

## **Query No. 12**

**Subject:** *Accounting treatment of liquidated damages (LD) recovered from suppliers/contractors as per the terms of contract, during the construction phase of the project.*<sup>1</sup>

### **A. Facts of the Case**

1. A company (hereinafter referred to as 'the company') is a Government company under the administrative control of the Department of Atomic Energy (DAE), incorporated on 22 October, 2003 as a public limited company under the Companies Act, 1956 with the objective of constructing and commissioning the first 500 MWe Fast Breeder Reactor (FBR) and to pursue construction, commissioning, operation and maintenance of subsequent fast breeder reactors for generation of electricity in pursuance of the schemes and programmes of Government of India (GOI) under the provisions of the Atomic Energy Act, 1962.

2. The company is currently constructing a 500 MWe prototype fast breeder reactor (PFBR). The PFBR is the forerunner of the future fast breeder reactors and is expected to provide energy security to the country. The PFBR is being built with the design and technology developed at the Indira Gandhi Center for Atomic Research (IGCAR).

3. Project cost of the company is funded by debt equity ratio of 20:80. Equity is in the form of equity share capital from the GOI and ABC limited (a CPSU) in the ratio of 95:5. Project cost of the company is Rs. 5,677 crores. Authorised capital of the company is Rs. 5,000 crores and paid up capital at the end of the financial year (F.Y.) 2016-17 is Rs. 4588.20 crores.

4. The project is nearing completion stage and expected to commission during financial year 2018-19. The PFBR is a single and indigenous project under construction, which is first of its kind in India.

5. The querist has stated that during the financial year 2016-17, the company has recovered liquidated damages (LD) amounting to Rs. 19,68,605 from various vendors/contractors, towards delayed supply/completion of contract. As per procedure, levy of LD will materialise only at the time of closure of contract. If there is a delay in supply, applicable LD for that delay will be temporarily withheld and shown as liability. The levy or refund of LD will be finalized only on closure of contract, after getting approval of competent authority. If on closure of contract, LD levy is approved, LD amount already withheld as temporary retention, will be credited to respective account, to which, the payment /expenditure of that contract is debited. *It is nothing other than reduction from the cost of the contract on the ground that, levy of LD is as per the contract condition.* This practice is being followed by the company from the inception of the project (2003), as and when the LD's levy is finalized as per the provision of adjusting the related income against indirect expenditure as envisaged in the Guidance Note on Treatment of Expenditure during Construction period, which was applicable at that time.

(Emphasis added by the querist).

6. Accounting policy relating to LD, as disclosed in the financial statements of the F.Y. 2016-17 is given below:

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<sup>1</sup> Opinion finalised by the Committee on 5.6.2018 and 6.6.2018.

*Under the Head Ind AS 18: Revenue - para B) Liquidated damages:*

“Until liquidated damages are decided as recoverable, retentions made on this account, if any are shown under liabilities. During construction phase, in respect of all contracts, liquidated damages recovered from supplier/contractors are taken to the respective head of account at the time of closure of contracts.”

7. Accordingly, the LD recovered as per contractual conditions are credited to the cost of that contract as reduction from the cost of contract, as it is a single project, which is under construction stage.

8. The querist has also reproduced relevant extracts of the CAG (Comptroller and Auditor General) report, along with the querist’s reply as follows:

<b>CAG’s Observation</b>	<b>Company’s reply for the CAG’s observation</b>
<p>The company has opted for 3 phase audit of CAG for the financial statements. In 2nd phase of CAG audit, the observation of the auditors of CAG, regarding treatment of liquidated damages is given below:</p> <p>“As per accounting policy relating to revenue recognition, in respect of all contracts, liquidated damages recovered from the suppliers/contractors should be taken to the respective head of account, at the time of closure of contracts during construction phase.</p> <p>However since liquidated damages is of revenue nature, the same should have been accounted as income in profit and loss account as recovery of liquidated damages is on account of inefficiency on the part of the contractor to execute the work by scheduled date and hence not attributable to construction/ commissioning of PFBR.</p> <p>Hence the non-accountal of LD recovered to the extent of Rs. 19,68,605/- has resulted in overstatement of financial liability (Retention money O&amp;M), understatement of income and consequent understatement of profit by Rs. 19,68,605/-. Further accounting policy require modification wherein liquidated damages recovered is recognised as income.”</p>	<p>“The company is a single unit company and does not have any commercial operation. The project ‘PFBR’ is under construction. All expenses (directly/indirectly) have to be linked with the respective asset. Since the LD levied is as per contract condition, it can be taken as directly linked transaction. Accordingly, LD has been taken (credited) to respective assets. This has been suitably given under accounting policy and is followed consistently.</p> <p>However for better clarity, we propose to take expert opinion from the Institute of Chartered Accountants of India (ICAI) during 2017-18.”</p>

According to the querist, as the company is a single unit company, all the credits/income generated out of project fund or as per the conditions of contracts awarded/executed for the construction of the project are capital in nature; hence, need not be classified as revenue expenditure during the construction phase of the project. Further, crediting LD to capital expenditure and capitalization of costs net of LD is in order in the light of the provision in the purchase/works contracts and also as per the provision of adjusting related income against indirect expenditure as envisaged in the Guidance Note on Treatment of Expenditure during Construction Period. Relevant General Conditions of Contract (GCC) in respect of LD for purchase contract and works contract have been provided by the querist for the perusal of the Committee.

