

Query No. 25

Subject: *Accounting treatment of Encashment of Bank Guarantee under Ind AS framework.*¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) incorporated as a wholly owned Government company under the Companies Act, 1956 during the year 1984-85 is engaged in construction and operation of thermal power plants. The Company prepares its annual financial statements as per the provisions of the Companies Act, 2013 as amended from time to time. Presently, the Company has operational capacity of 1740 MW.

2. The Company constructed two supercritical units of 660MW each, in the same location adjacent to its existing operational units (2x210 MW) and awarded the contracts to different parties in 2014. These additional two units, namely, Units 3 and 4 went into commercial operation in July’19 and Aug’19 respectively. The Company has signed a long-term power purchase agreement for supply of power, tariff of which is regulated by the appropriate regulatory commission.

3. The construction contract for the power plant was granted to various contractors, with one such contract awarded to Contractor X Ltd. specifically for the construction of the Balance of Plant (BOP) package at a contract price of Rs. 1638 crore on 11.7.2013. Notice to Proceed (NTP) issued to the contractor X Ltd. on 26.3.2014 with a scheduled completion of the BOP package within 44 months (25.11.2017) and 48 months (25.3.2018) for Unit 3 and Unit 4 respectively. The contractual duration of final completion was 51 months from NTP, of both the units for both the contracts.

4. The project is still in its execution phase, though the Company has declared commercial operation date as 03rd July, 2019 and 21st August, 2019 before substantial completion for Unit 3 and Unit 4, respectively. The total capitalisation of the BOP contract cost as on the Commercial Operation Date (COD) amounted to Rs. 1562.57 crore. This sum was subsequently claimed as part of the fixed cost component in the tariff in accordance with the directive of the Odisha Electricity Regulatory Commission (OERC).

5. The scope of BOP package includes design, engineering, procurement, manufacture, assembly, supply, inspection and testing at works, packing and forwarding, delivery at project site, for the complete main plant civil works and BOP package of mechanical, electrical, instrumentation and control systems and other miscellaneous systems.

6. As per the Contract terms, X Ltd. submitted bank guarantee (BG) amounting to Rs. 156 crore for availing advance termed as Notice to Proceed (NTP) advance of Rs. 156 crore paid by the Company to X Ltd. to start the work.

7. Further, X Ltd. submitted another BG amounting to Rs. 325 crore as performance guarantee of the constructed part of the power plant viz. BOP package.

¹ Opinion finalised by the Committee on 16.10.2024.

8. The NTP bank guarantee reduced to Rs. 81 crore i.e. by 5% on Contract Price after achievement of targeted contractual milestone by X Ltd.

9. The terms of the Contract provided for the performance guarantee of various sections of plant; figures of per hour output, power consumption etc. were specified. It was stipulated that after the erection and trial run, performance tests of the various sections of plant would be undertaken. Standards of liquidated damages (LD) towards performance failure were specified. As per the performance guarantee clause, X Ltd. gave bank guarantees totalling Rs. 325 crore. The maximum amount of liquidated damages as per bank guarantees was limited to 15% of the Contract Price including delay and performance LD and it was stipulated that the Company will be the sole judge as to whether performance failure had taken place and the banks will remit the amount to the Company on invocation of the bank guarantee. *The Contract also provided for reference of dispute to arbitrators.* (Emphasis supplied by the querist.)

10. The project exceeded its scheduled completion date, and according to the Company, the delay is attributable to X Ltd. Consequently, X Ltd. is liable to pay liquidated damages (LD) to the Company.

11. Additionally, the Company has undertaken certain tasks that fall within the scope of the BOP package, which X Ltd. was contracted to fulfil. Therefore, X Ltd. is obligated to compensate the Company accordingly for these additional works (back charged items).

12. The performance of X Ltd. fell short of expectations, as it failed to complete the remaining works citing financial difficulties. In response, the Company provided financial assistance in the form of interest-bearing advances to facilitate the completion of the outstanding works. Despite this support, X Ltd.'s performance remained unsatisfactory.

