Query No. 11

Subject: Discounting of deferred debts (retention money).[1]

A. Facts of the Case

1. ABC Ltd. is a listed central public sector company and its net worth as on 31.03.2015 was Rs. 34085 crore. Hence, Indian Accounting Standards (Ind ASs) are applicable from 1st April 2016 onwards. The company is an integrated power plant equipment manufacturer engaged in design, engineering, manufacture, construction, testing, commissioning of power projects and also in servicing of a wide range of products and services for the core sectors of the economy, viz., power, transmission, industry, transportation (Railways), renewable energy, oil & gas and defence. In power project business, the contracts received by the company are either Engineering, Procurement & Construction (EPC) contracts or Boiler, Turbine and Generator (BTG) packages. In case of BTG contracts, civil works and balance of plant (BOP) package items are not in its scope. Power projects are long gestation period projects where the normal execution period of a contract ranges between 3 to 5 years. The scope of the project includes supply of equipment, erection, commissioning, synchronizing the plant to the grid, completing the trial operation and proving the guaranteed parameters. For revenue recognition in respect of long term construction contracts, percentage of completion method is used**.**

2. The querist has stated that although the taking over of the project takes place after all the activities under the scope are complete, payments are released on progressive basis and achievement of specified milestones over the execution period of contract ranging between 3 to 5 years. For these type of contracts, generally, the payment terms are as follows:

a) Advances (generally 5% or 10% of contract value) received from customer before start of execution of contract and adjusted against progressive billing based on milestone achievements over the period of contact execution.

b) Payment against progressive billing linked with the completion of milestone activities defined in the contract concurrently over the execution period of the contract. This progressive billing contains minor percentage normally 5% to 10% which will become contractually due for payment by customer on the happening of another event, such as trial operation, PG test etc. This is accounted for as deferred debtors till completion of the specific performance activities of the contract.

3. The querist has referred to the following technical guidance from Indian Accounting Standards (Ind AS):

[1] Opinion finalised by the Committee on 2.9.2016.

Ind AS 11, Construction Contracts

According to the querist, the objective as stated in Ind AS 11 in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. Further, the querist has reproduced the following paragraphs of Ind AS 11:

"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. …"

"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.

…

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

"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."

To identify the fair value, the querist has reproduced the relevant paragraphs from Ind AS 113, 'Fair Value Measurement' are as below:

"9. This Ind AS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

"58 In many cases the transaction price will equal the fair value (eg that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold).

59 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. Paragraph B4 describes situations in which the transaction price might not represent the fair value of an asset or a liability at initial recognition."

Paragraph B4 of Appendix B, Application Guidance of Ind AS 113 provides that, "When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

(a) The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

(b) The transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (eg in a business combination), the transaction includes unstated rights and privileges that are measured separately in accordance with another Ind AS, or the transaction price includes transaction costs.

(d) The market in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market.

Further, relevant paragraphs of Ind AS 109, 'Financial Instruments', Ind AS 32 'Financial Instruments: Presentation' and Ind AS 115, 'Revenue from Contracts with Customers' (which was subsequently omitted by Companies (Indian Accounting Standards) (Amendments) Rules, 2016, vide notification dated March 30, 2016 by the Ministry of Corporate Affairs) have been reproduced by the querist as follows:

Ind AS 109

"2.1 This Standard shall be applied by all entities to all types of financial instruments except:

…

(j) rights and obligations within the scope of Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue*, that are financial instruments, except for those that Ind AS 11 and Ind AS 18 specify are accounted for in accordance with this Standard."

"4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding."

Ind AS 32, 'Financial Instruments: Presentation':

"A *financial asset* is any asset that is:

…

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity;"

Ind AS 115

"60 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties of the contract (either explicitly or implicitly*) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.* … A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract. (Emphasis supplied by the querist)

61 *The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the*

customer had paid cash for those goods or services when (or as) they transfer to the customer (i.e. the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

(b) the combined effect of both of the following:

(i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and

(ii) the prevailing interest rates in the relevant market.

62 Notwithstanding the assessment in paragraph 61, a contract with a customer would not have significant financing component if any of the following factors exist:

…

(c) the difference between the promised consideration and the cash selling price of the goods or service (as described in paragraph 61) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, *the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract."*

(Emphasis supplied by the querist)

The querist has also referred to paragraph 5.1.3 of Ind AS 109 (before consequential amendments due to withdrawal of Ind AS 115), which provides that, **"**Despite the requirement in paragraph 5.1.1, at initial recognition, an entity shall measure trade receivables at their transaction price (as defined in Ind AS 115) if the trade receivables do not contain a significant financing component in accordance with Ind AS 115 (or when the entity applies the practical expedient in accordance with paragraph 63 of Ind AS 115).