## **B. Query**

9. From the above, opinion of the Expert Advisory Committee of the ICAI is sought, as to whether the accounting treatment followed by the company is consistent with the Ind ASs. If not, it is requested to suggest the correct accounting treatment, applicable from the financial year 2017-18. In the context of the query raised, the querist has supplied the following information in respect of financial statements, that may be relevant for consideration:

- (i) It is an infrastructure project by nature, having long gestation period (project construction activities started in 2003, which is under construction stage and the commissioning is expected during the F.Y. 2018-19).
- (ii) The company is preparing the statement of profit and loss. Interest from employee loans and rent from the shops at township are credited to profit and loss account.
- (iii) CSR expenses are debited to profit and loss account.
- (iv) Interest earned from temporary deposit of project funds in bank fixed deposits (FDs) are credited to 'Expenditure During Construction (EDC) Account' and grouped under the 'Capital Work in Progress (CWIP)'.
- (v) Ind AS is applicable to the company from the financial year 2016-17 under the category, 'company having net worth Rs. 500 crore or more'.

## **C. Points considered by the Committee**

10. The Committee notes that the basic issue raised by the querist relates to accounting treatment of liquidated damages recovered from supplier/contractors during the construction phase. The Committee has, therefore, considered only this issue and has not considered any other issue arising from the Facts of the Case, such as, accounting treatment of interest from employee loans, rent from the shops at township, CSR expenses, interest earned from temporary deposits of project funds in bank FDs, etc. The Committee notes the querist's use of the phrase 'competent authority' in the context of approvals of the liquidated damages; while the phrase is not clear, the Committee presumes that the querist is referring to 'internal approvals', though this does not affect the opinion of the Committee. The Committee also wishes to point out that Guidance Note on Treatment of Expenditure during Construction Period has been withdrawn by the ICAI in August 2008 and thus, it is no longer relevant in the extant case. Further, the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective, such as, legal interpretation of purchase/works contract, etc.

11. The Committee notes paragraphs 16 and 21 of Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment', that explains the elements of cost:

“16 The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

...”

- “21 Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.”

From the above, the Committee notes that as per the requirements of Ind AS 16, only those items of costs which are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management can be included in the cost of the asset. Accordingly, in the context of liquidated damages, the Committee is of the view that treatment of liquidated damages would depend upon the fact whether these are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management and whether these are received for mitigating extra costs to be incurred on the asset which will be capitalised as part of the cost of the asset.

12. In the context of the nature of liquidated damages recovered by the company, the Committee notes the following clauses from the extracts of general conditions of contract (GCC) for works contract and purchase contracts, as provided by the querist for the perusal of the Committee:

### **“GCC-WORKS CONTRACT**

Clause 35-Compensation for Delay:

- 35.1 If the Contractor fails to maintain the required progress in terms of Clause 13 or to complete the work and clear the site on or before the Contract or extended date of completion, the Contractor shall, without prejudice to any other right or remedy of the company, on account of such breach, pay as agreed compensation amount calculated as stipulated below or such smaller amount as be fixed by the authority mentioned in Schedule ‘A’ on the Contract Value of the work for every week that the progress remains below that specified in Clause 13 or that the work remains incomplete.

...

- (a) Completion period (as originally @ 1% per week stipulated) not exceeding 1 year.
- (b) Completion period (as originally @ ½% per week stipulated) exceeding 1 year and not exceeding 3 years.
- (c) Completion period (as originally @ 1/4% per week stipulated) exceeding 3 years.

- 35.2 Provided always that the *total amount of compensation for delay to be paid under this clause shall not exceed 5% of the total value of the Contract Value* or of the

Contract Value of the item or group of items of work for which a separate period of completion is specified.

35.3 The amount of compensation may be adjusted or set off against any sum payable to the Contractor under this or any other contract(s) with same unit or any other unit(s) of the company. For the purpose of such adjustment/set off, it shall be deemed that the Contractor has given its free consent.