13. In an effort to encourage progress, the Company disbursed a final advance payment of Rs 1.41 crore to X Ltd. on March 6, 2023, following a meeting. During this meeting, X Ltd. committed to resuming the work after receiving the payment. However, X Ltd. failed to uphold this commitment, and the works have been completely suspended since January 2023. The Company, feeling frustrated by X Ltd.'s failure to fulfil its obligations and breach of terms under the supply and service contracts, took action by encashing the Notice to Proceed (NTP) Bank Guarantee and the Performance Bank Guarantee. This amounted to Rs. 59.01 crore and Rs. 324.65 crore respectively aggregating to Rs. 383.52 crore on April 16, 2024.

14. *In response to the invocation of the guarantees, X Ltd. has sought relief by approaching various legal forums to address its grievances.* (Emphasis supplied by the querist.)

Present accounting treatment:

15. The Company accounted for the BG encashment as a payable liability under the head 'Current Liabilities' unless and until the dispute resolved citing the uncertainty and showing the amount as special item in the Notes to Account as the amount is material for disclosure.

16. *Supporting facts in response to accounting treatment*

Reference to Accounting Policy No 2.19 (ix)

Other Income: Rent, interest / surcharge recoverable on advances to suppliers as well as warranty claims / liquidated damages are recognised when no significant uncertainty about collectability exists or accepted by other party.

The querist has also given reference to Ind AS principles:

Paragraphs 16 and 17 of Ind AS 16, 'Property, Plant and Equipment', issued by the Institute of Chartered Accountants of India (ICAI), have been provided by the querist as follows:

- 16 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.
- 17 Examples of directly attributable costs are:
 - (a) site preparation;
 - (b) initial delivery and handling costs;
 - (c) Installation cost;
 - (d) such as special foundations for plant;
 - (e) Professional fees, for example fees of architects and engineers.

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.

Due to above requirements, 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.

17. With regard to the issue raised, the querist has also referred to 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.”

“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).

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, it is noted 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 and from the Facts of the Case, since 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), the same should be recognised as income.

18. Regarding the issue as to whether such income can be adjusted against the cost of the project/asset(s) arising from the project, paragraph 88 of Ind AS 1 ‘Presentation of Financial Statements’, states that **“An entity shall recognise all items of income and expense in a period in profit or loss unless an Ind AS 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, it is noted that there is no specific requirement in any Accounting Standard for adjusting such income against cost of the project/ asset(s). Further, it may be noted 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-fulfilment 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 Company 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.

Further, the querist has referred to the following extracts from the Educational Material on Ind AS 16, Property, Plant and Equipment, issued by the erstwhile Ind AS Implementation Committee of the ICAI:

“Question 18

An entity has employed a contractor for construction of chemical plant. The terms of the agreement clearly specify that the liquidated damages are paid as compensation for failure to meet performance conditions in terms of the desired quality and level of output subsequent to commissioning of the plant. The damages will be calculated based on the shortfall in the output as a percentage of the contract price. Whether such liquidated damages received be deducted from the cost of the related asset or recognised as income?

Response

Paragraph 16 of Ind AS 16, *inter alia*, states that, 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...”

In the given case, the amount of liquidated damages received are not directly attributable to the construction of the chemical plant like trade discounts and rebates. Such damages are as a result of the inefficiencies on the part of the contractor. Further, the amount of liquidated damages is directly linked to performance parameters for the plant subsequent to commissioning of the

plant. Therefore, the liquidated damages should not be deducted from the cost of related asset and the same should be accounted as income.

Question 19

An entity PQR Ltd. employed a contractor to build a power plant on turnkey project basis for a total consideration of Rs. 100 crores. As per the terms of the contract, if there is more than one month delay in the completion of construction, PQR Ltd. is entitled to recover liquidated damages at 0.25% of the contract value for every week of delay subject to the maximum of 5% of contract value.

The contractor delayed the completion of construction by 45 days and therefore, PQR Ltd. received liquidated damages from the contractor. The management believes that liquidated damages basically compensate it for its loss of revenue for the period of 45 days. What will be the treatment of these liquidated damages received on delays by the contractor?

