being LD provision made in the year 2010-11 written back

II. LD Expense A/c Dr. 50 Lakh
To Trade Receivable
(If LD recovered by Customer) 50 Lakh

B. 1500 Nos. are not sold in the year 2011-12:

Profit & Loss A/c	Dr.	37.50 Lakh	
To Provision for LD			37.50 Lakh

Being LD provision created for 1500 Nos. which is due by 28th Feb., 2012. LD is calculated for March, 2012 only, i.e., @ 2.5% for 31 days or 5 weeks delay (Rs 15,00,00,000 * 2.5%).

<u>In the year 2012-13, entries to be passed:</u>

A. 1500 Nos. pertaining to the year 2011-12 are sold in the year 2012-13:

I.	Provision for LD	Dr.	37.50 Lakh	
	To Provision no longer required written back			
	(Profit & Loss Ac – Income)			37.50 Lakh

Being LD provision made in the year 2011-12 written back

II.	LD Expense A/c	Dr.	75 Lakh	
	To Trade Receivable			75 Lakh

(LD recovered by customer for 1500 nos. from 1st March, 2012 to 31st May, 2012 - 5% on 1500 lakh)

B. 1000 Nos. pertaining to the year 2012-13 are sold with delay in the year 2012-13:

Due date	: 30th Sep., 2012
Date of scale	: 31st Dec., 2012
Delay	: 3 Months
LD	: Max. 5 %

I.	LD Expense A/c	Dr.	50 lakh	
	To Trade Receivable			50 Lakh

(LD recovered by customer for 3 months subject to maximum of 5%. The delay is in the same financial year)

C. Balance 1000 Nos. are not sold in the year 2012-13:

LD provision is not provided for 1000 Nos. of items to be supplied in the year 2012-13 since due date for delivery is 31.03.3013 and further, it is the policy of the

company not to account for LD in case the due date is at the end of the financial year, i.e., 31st March, 2013."

B. Query

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

   (i) Whether the provision for liquidated damages should be made or not in respect of unexecuted portion of the contract for the period of delay from the due date of delivery till the date of accounts.

   (ii) Whether such provision for liquidated damages is also required to be made in case the due date falls exactly on the last date of the accounts of the financial year, viz., balance sheet date, i.e., whether one day delay is to be reckoned or not.

   (iii) Whether the practice is to be spelt out as a 'Major Accounting Policy' in terms of AS 1 or will it be sufficient if a financial note is appended to the statement of profit and loss or even financial note is not required to be appended.

C. Points considered by the Committee

7. The Committee, while expressing its opinion, has restricted itself to the issues raised in paragraph 6 above and has not examined any other issue that may arise from the Facts of the Case, such as, journal entries passed by the company in respect of liquidated damages and provision thereof, measurement of the provision/liability, if required to be created in respect of liquidated damages, propriety of recognising revenue in the extant case as per the principles of AS 9, etc.

8. The Committee notes from the Facts of the Case that the query is in the context of sales contract(s) for the sale of goods in respect of which the principles of Accounting Standard (AS) 9, 'Revenue Recognition' apply. The Committee also notes that in the extant case, the company has to supply goods to the customer as per the agreed schedule of delivery. At times, a portion of the contracted supplies is delayed on which the customer imposes liquidated damages. The Committee further notes the following requirements of AS 29 and Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006, and Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI as follows:

AS 29

"6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of AS 9.

7. This Standard defines provisions as liabilities which can be measured only by using a substantial degree of estimation. …"

"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

10.2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

"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."

Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'

"17.

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Framework for the Preparation and Presentation of Financial Statements

"59. An essential characteristic of a liability is that the enterprise has a present obligation. 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. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business

relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party."

"63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations."

The Committee notes that in the extant case, liquidated damages are recovered by the customers for the period of delay between the due date of supply of goods as per the delivery schedule and the actual date of delivery of the said goods. Further, as per the querist, there is no clause in the contract to exit from the sales contract(s) entered with the customer, with or without the payment of penalty and the past experience of the company shows that in most cases, although the customers extend the due date of supply, the liquidated damages are recovered in full. Accordingly, the Committee is of the view that the terms and conditions of the sales contract(s) are binding and legally enforceable with the customers. In the extant case, although the querist has stated in paragraph 4(13) above that the liquidated damages are in the nature of compensatory payment, the Committee is of the view that the liquidated damages are akin to penalty and there is a contractual obligation on the part of the company to pay for liquidated damages as soon as there is a delay in the supply of goods beyond the due date as per the delivery schedule. Further, this obligation cannot be avoided by the company's future course of actions as it does not have any realistic alternative but to settle the contractual obligation (i.e., making the payment of such liquidated damages). Thus, there exists a present obligation arising from past event, viz., delay beyond scheduled delivery and settlement of which is expected to result in an outflow of resources embodying economic benefits. Accordingly, the Committee is of the view that the company should recognise a provision in respect of liquidated damages for the period of delay between the due date of supply of goods as per the delivery schedule and the expected date of delivery of the said goods and not only for the period of delay till the date of financial statements, in the light of evidence provided by events occurring after the balance sheet date, as per paragraph 36 of AS 29 which provides as follows:

> "36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date."

The Committee is of the view that 'matching concept' does not preclude recognition of present obligations as liabilities at the reporting date.

10. As regards the issue relating to disclosure of accounting policy relating to the practice of the company in respect of provision/liability of liquidated damages, the Committee is of the view that the same would depend upon the materiality of the items and transactions and their impact on the financial statements from the perspective of users of financial statements. In this regard, the Committee notes the following paragraphs of AS 1:

> "11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements."
>
> "17.
>
> c. *Materiality*
>
> Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."
>
> ***"24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.***
>
> ***25. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place."***

On the basis of the above, the Committee is of the view that the company should consider disclosure of its accounting policies in accordance with the above-reproduced requirements of AS 1.

D. Opinion

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

(i) and (ii) The company should recognise a provision in respect of liquidated damages for the period of delay between the due date of supply of goods as per the delivery schedule and the expected date of delivery of the said goods and not only for the period of delay till the date of financial statements, in the light of evidence provided by events occurring after the balance sheet date, as per paragraph 36 of AS 29, as discussed in paragraph 9 above.

(iii) The company should disclose its accounting practice in respect of liquidated damages, considering the materiality of the items and transactions and their impact on the financial statements from the perspective of users of financial statements, as discussed in paragraph 10 above.