Query No. 18

Subject: Forfeiture of bank guarantees of contractors.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the çompany') is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May 2002 after unbundling of erstwhile State Electricity Board (SEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP notification no. 226 dated 31st May, 2005.

2. The company is engaged in the business of electricity distribution in the area of Indore and Ujjain Commissionaire of State of Madhya Pradesh and is governed by the provisions of the Electricity Act, 2003. The company is responsible for all activities associated with distribution of power within its territory, including management of assets, operation and maintenance of network and supply, technical and financial planning, business development and management of human resources, legal and regulatory affairs etc.

3. The Ministry of Power, Government of India has introduced Restructured Accelerated Power Development and Reforms Programme (RAPDRP) scheme during 11th five year plan as central sector scheme. ABC Corporation has been made nodal agency to operationalise the programme under the guidance of Ministry of Power. For implementation of the approved projects, funds are provided as a loan for the works within the scope of scheme from the Government of India on the terms decided by the Ministry of Finance. Accordingly, the company is receiving funds from ABC Corporation for executing the above capital projects. The querist has separately informed that in the process of tendering of contract, the contractor has to submit two types of securities:

- Bid security commonly known as earnest money deposit. This security shall be forfeited by the company if the contractor fails to accept the allotted work or in other specified circumstances including failure of the bidder to furnish performance security. The company releases this security upon signing of agreement and submission of performance security.
- Performance security for satisfactory execution of work. This security shall be forfeited by the company on the breach of condition of contract during the execution of work.

4. The querist has submitted that the company awarded one tender under RAPDRP Scheme to M/s A Infrapower for execution of some capital work but they denied to provide requisite performance guarantee to the company. Accordingly, the company forfeited the bank guarantee (BG) submitted by the firm as earnest money deposit (EMD) and accounted for it as income. The querist has separately informed that in this case, letter of award was issued to contractor to take up the works after selection of contractor in the tendering procedure. M/s A Infrapower had denied to provide requisite performance guarantee and accordingly, the company has forfeited bank guarantee submitted as EMD. Hence, the company is of the view that since no work is executed by the contractor and security is forfeited at the tendering level itself, the question of adjustment with the cost of work does not arise. Accordingly, the company accounted for the said receipt as other income.

5. The querist has further submitted that the company awarded another tender under RAPDRP Scheme to M/s B for execution of some capital work. The firm has also drawn mobilisation advance

[1] Opinion finalised by the Committee on 26.10.2016.

from the company and subsequently, they expressed inability to execute the aforesaid work. Accordingly, the company forfeited the BG submitted by firm and after adjusting the amount of mobilization advance, remaining amount has been treated as other income. The querist has separately informed that in this case, after signing of the agreement for work, contractor has drawn mobilisation advance amounting to Rs. 9.29 crore but the work was not executed. M/s B subsequently expressed inability to execute the work. Accordingly, the company forfeited 'Performance Security' amounting to Rs. 19.37 crore. The company, after adjustment of advance of Rs. 9.68 crore, accounted for Rs. 9.69 crore as income. In this case also, there was no work executed by the contractor. Since these receipts arise because of inefficiency on the part of the contractor, i.e., delay in completion of contracts and supply of materials or non-completion of work at all, relying upon the earlier opinions of EAC on the similar matters, the company has accounted for this receipt as income in the accounts of the company.

6. In both the above cases, the company earned total Rs. 21.24 crore towards encashment of bank guarantees due to default of contractors in execution of RAPDRP capital works. Since the amount earned was in connection with RAPDRP works, the company credited this amount to RAPDRP bank account by treating it as its other income.

7. The querist has also provided abstracts of the relevant terms of the tender document which are as follows:

"19. Bid Security

19.1 Unless otherwise specified in the BDS, the Bidder shall furnish as part of its bid, a bid security in original form and in the amount and currency as specified in the BDS.

19.2 The bid security shall be a demand guarantee, at the Bidder's option, in any of the following forms:

(a) an unconditional bank guarantee; or

(b) an irrevocable letter of credit; or

(c) a banker's cheque from a reputable source.

The bid security shall be submitted either using the bid security form included in Section 4 (Bidding Forms), in the case of a bank guarantee, or in another substantially similar format approved by the Employer prior to bid submission. In either case, the form must include the complete name of the Bidder. The bid security shall be valid for twenty-eight days (28) beyond the original validity period of the bid, or beyond any period of extension if requested under ITB 18.2.