Response

Paragraph 16 of Ind AS 16, *inter alia*, states that “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...”

The treatment of liquidated damages received on delays by the contractor depends on the facts and circumstances. Hence, whether or not the liquidated damages should be adjusted against the project cost would depend upon the fact whether the liquidated damages are directly identifiable with the project and whether, in fact, they are received for mitigating extra project costs to be incurred by the entity which will be capitalised as part of the cost of the plant. Where and to the extent the liquidated damages meet the aforesaid stipulations in affirmative, the same should be adjusted in the cost of the project. Otherwise the same should be accounted for as income.”

The querist has also referred to the opinions of Expert Advisory Committee of the ICAI as follows:

1. 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 may be referred to, which provides as under:

“...liquidated 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. ...”

2. Further, an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), finalised on 26th October, 2016 (published as Query No. 18 of Volume XXXVI of the Compendium of Opinions on the similar matter states as under:

“...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...”.

3. Furthermore, an earlier opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI), finalised on December 21, 1988 (published as Query No. 39 of Volume VIII of the Compendium of Opinions) on the similar matter states as under:

“... On the basis of the above, the Committee is of the view that, in the circumstances cited by the querist, the most appropriate course of action would be to keep the amount of guarantees invoked (i.e., Rs. 64 lakhs) in a suspense account till such time that the dispute is settled. In case the dispute is settled in favour of company, it would be appropriate to effect change in the historical cost of the fixed asset(s) concerned, to the extent the liquidated damages represents reduction in the standard of performance. The total guarantee amount received can be apportioned amongst the various items of plant and machinery concerned on a reasonable basis, e.g., in proportion of gross value of various items of plant and machinery concerned. As recommended by AS 6, the change in the historical cost in the above circumstances would not require recomputation of depreciation for the past years. However, the depreciation charge for future years would require to be suitably adjusted to take account of the change in the historical cost of fixed assets. That part of the liquidated damages which does not represent reduction in the standard of performance, should be treated as other income and should be disclosed as an ‘Extraordinary Item’ as recommended in Accounting Standard (AS) 5 on ‘Prior Period and Extraordinary Items and Changes in Accounting Policies’, issued by the Institute of Chartered Accountants of India. However, if it is not possible to ascertain the extent of the amount penalty, the entire amount should be deducted from the cost of the assets concerned.”

B. Query

19. In view of above facts, earlier opinions of EAC and accounting requirements, the Company seeks opinion of the Expert Advisory Committee (EAC) with respect to the following issues:

- (i) Whether the encashed bank guarantee (BG) be offset against the project cost through a reduction in the project cost.
- (ii) Whether the income derived from forfeited or invoked bank guarantees be recognised in the Statement of Profit and Loss.
- (iii) Whether the value of the BG encashed will be kept as liability until the dispute settled with disclosure note in Notes to Account.

C. Points considered by the Committee

20. The Committee notes that the basic issue raised in the query relates to the accounting for the encashed bank guarantee (BG) and the income derived from forfeited or invoked bank guarantees. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, the appropriateness of timing of capitalisation of the two units - Units 3 and 4, accounting for costs incurred in relation to the

two units - by the contractor and the Company, rate regulation related aspects, related tax and regulatory matters, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various agreements viz. legal interpretation of power purchase agreement for supply of power, order of State Electricity Regulatory Commission, Coordination agreement, Services Contract, Supply Contract, etc. Furthermore, since the EAC opinion is expressed in the specific facts and circumstances, the Committee has not examined the applicability of earlier opinions referred by the querist.

21. The Committee notes that Ind AS 16, 'Property, Plant and Equipment' states the following:

“10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. ...

Initial costs

11 Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with Ind AS 36, *Impairment of Assets*.”

