

Query No. 1

Subject: Netting off of trade receivable and advances received from customers.¹

A. Facts of the Case

1. A company (hereinafter referred to as the ‘company’) is a Government of India (GoI) undertaking under the Ministry of Defence. It manufactures a wide range of products, like super alloys, titanium alloys, maraging steel, etc. for strategic sectors like space, defence, nuclear power, etc. The products manufactured are sold in the form of ingots, forged billets, sheets, plates, strips, rods, rings, etc. The company’s turnover in the financial year 2016-17 was to the tune of Rs. 809.71 crore.

2. The querist has stated that as the products are niche products, made only against specific orders, the company receives advances from various customers on agreed percentages of sale value of an order for supply of goods and services. While raising the sale invoice on supply of ordered goods or services, advances to the extent of proportionate value of invoice to the total sales value of the order is adjusted. The balance amount of the invoice is included in the trade receivable schedule and the balance amount of advance is included in the advances from customer schedule. Above practice is being followed by the company for the past several years.

3. Under the normal course, on the reporting date, there may be both receivables as well as advances appearing against the same party which is shown under ‘Trade Receivables’ and ‘Other Current/Non-Current advances’ in the notes to the balance sheet.

4. Complete party-wise, voucher-wise details against each of the receivable and advances are maintained at subsidiary ledger level. The company is of the view that such advances and receivable for the same customer may be netted-off in the balance sheet either

- At customer level (or)
- At customer’s purchase order i.e. at contract level

Above depiction provides better clarity in respect of net balances of trade receivables/advances at customer level or contract level as compared to showing both the receivables and advances separately against the same customer.

5. It is observed by the Government audit during audit of annual accounts for the financial year 2016-17 that trade receivables are financial assets in nature as they give rise to contractual right to receive cash or another financial asset from another entity. On the other hand outstanding advances received from customer are non-financial liability in nature as the same are to be discharged by supply of goods or services to the customer and does not involve discharge of liability through payment of cash or exchange of other financial asset. While presenting the trade receivables and outstanding advances from the customers in the balance sheet, even if trade receivables are due from the customer whose advances are outstanding after the adjustment of proportionate value of supplies with reference to each specific order, they are to be disclosed separately as these assets and liabilities pertain to different classes of financial and non-financial category.

6. However, the company is of the view that, as per the provisions of Indian Accounting Standard (Ind AS) 32, ‘Financial Instruments: Presentation’, offsetting is permissible for a financial assets and a financial liability. This is to present the net realisable value of a transaction at the reporting date to give a fair view to the users. Drawing a simile from Ind AS 32 which speaks of off-setting of financial assets and financial liability, it would be

¹ Opinion finalised by the Committee on 4.4.2018 and 5.4.2018.

appropriate to consider the principles of Ind AS 32, for setting-off the customer's dues and advances at customer levels to reflect the net receivable / net payable of a customer instead of showing them separately in the financial statements.

7. It may be noted that as far as trade receivables are concerned, they are a financial asset. In case of advances from customers, as they are liable to be returned in cash in case of company's failure to supply the contracted material as per contract, the same are also classifiable as financial liabilities.

8. The querist has separately provided the query of the Comptroller and Auditor General (C&AG) auditors and management's reply thereto.

9. The querist has also submitted following example for easy understanding of the issue:

Customer: XYZ

Contract No. XYZ-001:

For supply of material Qty. 100 MT @ 1000, value Rs.1,00,000

Payment terms – Advance 30%, thus paid an amount of Rs. 30,000

During the year 40MT Qty supplied to the customer, invoice raised for Rs.40,000 and advance adjusted for Rs.12,000 (40,000 x 30%) at the invoice level

Contract No. XYZ-002:

For supply of material Qty. 200 MT @ 1000, value Rs.2,00,000

Payment terms – Advance 30%, thus paid an amount of Rs.60,000

During the year 90MT Qty supplied to the customer, invoice raised for Rs.90,000 and advance adjusted for Rs.27,000 (90,000 x 30%) at the invoice level

Contract No. XYZ-003:

For supply of material Qty. 50 MT @ 1000, value Rs.50,000

Payment terms – Advance 30%, thus paid an amount of Rs.15,000

As on the reporting date, no supplies made against this order

Customer-XYZ

	Contract: 001	Contract: 002	Contract: 003	Total
A. Receivables				
Invoice	Rs.40,000	Rs.90,000	Rs.0	Rs.1,30,000
Less: Advance adjusted	Rs.12,000	Rs.27,000	Rs.0	Rs.39,000
Balance (A)	Rs.28,000	Rs.63,000	Rs.0	Rs.91,000 A
B. Customer Advances				
Advance Received	Rs.30,000	Rs.60,000	Rs.15,000	Rs.1,05,000
Less: Adjusted on Supplies	Rs.12,000	Rs.27,000	Rs.0	Rs.39,000
Balance (B)	Rs.18,000	Rs.33,000	Rs.15,000	Rs.66,000 B
C. Order Level Balance (A - B)				
C1. Trade Receivables	Rs.10,000	Rs.30,000	-	Rs.40,000 C1
C2. Customer Advances			Rs.15,000	Rs.15,000 C2
D. Customer Level Balance (Total A - Total B)				Rs.25,000 D

