

Query No. 11

Subject: Accounting treatment of temporary income in relation to construction contract.¹

A. Facts of the Case

1. A Ltd. is a public sector shipyard under the Ministry of Defence and is in the business of construction of warships. Indian Navy, Coast Guard and other customers award contracts to the company on commercial terms. The contracts are awarded on fixed price basis except certain variable components, such as, foreign exchange variation and cost of spares etc. The payment for fixed price part is on the basis of completion of milestones. The payment for variable component is based on actual cost to the shipyard.
2. The querist has informed that the shipyard recognises revenue on percentage completion method as per Accounting Standard (AS) 7, 'Construction Contracts'. The total revenue from a project is the contract price of the project plus extras as mentioned above.
3. The payment terms for fixed price portion of the contract are generally spread over 10-12 milestones starting with initial payment of 10% on signing of the contract. As the gestation period of the contracts for shipbuilding is longer, it so happens that during initial period when the funds are made available, at times, become temporary surplus funds, which are deployed in short-term fixed deposits. However, in the later part of execution of the contract, the cost incurred on the project exceeds the stage payments received on the vessel leading to a negative cash flow. Further, the last stage payment of the project is deferred till one year after the delivery of the vessel.
4. Thus, the interest earned initially on the temporary surplus compensates to a certain extent for the period of deficit cash flow, especially at the later part of the execution of the project.
5. The querist has further informed that at present, in the books of account, the total stage payments, i.e., contract price is taken as operating revenue and interest earned from the surplus of stage payments is accounted for under the head 'Other Income'.
6. In view of the facts mentioned, it is felt that interest earned from such surplus of stage payments should also be considered under 'other operating revenue' since the interest is inextricably connected to stage payments and is one of the parameters for contract price.
7. The querist has provided the reasons for inclusion of interest earned on stage payments under 'other operating revenue' for shipyards in brief as follows:
 - (a) Shipyards are engaged in long gestation contracts with operating cycle ranging from 3 to 4 years. The stage payments for milestone activities are directly linked to physical progress achieved in each project (sample copy for one of the project has been supplied by the querist for the perusal of the Committee). Stage payments are not released in the event of non-completion of specified milestones. Thus, the stage payments received on milestone achievement and interest, if any, earned thereon arises from operations.
 - (b) If customer had not agreed for stage payments in the existing manner, the company will have to arrange funds to meet working capital requirements and

¹ Opinion finalised by the Committee on 4.5.2017.

cost of working capital would have been factored in for arriving at contract price. In such a scenario, the profit arising out of revised contract price would be higher to the extent of such interest factor considered for quoting the price. Therefore, the interest earned out of stage payments shall also deserve to be treated as a part of core business activities and considered under ‘operating revenue’.

- (c) The notional interest income arising out of investments from temporary surpluses of stage payments is considered by the customer as a negotiating point during the price negotiation of the contracts.

B. Query

8. Considering the facts submitted as above, opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) is sought on whether interest earned on deposits made out of temporary surpluses of milestone payments can be considered as ‘other operating revenue’.

C. Points considered by the Committee

9. At the outset, the Committee notes that although the issue raised is whether interest earned on deposits made out of temporary surpluses of milestone payments can be considered as ‘other operating revenue’, the basic issue raised by the querist relates to presentation of such interest earned during contract execution under the head ‘other income’ or under ‘other operating revenue’. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. Further, the opinion being expressed hereinafter is purely from the perspective of presentation in the financial statements and not from any other perspective. The Committee also wishes to point out that since the querist has referred to Accounting Standard (AS) 7, ‘Construction Contracts’, the opinion has been expressed considering the requirements of Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 and not the requirements of Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015.

10. The Committee notes that Note 2(A) to General Instructions for the Preparation of Statement of Profit and Loss in Part II – Form of Statement of Profit and Loss of Schedule III to the Companies Act, 2013 requires that in respect of a company other than a finance company, revenue from operations shall disclose separately in the notes revenue from (a) sale of products, (b) sale of services, (c) other operating revenues, and (d) less: excise duty. The Committee further notes the following requirements of the Guidance Note on Schedule III to the Companies Act, 2013², issued by the ICAI:

“**9.1.6** For non-finance companies, revenue from operations needs to be disclosed separately as revenue from

- (a) sale of products,
- (b) sale of services and
- (c) other operating revenues.

It is important to understand what is meant by the term “other operating revenues” and which items should be classified under this head vis-à-vis under the head “Other Income”.

² Subsequently, this Guidance Note was revised in July, 2019 as ‘Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013’.

9.1.7 The term “other operating revenue” is not defined. This would include Revenue arising from a company’s operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from the sale of products or rendering of services. Whether a particular income constitutes “other operating revenue” or “other income” is to be decided based on the facts of each case and detailed understanding of the company’s activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held. For instance, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is continuously engaged in leasing of real estate properties, the rent arising from leasing of real estate is likely to be “other operating revenue”. On the other hand, consider a consumer products company which owns a 10 storied building. The company currently does not need one floor for its own use and has given the same temporarily on rent. In that case, lease rent is not an “other operating revenue”; rather, it should be treated as “other income”.’”

“9.2 Other income:

The aggregate of ‘Other income’ is to be disclosed on face of the Statement of Profit and Loss.

9.2.1 As per Note 4 to General Instructions for the preparation of Statement of Profit and Loss ‘Other Income’ shall be classified as:

- (a) Interest Income (in case of a company other than a finance company);
- (b) Dividend Income;
- (c) Net gain/loss on sale of investments;
- (d) Other non-operating income (net of expenses directly attributable to such income).

9.2.2 All kinds of interest income for a company other than a finance company should be disclosed under this head such as interest on fixed deposits, interest from customers on amounts overdue, etc.”

From the above, the Committee notes that the classification of an item under “other operating revenue” or “other income” is a matter of judgement considering the specific facts and circumstances of each case, for example, considering the nature of activity the company is engaged into, etc. The Committee also notes that the Guidance Note requires all types of interest income in case of a company other than finance company to be disclosed under the head ‘other income’. Accordingly, considering the company’s business of construction of warships, the Committee is of the view that interest income from temporary investments of milestone payments cannot be classified as ‘other operating revenue’; rather the same should be classified as ‘other income’ only.

D. Opinion

11. On the basis of the above, the Committee is of the view that interest income from temporary investments of milestone payments cannot be classified as ‘other operating revenue’; rather the same should be classified as ‘other income’ only.