“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.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

- 17 Examples of directly attributable costs are:
- (a) costs of employee benefits (as defined in Ind AS 19, *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
 - (b) costs of site preparation;
 - (c) initial delivery and handling costs;
 - (d) installation and assembly costs;
 - (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment). Excess of net sale proceeds of items produced over the cost of testing, if any, shall not be recognised in the profit or loss but deducted from the directly attributable costs considered as part of cost of an item of property, plant, and equipment; and
 - (f) professional fees.”

“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.”

The Committee further notes the guidance given under the Educational Material on Ind AS 16, as reproduced by the querist in paragraph 18 above.

22. The Committee also notes the key clauses from the ‘Coordination Agreement’, ‘Contract for Services’ and ‘Contract for Supply of Equipment’ between the Company (Owner/Buyer) and X Ltd. (Contractor/Seller), as shared by the querist as follows:

Coordination Agreement dated 11th July, 2013

“WHEREAS:

...

(B) The Company and X Ltd. have entered into the following contracts (herein referred to individually as a “Contract” and collectively as the “Contracts” as may be amended from time to time) on 11th July 2013;

- (i) a contract for the Supply of Equipment (the “Supply Contracts”); and
- (ii) a contract for the provision of Services (the “Services Contract”).

(C) ...

(D) X Ltd. has agreed to guarantee, coordinate and assume full and single point responsibility for the performance of (i) the Works (as defined hereunder), (ii) its obligations as the Seller under the Supply Contract and (iii) its obligations as the Contractor under the Services Contract for the Aggregate Contract Price.”

“Cumulative Delay Liquidated Damages Cap” means the amount that is fifteen percent (15%) of the Aggregate Contract Price.

“Cumulative Overall Liquidated Damages Cap” means the amount that is twenty percent (20%) of the Aggregate Contract Price.

“Cumulative Performance Liquidated Damages Cap” means the amount that is fifteen percent (15%) of the Aggregate Contract Price.”

“Liquidated Damages” means collectively, the Stage-wise Completion Delay Liquidated Damages payable under the Services Contract, the LNTP Deliverables Delay Liquidated Damages and the Completion Delay Liquidated Damages payable under both Contracts and the Performance Liquidated Damages payable under the Supply Contract.”

“4.1 Recourse:

4.1.1 Notwithstanding anything to the contrary stated in Section 15.2 of the Contracts or on the face of each Common Security, X Ltd. agrees that and shall procure that the issuer of each Common Security shall confirm that each Common Security shall secure the due performance of all of X Ltd's obligations under both the Contracts and under this Agreement.

4.1.2 The Company may at any time in its absolute, sole and unfettered discretion make demand on and utilize any or all of the Common Securities provided by X Ltd., to pay for any Buyer's Costs or Owner's Costs, as applicable, or damages (including any liability for Liquidated Damages to the full extent of the Cumulative Overall Liquidated Damages Cap) which the Company claims that it has incurred, as a consequence of any act or omission of, Contractor Event of Default, Seller Event of Default, or other non-performance of either or both of the Contracts or this Agreement by X Ltd. or to satisfy any amount which the Company asserts is payable by X Ltd. under either or both the Contracts or under this Agreement.”

“6 **Limitations of Liability**

6.1 X Ltd. liability for Liquidated Damages.

...

6.1.2 Limitation of Liability for Liquidated Damages. The aggregate amount payable by X Ltd. to the Company:

- (a) for all Delay Liquidated Damages, shall not exceed the Cumulative Delay Liquidated Damages Cap, notwithstanding Section 17.1(a) of the Contracts.

- (b) for all Performance Liquidated Damages shall not exceed the Cumulative Performance Liquidated Damages Cap, notwithstanding the provisions of Section 17.1(b) of the Supply Contract.
- (c) for all Liquidated Damages under the Contracts and this Agreement shall not exceed the Cumulative Overall Liquidated Damages Cap, notwithstanding the provisions of Section 17.1 of the Contracts.

6.2 Claim for Liquidated Damages. If any liability for Liquidated Damages arises under either Contract, the Company shall have a right to make a claim for such Liquidated Damages under both Contracts or deduct the amount of such Liquidated Damages from amounts payable under both Contracts. ...”