Practice of the company

4. The querist has further stated that the company, as stated, is into long-term contract execution with a normal contract period ranging from 3-5 years. The long-term construction contracts are received by the marketing wing of the company, which allocates the scope and value to various manufacturing units and region/sites for execution. The units/ regions bill the customer based on the Billing Break up (BBU) agreed with the customer. *The billing is basically to ensure cash flows and may not represent the true value of the despatches or the project progress at the site.* Thus, the billing schedule is customary industry practice and contracts are structured in similar fashion across the sector by all the customers as well as contractors. A typical contract includes retention of fixed % (generally 5% to 10%) on

successful completion of trial run/PG test. These activities (Trial run/PG test) are the core activities and completion of these activities signify fulfillment of the company's contractual obligation and customer's objective. Presently, the company recognises revenue as per percentage of completion method in accordance with the requirements contained in Accounting Standard (AS) 7 'Construction Contracts'. The amount of retention money is not presently due for payment by customer and is reflected in the balance sheet as deferred debtors at transaction value. As per the querist, this is nothing but activity linked payments and is not resulting from any specific financing arrangement.

Analysis by the company

5. Based on the background of the company and other paragraphs referred above, the transaction value is fair value for revenue recognition and deferred debt (retention money) need not be discounted on the following grounds on both initial recognition as well as subsequent measurement:

a. The price charged by the company for construction of power plant represents the fair value of the transaction as the price charged from the customer remains same irrespective of the retention money agreed with the customer. Further, none of the conditions mentioned in Para B4 of Appendix to Ind AS 113 are applicable.

b. Payment terms as being followed by the company are generally followed by most of the companies (customers as well as contractors) in the same segment of construction contracts in power sector. Customer also pays advance before start of the project and also retains a specified % of the contract value as retention money to ensure successful completion of core milestone activities. This is the generally accepted industry practice. Moreover, these contracts are generally based on competitive bidding and are awarded based on the lowest evaluated price.

c. The payment schedule as per the agreed billing schedule is basically to ensure cash flows and is independent of the revenue recognition which is guided by the method as prescribed in applicable Ind AS 11. Revenue will be continued to be recognized on POC method at transaction value in case of construction contracts as there is no financing arrangement. Thus, transaction value is fair value.

d. These deferred debtors are contractually due for payment by customer on completion of a specific core activity (generally PG test/Trial Operation) which is a must to fulfil the customer's ultimate objective, satisfaction of conditions specified and adequate protection to meet obligations in the contract. Similarly, customer also pays advances before start of the execution of the project which reflects commitment from the customer.

e. The objective of Ind AS 11 as stated in the Standard for accounting for construction contracts is the allocation of contract revenue and cost over the execution period. Discounting of deferred debtors and accounting for interest income instead of contract revenue is applicable in case of specific financing arrangement only. Hence, deferred debts are to be recognised initially at transaction value only.

f. As per the exception given in paragraph 2.1 of Ind AS 109, it is understood that, Ind AS 109 (except for impairment and derecognition requirements) is not applicable on trade receivables which are governed by Ind AS 11 and 18. Therefore, even though deferred debtors meet the definition of financial instruments but they are specifically excluded from the scope of Ind AS 109 and accordingly need not be discounted at the time of subsequent measurement also.

g. The billing schedule representing the cash flows is fixed after the price is finalized with the customer. Since the billing schedule is decided only post the price is finalized, the billing schedule representing cash flows does not have any bearing on price/ consideration.

Accordingly, the company has concluded that the fair value of the transaction is equal to the transaction value.

6. The querist has also separately clarified that the amount of deferred debtors (retention money) is paid by customer on satisfactory completion of performance activities linked to completion of various milestones to ensure completion of the project. In case of any shortcomings, the same has to be rectified by the company to the satisfaction of customer before release of deferred debtors. The amount of deferred debtors and contract revenue remain same irrespective of delay in release of payment by customer even if delay is on account of customer due to their fund constraint. The company is a leading manufacturer in this field since long and if any technical issue arises, the same is resolved for successful running of the project to the satisfaction of customer before release of deferred debtors is ensured. Till that time, the customer has the right to hold the release of payment of deferred debtors.

7. The querist has also separately supplied the following information for the perusal of the Committee:

1. The revenue in respect of construction contracts is recognised based on percentage of completion method over the period of contract based on cost incurred to total estimated cost of contract on performance of various activities at various stages of execution of project as per Ind AS 11 (earlier AS 7).

2. Trial operation (TO) and performance guarantee (PG) test are main activities to be done for successful completion of project and handing over the plant to customer, which is the core essence of the contract from the customer angle, and revenue pertaining to that activity based on percentage completion method is recognised at that point of time.

