

Query No. 26

Subject: Factoring time value of money while calculating Expected Credit Losses (ECL) on deferred debt (retention money) under Ind AS framework.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) is a listed central public sector company and its net worth as on 31.03.2022 was Rs. 26971 crore. The Company is an integrated power plant equipment manufacturer engaged in design, engineering, manufacture, construction, testing and 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. Power projects are long gestation period projects where the normal execution period of a contract ranges between 3 to 5 years. Billing is done on progressive basis upon achievement of specified milestones over the execution period of contract.

2. The querist has stated that for revenue recognition in respect of such contracts, the Company uses input method based on cost approach to record revenue over the period of time. The performance obligation is satisfied over time and the milestone payments are scheduled to coincide with the Company’s expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (i.e., retained known as ‘Deferred Debts’) by the customer throughout the arrangement and paid to the Company only when the specified milestones of the project are complete. This amount is withheld by the customer purely for the purpose of protecting itself from non-performance of the Company. The Company provides for Expected Credit Losses (ECL) on the trade receivables, including deferred payments on case to case basis after duly evaluating the criteria laid down in Indian Accounting Standard (Ind AS) 109, ‘Financial Instruments’, following the simplified approach. While evaluating Ind AS 109 criteria for ECL on deferred debts, the Company does not consider time value of money since the extended period for receipt of retention money is for reasons other than provisions of finance and is purely to protect against non-performance of the Company.

3. *Analysis*

- Revenue is recognised to depict the transfer of promised goods or services to customer at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
- In relation to construction and long-term service contracts, the Company transfers control of goods or services to the customer and recognises revenue over time. Revenue is recognised using input method based on the cost approach in accordance with the requirements of Ind AS 115, ‘Revenue from Contracts with Customers’. There is no component of time value of money involved while recognising the revenue including in cases of deferred debts.
- As per paragraph 5.5.17 of Ind AS 109:
 - An entity shall measure expected credit losses of a financial instrument in a way that reflects: an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
 - the time value of money; and

¹ Opinion finalised by the Committee on 29.8.2023.

- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.
- As permitted under Ind AS 109, the Company is using simplified approach for providing ECL on its trade receivables including deferred debts. As mentioned above in paragraph 5.5.17, while calculating ECL provision, the Company needs to consider time value of money. *As per paragraph B5.5.44 of Ind AS 109, expected credit losses shall be discounted to the reporting date, not to the expected default or some other date, using the effective interest rate determined at initial recognition or an approximation thereof.* (Emphasis supplied by the querist.)
- It is to be noted that Ind AS 109 requires the Company to consider time value of money using the effective interest rate determined at initial recognition of the contract. Since the Company recognises at the transaction value, the effective interest rate in the contract at initial recognition is zero.

In light of above, the Company is of the view that the ECL provision owing to the specific time value factor shall be zero in cases wherein the Company does not have significant financing component at inception and also during later stages of the project (unless the financing component is incorporated in the contract by the parties during the contract) and the Company shall continue to assess its deferred debts for the credit risks following the relevant principles of Ind AS 109 on case to case basis as mentioned in the facts.

B. Query

4. Whether the Company should factor in the time value of money while providing for expected credit loss on the deferred debts (retention money).

C. Points considered by the Committee

5. The Committee notes that the basic issue raised by the querist relates to the accounting for expected credit losses on deferred debts (retention money) treated as trade receivables of the Company, for which it is stated that the Company is following ‘simplified approach’ under Ind AS 109. 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, appropriateness of revenue recognition policy of the Company, provision for ECL in other cases, etc. Further, the Committee has also not examined whether it is appropriate to treat the deferred debts in the extant case as trade receivables and therefore, it is presumed for the purpose of this opinion that the treatment of deferred debts as trade receivables is appropriate in the facts and circumstances of the case. Furthermore, the opinion hereinafter has been expressed in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time and is purely from accounting perspective and not from any other perspective.

6. The Committee notes that as per the requirements of Ind AS 115, upon initial recognition, a receivable including impairment thereof is accounted for in accordance with Ind AS 109.

7. The Committee further notes the requirements of Ind AS 109 as follows:

- “5.1.3 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).”

“Simplified approach for trade receivables, contract assets and lease receivables

5.5.15 Despite paragraphs 5.5.3 and 5.5.5, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for:

- (a) trade receivables or contract asset that result from transactions that are within the scope of Ind AS 115, and that:**
 - (i) 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); or**
 - (ii) contain a significant financing component in accordance with Ind AS 115, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all such trade receivables or contract assets but may be applied separately to trade receivables and contract assets.**

...”

“Measurement of expected credit losses

5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;**
- (b) *the time value of money*; and**
- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.”**

“B5.5.35 An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17. An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs B5.5.51–B5.5.52) for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc). Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different

customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).”

The Committee further notes the basis for conclusions of IFRS 9, issued by IASB for simplified approach as follows:

Basis for Conclusions for IFRS 9

“BC5.225 ... IASB noted that, in its view, a provision matrix can be an acceptable method to measure expected credit losses for trade receivables in accordance with the objectives for the measurement of expected credit losses in IFRS 9. An entity would adjust historical provision rates, which are an average of historical outcomes, to reflect relevant information about current conditions as well as reasonable and supportable forecasts and their implications for expected credit losses, *including the time value of money*. Such a technique would be consistent with the measurement objective of expected credit losses as set out in IFRS 9. ...”

(Emphasis supplied by the Committee.)

The Committee notes from the Facts of the Case that the Company is following the simplified ECL approach under Ind AS 109 and therefore, should measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables. Further, as required by paragraph 5.5.17, measurement of expected credit losses must reflect, inter alia, time value of money (which represents passage of time between the recognition of the receivables including deferred debts and receipt of cash). The Committee further notes that one of the approaches suggested in paragraph B5.5.35 of Ind AS 109 is the use of a provision matrix as a practical expedient for measuring ECLs on trade receivables. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is *past due* (e.g. 1 per cent if not past due, 2 per cent if less than 30 days past due, etc. for groupings of various customer segments that have similar loss patterns). To calibrate the matrix, the entity would adjust its historical credit loss experience with forward-looking information. The Committee is of the view that if the ECL rates in the provision matrix rates of the Company already consider the impact of time value of money, the loss provision calculated as per the same may be used; however in case the provision matrix rates do not consider the impact of time value of money, then the same should be considered separately over and above such rates in provision matrix. Thus, the impact of time value of money should be considered while calculating the provision. Accordingly, the Committee is of the view that in the extant case, the Company should follow the requirements of paragraphs 5.5.15, 5.5.17 and B5.5.35 of Ind AS 109, as discussed above, and also factor in the impact of time value of money while calculating ECL.

D. Opinion

8. On the basis of above and subject to paragraph 5 above, the Committee is of the opinion that in the extant case, the Company shall follow the requirements of paragraphs 5.5.15, 5.5.17 and B5.5.35 of Ind AS 109, and also factor in the impact of time value of money while calculating ECL, as discussed in paragraph 7 above.