“8.9 X Ltd.’s obligations and liabilities under this Agreement are for the sole purpose of consolidating the obligations of the Contracts to ensure that Contracts are on single point responsibility basis and this Agreement do not create any additional liability and/or obligation except Cumulative Delay Liquidated Damages Cap, Cumulative Overall Liquidated Damages Cap, Cumulative Performance Liquidated Damages Cap and that provided in Section 2, 3, 4, 6 and 8 of the Agreement. ...”

Contract for the Services between the Company as Owner and X Ltd. as Contractor dated 11th July 2013

“2.24.5. No Relief: If there is a delay in the performance of the Services such that Contractor is unable to meet any Guaranteed Delivery Date or any Guaranteed Completion Date specified in the Contract Schedule or the Guaranteed Substantial Completion Dates or the Guaranteed Final Completion Date, and such delay is caused in whole or in part by an act or omission of Contractor or any Subcontractor, then Contractor shall bear all costs and expenses of providing extra resources, personnel or equipment, supplies, materials or other things; ...”

“7.1.2.4. Stage-wise Completion Delay Liquidated Damages:

- (a) If: Contractor fails to complete any of the Services on or before the Guaranteed Completion Dates specified in the Contract Schedule,... Contractor shall pay as liquidated damages, and not as a penalty, liquidated damages (the “Stage-wise Completion Delay Liquidated Damages”) at the rate specified in the column titled “Stage-wise Completion Delay Liquidated Damages” ...
- (b) *The Parties acknowledge and confirm that the Stage-wise Completion Delay Liquidated Damages are a genuine and reasonable pre-estimate of the damages or costs likely to be incurred by Owner as a result of Contractor's failure to complete the Services by the relevant Guaranteed Completion Dates including damages or costs that may be incurred by Owner upon acceleration of the progress of the Related Works.*

...

- (e) ... the payment of Stage-wise Completion Delay Liquidated Damages under this Section 7.1.2.4 is in addition to any liability of Contractor for Completion Delay Liquidated Damages under Section 7.2.5.
...”

“7.2.7.2 Completion Delay Liquidated Damages.

7.2.7.2.1. Amount. If the Substantial Completion Balance of Plant Unit 3 or Substantial Completion Balance of Plant Unit 4 does not occur on or before the respective Guaranteed Completion Dates and such failure is caused by or contributed to by:

- (i) any failure by Contractor to perform the Services in accordance with the Contract;

...

then Contractor shall pay to Owner liquidated damages (the “Completion Delay Liquidated Damages”) at the rate specified... In the event, Contractor has paid Completion Delay Liquidated Damages, ... Owner shall refund, without any interest, the amount that is equal to the difference between: (i) Completion Delay Liquidated Damages,... that have been paid by Contractor; and (ii) Owner's Costs of acceleration of Services (including any payments made to the Related Contractor for accelerating the Services) so as to achieve the Substantial Completion Balance of Plant Unit 3 by Guaranteed Substantial Completion Date Balance of Plant Unit 3 and/or Substantial Completion Balance of Plant Unit 4 by Guaranteed Substantial Completion Date Balance of Plant Unit 4... respectively. Contractor agrees that Owner's determination regarding Owner's Costs incurred in relation to the acceleration of Services shall be binding on Contractor.

7.2.7.2.2. Amounts Reasonable. The Parties hereby acknowledge and agree that the terms, conditions and amounts fixed as *liquidated damages pursuant to Section 7.2.7.2.1 for Completion Delay Liquidated Damages are reasonable, considering the loss of revenues and the actual costs that Owner will incur if Contractor fails to achieve completion of Substantial Completion Balance of Plant Unit 3 and Substantial Completion Balance of Plant Unit 4 by the respective Guaranteed Substantial Completion Dates. The amounts of these liquidated damages are agreed upon and fixed hereunder by the Parties because of the difficulty of ascertaining the exact amount of losses and/or costs that will be actually incurred by Owner in such event, and the Parties hereby agree that such amounts are a reasonable estimate of Owner's probable loss (and are not a penalty) and that such amounts shall be applicable regardless of the amount of such lost revenues and increased costs actually incurred by Owner. ...*”

“14.1.2. Remedies for a Contractor Event of Default.