19.3 Any bid not complying with ITB 19.1 and ITB 19.2, shall be rejected by the Employer as non-responsive.

19.4 The bid security of unsuccessful Bidders shall be returned as promptly as possible upon the successful Bidder's furnishing of the performance security pursuant to ITB 40.

19.5 The bid security of the successful Bidder shall be returned as promptly as possible once the successful Bidder has signed the Contract and furnished the required performance security.

19.6 The bid security may be forfeited or the bid securing declaration executed:

(a) if a Bidder withdraws its bid during the period of bid validity specified by the Bidder on the Letter of Bid Form, except as provided in ITB18.2 or

(b) if the successful Bidder fails to:

(i) sign the Contract in accordance with ITB 39; or

(ii) furnish a performance security in accordance with ITB 40."

8. The querist has referred to paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets'[2], issued by the Institute of Chartered Accountants of India (ICAI), which provides as follows:

> "9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:
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> (i) site preparation;
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> (ii) initial delivery and handling costs;
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> (iii) Installation cost, such as special foundations for plant; and
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> (iv) Professional fees, for example fees of architects and engineers.
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> The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, and changes in duties or similar factors."

9. Due to above treatment, the company is of the view that the amount of forfeiture of bank guarantee/ liquidated damages recovered from the contractors or suppliers, are not directly attributable, like rebates and trade discounts, to acquisition of asset. They can also not be regarded as price adjustments. Such damages result from inefficiency on the part of the contractor/supplier, i.e., delay in completion of works contracts and supply of materials or non-completion of work at all, as the case may be. Therefore, such claims received from the contractors/suppliers cannot be adjusted in the cost of the assets.

10. The querist has also referred to paragraph 6 of an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), finalised on 3rd February, 1994 (published as Query No. 1.15 of Volume XIII of the Compendium of Opinions) on the same subject matter which is reproduced as under:

> "6. On the basis of the above, the Committee is of the opinion that the accounting policy of the company with regard to the liquidated damages/penalties recovered/recoverable from the contractors or suppliers, as stated at para 2 of the query, is not correct. Such damages/penalties should be shown as income separately, in the profit and loss account, and not be adjusted in the cost of the relevant asset or repairs and maintenance or raw materials account. However, if the amount of such damages/penalties is not material, it can be shown as a part of miscellaneous income. Insofar as the timing of the recognition of such damages/penalties in accounts is concerned, these should be recognised when the following conditions are satisfied, namely-
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> (i) The amount of such damages/penalties, is reasonably measurable; and
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> (ii) It is not unreasonable to expect its ultimate collection."

11. The querist has submitted that the facts and grounds of the above opinion are similar with the company and in present case, the bank guarantee is forfeited only because of inefficiency on the part of the contractor for non-execution of work.

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[2]AS 10 has been subsequently revised as AS 10, 'Property Plant and Equipment' by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364 (E) dated 30.03.2016.

12. However, while conducting audit of annual accounts of the company for the financial year 2013-14, the government auditor (CAG auditor) observed that as the company has incurred extra expenditure on the scheme by awarding of work at higher cost. Hence, any income realised should be adjusted against the project cost instead of treating as income. This has resulted in overstatement of capital work in progress (CWIP) and understatement of loss by the same amount.

13. Auditor was requested to consider the above opinion of the Expert Advisory Committee of the ICAI on same subject matter but it was not considered by them.

14. The querist has also stated that as per general instruction no. 3 to the Companies (Accounting Standards) Rules, 2006, the Accounting Standards are intended to apply only to items which are material.

B. Query

15. In light of the above facts and earlier EAC opinion, the Committee is requested to provide the opinion on the following issues:

(i) Accounting treatment of forfeiture of bank guarantees of contractors.