- a) Presentation at Customer Level
 - Trade receivable Rs.25,000 (Ref. D of above table)
 - Customer Advances NIL
- b) Presentation at Customer Order Level
 - Trade receivable Rs.40,000 (Ref. C1 of above table)
 - Customer Advances Rs.15,000 (Ref. C2 of above table)
- c) Presenting Receivables and Advances on Proportionate adjustments
 - Trade receivable Rs.91,000 (Ref. A of above table)
 - Customer Advances Rs.66,000 (Ref. B of above table)

As per the Accounting Standard, netting-off is permissible when there is a legal right to do so. When the company prepares a customer statement, all dues and advances will be shown in the statement and the net balance, i.e., net due/advance is arrived at (a) above. As such, the company is of the view that disclosing only net trade receivables/ advance (as the case may be) at customer level in the balance sheet is perfectly acceptable.

10. The querist has separately informed that in normal circumstances, advance of one purchase order is not adjusted against dues of another purchase order. In the event of termination of contract, customer may recover outstanding advance from the dues of some other order or they may ask for refund of same. Further, there are incidents where customer has recovered the outstanding advance of short closed/ closed purchase order from the dues of another purchase order (one settlement bill where customer has mentioned the recovery of advance of one short closed purchase order from the dues payable against another purchase order has also been separately supplied by the querist for the perusal of the Committee).

B. Query

11. On the basis of above, the querist has sought the opinion of the Expert Advisory Committee as to whether the company is right in netting-off trade receivable and advances of the same customer at customer level or at customer's purchase order level in presenting the financial statements at the balance sheet date (considering that sub-ledgers of dues and advances are maintained by the company separately at transaction level with full details).

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to whether the company is right in netting of trade receivable and advances of the same customer, either at customer level or at customer's purchase order level while presenting the financial statements at the balance sheet date. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case.

13. The Committee notes the following paragraphs of Ind AS 32, Financial Instruments: Presentation:

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

- (a) cash;**
- (b) an equity instrument of another entity;**
- (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; or

...

A financial liability is any liability that is:

- (a) a contractual obligation :
 - (i) to deliver cash or another financial asset to another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity's own equity instruments and is: ...”

“42 A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

- (a) currently has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see Ind AS 109, paragraph 3.2.22).”

“46 The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. When an entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

47 An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off, but does not intend to settle net or to realise the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with paragraph 36 of Ind AS 107.”

From the above definitions of ‘financial asset’ and ‘financial liability’, the Committee notes that a financial asset is any asset that is a contractual right to receive cash or another financial asset from another entity and financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another entity. Further, it is also noted from paragraph 42, 46 and 47 reproduced above that an entity can offset a

financial asset and financial liability in the balance sheet when it currently has a legally enforceable right to set off and it intends to either set off on net basis or to realise the asset and settle the liability simultaneously. Legal right of set-off in the event of bankruptcy or cancellation of contracts by parties, etc. are not currently enforceable right of set-off but are contingent rights also. The existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. Further, an intention by one or both parties to settle on a net basis without the legal right to do so is also not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered. Paragraph 47 also states that entity's intention to settle particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously.

15. The Committee notes that in the extant case, trade receivable is a financial asset as it represents a contractual right to receive cash. With regard to advance received, the Committee notes that in normal circumstances, there is no contractual obligation to pay cash/financial asset but the obligation is for providing goods and services and therefore, cannot be classified as financial liability. Accordingly, in such circumstances, the question of set-off of financial asset and financial liability does not arise. However, where the contract specifically provides for the refund of the advance resulting in contractual obligation to pay cash or another financial asset in respect of advance received then the same will be considered as financial liability. In such case, the set-off is possible if the requirements of paragraphs 42, 46 and 47 are fulfilled. In this regard, the Committee notes from the Facts of the Case that in normal circumstances, advance received and which is pending for adjustment from future invoices/billings on the customer cannot be set-off against the outstanding trade receivables either at contract/purchase order level or at customer level (two contracts with same customer). Therefore, in the extant case, such a set-off cannot be made.

D. Opinion

16. On the basis of above, the Committee is of the opinion that the company is not right in offsetting trade receivables and entire advances received either at customer level or at contract/ purchase order level in normal circumstances while presenting the financial statements at the balance sheet date; set-off is possible only if the requirements of paragraphs 42, 46 and 47 of Ind AS 109 are fulfilled, as discussed in paragraphs 14 and 15 above.