14.1.2.1. If any Contractor Event of Default exists, Owner may take one (1) or more of the following actions:

...

14.1.2.1.2. draw upon the Security and/or the Punch List Security in an aggregate amount not to exceed the amount that Owner reasonably believes would be payable to it in respect of all of its remedies hereunder, ...”

“15.2. Security.

15.2.1. Issuance. On the dates set forth in Article 15, Contractor shall furnish to Owner the Performance Security, the LNTP Payment Security, the NTP Payment Security and each Warranty Security (each a “Security” and together “Securities”). ...”

“15.2.6. Recourse. Owner may at any time in its absolute, sole and unfettered discretion make demand on and utilize any Security provided by Contractor, to pay for any Owner's Costs or damages which Owner claims that it has incurred, as a consequence of any act or omission of Contractor or to satisfy any amount which Owner asserts is payable by Contractor pursuant to the Contract.”

“20.6. Right of Set-Off. Owner may set off or deduct any sums payable by Contractor to Owner under this Contract against or from any payment due to Contractor under this Contract.”

Contract for supply of equipment between the Company as Buyer and X Ltd. as Seller dated 11th July 2013

““Liquidated Damages” means the Delay Liquidated Damages and the Performance Liquidated Damages.”

“2.24.4. No Relief: If there is a delay in the performance of the Supply of Equipment such that Seller is unable to meet any Guaranteed Supply Date specified in the LNTP, Contract Supply Schedule or the Guaranteed Substantial Completion Dates or the Guaranteed Final Completion Date, and such delay is caused in whole or in part by an act or omission of Seller or any Subcontractor, then Seller shall bear all costs and expenses of providing extra resources, personnel or equipment;...”

“9.2.1 Payment of Liquidated Damages: If any Completed Performance Test fails to demonstrate satisfaction of any of the Performance Guarantees ..., Seller shall pay Buyer within thirty (30) days following the end of such Completed Performance Test, as liquidated damages, an amount equal to the corresponding Liquidated Damages Amount specified in the column titled “Liquidated Damages” in Section 2.1 of Appendix A; ...”

9.2.2 Liquidated Damages Reasonable: The Parties hereby acknowledge and agree that the Liquidated Damages fixed as liquidated damages pursuant to this Article 9 are reasonable liquidated damages, considering the actual increased costs and reduction in the value of the Equipment that Buyer will sustain in

the event of Seller's failure to achieve any Performance Guarantee. The amounts of the Liquidated Damages are agreed upon and fixed hereunder by the Parties as liquidated damages because of the difficulty of ascertaining the exact amount of such increased costs and reduction in value that will actually be sustained by Buyer in the event of any such failure by Seller, and the Parties hereby agree *that the Liquidated Damages specified herein are a reasonable estimate of Buyer's probable loss (and not a penalty)* and that they shall be applicable regardless of the amount of such reduction in value actually sustained by Buyer."

"15. SECURITY

...

15.2.2.2. Performance Security.

- (a) On or before the issuance of LNTP, Seller shall provide to Buyer a Security in the amount of fifteen percent (15%) of the Contract Price. On or before the issuance of NTP, Seller shall enhance the value of this Security to the amount of twenty percent (20%) of the Contract Price (the "Performance Security") for the due performance of the Contract.
..."

"17.1 Seller's Liability for Certain Liquidated Damages. The aggregate amount payable by Seller to Buyer for all:

- (a) Completion Delay Liquidated Damages shall not exceed the Completion Delay Liquidated Damages Cap; and
(b) Performance Liquidated Damages shall not exceed the Performance Liquidated Damages Cap.

The aggregate amount payable by Seller to Buyer for all Liquidated Damages shall not exceed the Overall Liquidated Damages Cap."

(Emphasis supplied by the Committee.)

From the above, the Committee notes that the Coordination contract limited the maximum amount of liquidated damages, including delay and performance LD, to 15% of the aggregate Contract Price and cumulative overall liquidated damages to 20% of the Aggregate Contract Price.