(ii) As stated above, the amount of bank guarantee is Rs. 21.24 crore as against the total turnover of the company Rs. 6956 crore. Therefore, in the light of principle of materiality, whether the treatment given by the company in its books of account is correct or not.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised relates to accounting treatment of forfeiture/invoking of bank guarantees of contractors. The Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, classification and presentation of forfeited/invoked bank guarantee as 'revenue' or 'other income', etc. Further, the Committee wishes to point out that its opinion is expressed considering the specific facts of the two cases referred by the querist and may not be relevant for other similar situations. The Committee further wishes to point out that its opinion is expressed purely from accounting perspective and not from any legal perspective. The Committee has presumed from the Facts of the Case that forfeited/invoked bank guarantees are not under dispute/arbitration. Further, the Committee wishes to point out that since the query refers to the financial year 2013-14, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

17. The Committee notes that in the extant case, there have been two cases of forfeiture/invoking of bank guarantees. In one case, the company awarded one tender under RAPDRP Scheme to M/s A Infrapower for execution of some capital work but it denied to provide requisite performance guarantee to the company and, accordingly, the company forfeited/invoked the bank guarantee (BG) submitted by the contractor as EMD. In other case, the company awarded another tender under RAPDRP Scheme to M/s B for execution of some capital work. The firm has also drawn mobilisation advance from the company but the work was not executed. Subsequently, the contractor expressed inability to execute the aforesaid work. Accordingly, the company forfeited/invoked the bank guarantee submitted by the contractor after adjusting the amount of

mobilisation advance. Further, the Committee notes that in both the cases, there was no work executed by the contractors. Now, the question that has been raised relates to accounting for such forfeiture/invoking of bank guarantees.

18. With regard to the issue raised, the Committee notes the following definition of the term 'income' as per paragraph 69(a) and paragraphs 91 and 92 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

> "69 (a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants."
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> "91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).
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> 92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty."

From the above, the Committee notes that an increase in future economic benefits related to an increase in asset which can be measured reliably should be recognised as income in the statement of profit and loss. In this regard, the Committee notes from the Facts of the Case that in both the cases referred above, the contractors have either denied to provide requisite performance guarantee or expressed inability to execute work and therefore, the company has forfeited/invoked the bank guarantee which has resulted in inflow of economic benefits/resources (viz., increase in cash/bank balance) and therefore, the same should be recognised as income.

19. With regard to the issue as to whether such income can be adjusted against the cost of the project/asset(s) arising from the project, the Committee notes that paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies' states that ***"All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."*** Thus, any item of income can be adjusted against the cost of the fixed asset/project only when an Accounting Standard requires the same. In this regard, the Committee notes that there is no specific requirement in any Accounting Standard for adjusting such income against cost of the project/asset(s). The Committee further notes that income in the extant case results from forfeiture/invoking and cancellation of certain contracts on which the contract work had not even started. Thus, the income from forfeiture/invoking in the extant case is of the nature of a penalty on the contractors due to non-fulfillment of the tender/contract conditions. Moreover, in the extant case, the forfeiture is not intended to be a compensation for additional costs, if any, incurred on the project. These are received due to cancellation of the contract and do not have any nexus with extra costs that may result for the company due to cancellation of the contract. Accordingly, the Committee is of the view that income arising from forfeited/invoked bank guarantees cannot be adjusted against the cost of the asset/project; rather, the same should be recognised in the statement of profit and loss.

20. With regard to the issue raised by the querist in relation to materiality aspect of the interest income, the Committee notes that paragraph 4.3 of the Preface to the Statements of Accounting Standards, issued by Institute of Chartered Accountants of India, states, inter alia, that "The Accounting Standards are intended to apply only to items which are material". The Committee further notes that paragraph 17(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', explains 'materiality' as below:

> *"c. Materiality*
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> 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."

21. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If an information is not material, on the consideration of materiality as mentioned in the paragraph 20 above, its accounting would not have any effect on the decisions of the users of the financial statements. Thus, assessment of materiality is a matter of judgement and needs to be determined under the specific facts and circumstances of the company concerned. Accordingly, in the extant case also, the Committee is of the view that it needs to be determined under the specific facts and circumstances of the company as to whether income arising out of bank guarantees forfeited/invoked, if not accounted for appropriately, can influence the decisions of the users of the financial statements. For this purpose, apart from the volume of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered. Moreover, materiality concept should be seen in totality.

D. Opinion

22. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 15 above:

(i) Income arising from forfeited/invoked bank guarantees cannot be adjusted against the cost of the asset/project; rather, the same should be recognised in the statement of profit and loss, as discussed in paragraph 19 above.

(ii) The treatment made by the company is correct. However, considerations of materiality should be applied based on the specific facts and circumstances in the given case, i.e., as to whether income arising out of bank guarantees forfeited/invoked, can influence the decisions of the users of the financial statements, as discussed in paragraphs 20 and 21 above. For this purpose, apart from the volume of transactions and quantum of turnover, other factors, such as, nature of the item, impact on profit/loss etc., should also be considered.

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