3. After finalisation of contract value as per contracts terms and conditions only, billing break up is agreed with customer which is not linked with revenue recognition and it is to ensure cash flow over the tenure of the contract. Since the contract value is determined first and thereafter only billing break up is agreed with customer, the contract value clearly reflects fair value of consideration. For example, revenue recognition may be at Rs. 100 and billing may be at Rs. 120. This difference is accounted as part of valuation adjustment liability. However, total billing and revenue

recognition at the end of the contract will remain same. Accounting entries with respect to one such construction contract, as an example/sample basis, have been separately supplied by the querist for the perusal of the Committee.

4. Generally, the terms of payment of such construction contracts are 10% advance, 80% on dispatch and 10% deferred payment on PG test/ TO. Considering advance and deferred billing payable on milestone within the contractual period, the contract value represents fair value in such construction contracts as the intent behind deferred billing is to secure the execution and performance of the contract and hence, there is no time value of money involved in such contracts.

5. Financing of such contracts is being done by international/domestic funding agencies and the company is not financing any part of such project. The role of the company is to manufacture the items, supply, erection and commissioning of the project. Further, customer shall also not be willing to have financing arrangement with the company as their cost of funding from international/domestic agencies is much lower than the company's incremental borrowing rate.

6. Based on the audited annual accounts and published results for 1st Quarter of financial year (Q1 F.Y.) 2016-17 of similar companies of international repute who are also the competitor of the company and executing the same type of contract with similar terms, the contract value has been accounted as the fair value of consideration and no discounting has been done (Extracts from annual accounts of two such similar companies have been provided by the querist for the perusal of the Committee).

7. The querist has also confirmed that considering the contract value awarded through competitive bidding route / negotiated route, the contract value is fair value of consideration since intent behind advance and deferred billing /debtors are to protect the interest of respective parties such as to secure the execution and performance of the contract and hence, there cannot be in-built interest/time value of money.

B. Query

8. Based on the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the company's accounting practice of not discounting deferred debts both at:

(a) initial recognition and;
(b) subsequent measurement

is in line with the requirements contained in Ind ASs.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to whether the company's accounting practice of not discounting deferred debts both at initial recognition and subsequent measurement is in line with the requirements contained in Ind ASs. 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 for advance payments and progress payments received during the contract period, recognition of contracts costs and revenue recognition policy of the company, etc. Further, the Committee presumes that the deferred debts, as referred to by the querist, in the extant case, are only in respect of retention money. Further, it is presumed that there are no performance obligations remaining unfulfilled in respect of retention money and conditions for revenue recognition as per Ind AS 11 in respect of deferred debts have been met. In other words, no contractual performance obligations remain unfulfilled in respect of the revenue recognized for deferred debts as in that case to the extent of unfulfilled performance obligations, revenue would not be recognised.

10. The Committee notes the following paragraphs of Ind AS 11:

> "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 orclaims that increase or decrease contract revenue in a period subsequent to that in which the contract wasinitially agreed;
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> (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."
>
> "22. When the outcome of a construction contract canbe 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."

From the above, the Committee notes that as per the requirements of paragraph 12 of Ind AS 11, contract revenue should be measured at fair value. The Committee also notes that the Standard does not specifically require to discount or determine the present value of various payments made over the contract period. It only requires to recognize the contract revenue, measured at fair value by reference to the stage of completion of the contract activity at the end of the reporting period. However, the Committee is of the view that when a contract payment would be received at a later date, viz., there is a deferment of payments, for example, in case of deferred debtors/payments, such that the effect of the time value of money

is material, the nominal amount of consideration receivable from the contract activity would not represent its fair value. Further, the Committee is of the view that whether the effect of the time value of money is material or not should be determined on a overall consideration of total cash flows including advance payments, etc. Accordingly, the Committee is of the view that where the effect of time value of money is material, the deferred debts/receivables to the extent revenue is recognised in respect of them as per Ind AS 11 should be discounted in order to arrive at the fair value of the consideration from the contract activity and the difference between the nominal value and fair value should be recognised as interest element over the contract period.

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11. In this regard, the Committee also wishes to point out that if the company expects that significant rectification work will have to be carried out in order to claim retention money from the customers, it should be examined as to whether the retention money represents the cost of rectification work normally undertaken. If this is the case, the Committee is of the view that rectification work becomes a performance obligation and the retention money in such cases accrues to the company only after satisfaction of such performance obligation. Therefore, in such cases, retention money should not be recognised as revenue unless such performance obligation is satisfied. Further, this should also be considered while determining the stage of completion of the contract activity as per the requirements of the Standard.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that where the effect of the time value of the money is material, deferred debtors due to retention money to the extent revenue has been recognised in respect of them should be discounted in order to arrive at the fair value of the consideration receivable from the contract, as discussed in paragraph 10 above. Further, whether the time value of money is material or not, should be determined on a overall consideration of total cash flows including advance payments, etc.