The Committee further notes that the querist has stated in the facts supplied 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-fulfilment 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".

However, the Committee notes that Service Contract inter alia states that "Completion Delay Liquidated Damages are reasonable, considering the loss of revenues and the actual costs that Owner will incur if Contractor fails to achieve completion of Substantial Completion Balance

of Plant Unit 3 and ... Unit 4 by the respective Guaranteed Substantial Completion Dates. ... such amounts are a reasonable estimate of Owner's probable loss (and are not a penalty) and that such amounts shall be applicable regardless of the amount of such lost revenues and increased costs actually incurred by Owner". Similarly, Supply of Equipment Contract states that "the Liquidated Damages ...are reasonable liquidated damages, considering the actual increased costs and reduction in the value of the Equipment that Buyer will sustain in the event of Seller's failure to achieve any Performance Guarantee. The amounts of the Liquidated Damages are agreed upon and fixed hereunder by the Parties as liquidated damages because of the difficulty of ascertaining the exact amount of such *increased costs* and reduction in value that will actually be sustained by Buyer in the event of any such failure by Seller, and the Parties hereby agree that the Liquidated Damages specified herein are a reasonable estimate of Buyer's probable loss (and not a penalty) and that they shall be applicable regardless of the amount of such reduction in value actually sustained by Buyer". Thus, the clauses of the contract appear to indicate that there is nexus between the liquidated damages and the probable /estimated cost on the contract work and losses (including revenue losses) to be incurred by the Company.

The Committee also notes that paragraph 16 of Ind AS 16 states that the cost of an item of property, plant and equipment comprises of, amongst other things, ... 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. Further, considering the requirements of paragraph 21 of Ind AS 16 (as reproduced above), it can be inferred that income generated or earned from the activities/operations that are necessary for the process of bringing the asset to the location and condition for its intended use can be capitalised. Thus, a judgement is required to be made in the specific facts and circumstances (including the terms of the contract) to determine the nature of income.

Accordingly, the Committee is of the view that in the extant case, if the liquidated damages (income) are received towards compensating extra costs incurred on the project/asset for bringing it into the location and condition for its intended use, the same (to that extent) should be capitalised/included in the cost of the asset/project. However, in other cases, for example, if liquidated damages are received towards compensating revenue losses, the same cannot be capitalised and should be accounted for as income in Statement of Profit and Loss.

23. With respect to the bank guarantee encashed by the Company, the Committee notes that the querist has submitted that, in response to the invocation of the guarantees, the contractor has sought relief by approaching various legal forums to address their grievances. In this regard, the Committee notes that Ind AS 37 states the following:

“53 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.”

From the above, the Committee notes that liquidated damages, which is a type of reimbursement of losses/expenditure incurred by the entity should be recognised when and only when it is virtually certain that the same will be received. In the extant case, since the matter is before legal forum, there appears to be no virtual certainty with respect to receipt of the liquidated damages. Therefore, the Company should not recognise the same either as reduction from CWIP/property, plant and equipment or as income in statement of profit and loss until it is

virtually certain that the amount encashed would not be required to be refunded back to the contractor and therefore, there is no significant uncertainty with respect to the same. Until that point in time, the same shall be treated as a liability in the books of the Company.

D. Opinion

24. Based on the above, the Committee is of the following opinion on the issues raised in paragraph 19 above:

- (i) The treatment of liquidated damages shall depend on the judgement in the specific facts and circumstances. Whether or not the liquidated damages should be adjusted against the project cost would depend upon the fact whether they are received towards compensating extra costs incurred on the project/asset for bringing it into the location and condition for its intended use, in which case, the same (to that extent) will be capitalised as part of the cost of the plant. However, in other cases, for example, if liquidated damages are received towards compensating revenue losses, the same cannot be capitalised and should be accounted for as income in Statement of Profit and Loss, as discussed in paragraph 22 above.
- (ii) Refer (i) above.
- (iii) Refer paragraph 23 above.