**GCC-PURCHASE CONTRACT**

**Clause no. 15 DELIVERY SCHEDULE AND LIQUIDATED DAMAGES:**

15.1 Time and date of delivery of the Stores stipulated in the Contract, shall be essence of the contract and delivery must be completed by the dates specified therein. Unless otherwise agreed, the contract shall be deemed to have come into force from the date of issue of priced Letter of Indent/Purchase Order and accordingly contractual delivery period shall be reckoned from that date.

15.2 Delay in Supply and Termination:

15.2.1 Should the Contractor fail to deliver the Stores or any part thereof within the period prescribed for such delivery, it shall be construed as a breach of the Contract and the Purchaser shall be entitled at his option to the following:

15.2.1.1 To receive the Stores after prescribed date of delivery with the right to recover from the Contractor agreed Liquidated Damages (LD) at the rate indicated below:

	<b>Delivery Period</b>	<b>Liquidated Damages, Rate / Week</b>	<b>Maximum Amount of LD</b>
1.	Delivery period (as originally stipulated) not exceeding one year.	@1% per week on the undelivered / delayed portion of supplies of Purchase Order	5% on the undelivered/delayed portion of supplies of Purchase Order
2.	Delivery period (as originally stipulated) exceeding one year but not exceeding two years.	@0.5% per week on the undelivered / delayed portion of supplies of Purchase Order	5% on the undelivered/delayed portion of supplies of Purchase Order
3.	Delivery period (as originally stipulated) exceeding two years.	@0.25% per week on the undelivered / delayed portion of supplies of Purchase Order	5% on the undelivered/delayed portion of supplies of Purchase Order
In case of Contracts for Plant / Equipment/Machinery/Instruments which includes erection and commissioning and which could be put into use only after final acceptance, the Purchaser may levy Liquidated Damages on total Contract price, but in case of Stores which can be put to use or pro-rata deliveries are permitted in the contract, on the price of the delayed supply. The applicable terms and conditions governing the levy of liquidated damages will be specifically laid out in the Notice Inviting Tender (NIT)/Contract.			

15.2.1.2 To purchase from elsewhere, after (thirty) 30 days notice to the Contractor, on his account and at the risk of the Contractor, the Stores, not delivered or other items of similar description when such Stores exactly complying with the Particulars are not in the opinion of the Purchases readily procurable, such

opinion being final, without cancelling the Contract in respect of the consignment(s), not yet due for delivery.

15.2.1.3 To cancel the total contract or balance portion thereof, and if so desired, to purchase or authorise the purchase of stores not so delivered or other Stores of similar description, when such Stores exactly complying with the particulars are not, in the opinion of the Purchaser, readily procurable, such opinion being final, *at the risk and cost of the Contractor.*

15.2.2 *In the event of action being taken under clause 15.2.1.2 or 15.2.1.3 above, the Contractor shall also be liable for Liquidated Damages for delay in deliveries, which the Purchaser is entitled to recover as per 15.2 on that account provided an agreement for such alternative purchase from elsewhere, is made within (six) 6 months of the notice of failure or letter of cancellation sent to the Contractor. The Contractor shall not be entitled to any gain on such purchase made on account of default. The manner and method of such alternate purchase shall be at the entire discretion of the Purchaser, whose decision shall be final. This right shall be without prejudice to the right of the Purchaser, to recover the damages for breach of Contract by the Contractor as provided in the Contract or under the general law.”*

(Emphasis supplied by the Committee.)

From the above clauses of the contract, it appears that liquidated damages are in addition to the compensation for extra cost to be borne by the company due to delay in the delivery/contract performance schedule, for example, extra cost incurred due to purchase of the same supplies/component from some other supplier/contractor at a higher price. If this is the case, the Committee is of the view that the liquidated damages would not be on account of compensation towards extra costs due to delays; rather would be of the nature of compensation for breach of terms of contract and therefore, in that case, liquidated damages should not be capitalised as/adjusted against the part of project/contract cost and the same should be recognised in the statement of profit and loss. However, if this is not the case and the liquidated damages are received in mitigation of the extra project costs incurred on the asset/project, the same should be adjusted against the cost of the asset/project. Since the above is a matter involving exercise of the judgement in the light of the factual position and terms and conditions of the contract with the supplier/contractor, the Committee is of the view that the company in the extant case should evaluate its own facts and circumstances and accordingly, account for the liquidated damages after determining its nature, as discussed above.

#### **D. Opinion**

13. On the basis of the above, the Committee is of the opinion that whether or not the treatment followed by the company in respect of liquidated damages in the extant case is consistent with Ind ASs would depend upon the nature of liquidated damages in the extant case and since the same is a matter involving exercise of the judgement considering the factual position and terms and conditions of the contract with the supplier/contractor, the Committee is of the view that the company should evaluate its own facts and circumstances and accordingly, account for the liquidated damages, as discussed in paragraph 12 above.