Accounting treatment of liquidated damages

This article aims to:

Provide an overview of the accounting treatment of liquidity damages under current GAAP and impact under Ind AS 115.

Introduction

Under the current Indian Generally Accepted Accounting Principles (GAAP), there is no specific guidance on accounting treatment of liquidated damages under a contract i.e. credits given to the customers on account of delay in delivery under a contract. These credits could be in the form of price discounts, rebates, marketing and spare parts support at concessional or zero cost, etc.

Therefore, an issue arises as to how to account these credits i.e. whether a provision for liquidated damages should be recognised in the statement of profit and loss as and when incurred or it should be reduced from the revenue from such products and services.

In this article, we aim to highlight the accounting treatment of liquidated damages under current GAAP and the corresponding impact under Indian Accounting Standard (Ind AS) 115, *Revenue from Contracts with Customers*.

Accounting treatment under current GAAP

The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI)[1] has considered the issue on accounting of liquidated damages and has issued an opinion on 'Accounting treatment of liquidated damages on unexecuted portion of the contract'.

In the given case, the company has to supply goods to the customer as per the agreed schedule of delivery. However, at a particular time a portion of the contracted supplies is delayed on which customer imposes liquidated damages. Such damages are recovered by the customer for the period of delay between the due date of supply of goods as per the delivery schedule and the actual date of delivery of the said goods.

The issue relates to whether the provision for liquidated damages should be made in respect of unexecuted portion of the contract for the period of delay from the due date of delivery till the date of financial statements or till the date of actual delivery of goods.

The EAC considered the guidance provided by AS 1, *Disclosure of Accounting Policies*, AS 29, *Provisions, Contingent Liabilities and Contingent Assets* and Framework for the Preparation and Presentation of Financial Statements issued by ICAI to resolve the issue.

The EAC noted that in this case there is no clause in the contract to exit from the sales contract(s) entered with the customer, with or without the payment of penalty and the past experience of the company shows that in most cases, although the customers extend the due date of supply, the liquidated damages are recovered in full. Accordingly, the EAC highlighted that the terms and conditions of the sales contract(s) are binding and legally enforceable with the customers.

1. ICAI journal - The Chartered Accountant, September 2014

Based on the given facts, the EAC considered the liquidated damages akin to penalty and provided that there is a contractual obligation on the part of the company to pay for the liquidated damages as soon as there is a delay in the supply of goods beyond the due date as per the delivery schedule.

Further, this obligation cannot be avoided by the company's future course of actions as it does not have any realistic alternative but to settle the contractual obligation (i.e., making the payment of such liquidated damages). Thus, there exists a present obligation arising from past event, viz., delay beyond scheduled delivery and settlement of which is expected to result in an outflow of resources embodying economic benefits.

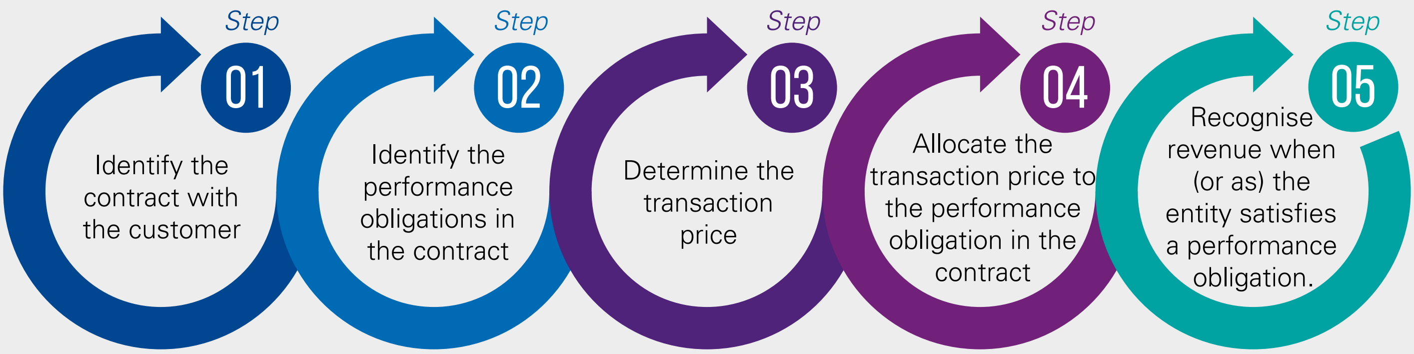
Accordingly, in the given case, the company should recognise a provision in respect of liquidated damages for the period of delay between the due date of supply of goods as per the delivery schedule and the expected date of delivery of the said goods and not only for the period of delay till the date of financial statements, in the light of evidence provided by events occurring after the balance sheet date, as per paragraph 36 of AS 29.

Additionally, the company should disclose its accounting practice in respect of liquidated damages, considering the materiality of the items and transactions and their impact on the financial statements from the perspective of users of financial statements.

Accounting treatment under Ind AS 115

The new standard on revenue recognition for Ind AS compliant companies i.e. Ind AS 115 has been made effective for accounting periods beginning on or after 1 April 2018.

Ind AS 115 provides a new approach of revenue recognition i.e. revenue should be recognised when (or as) an entity transfers control of goods or services to a customer at the amount to which an entity expects to be entitled. To achieve this, the new standard establishes a five-step model that entities would need to apply to determine when to recognise revenue, and at what amount. These are explained in the diagram below:



As per the standard, an entity is required to recognise the revenue at the amount of the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales tax).

The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price.

While determining the transaction price, an entity is required to consider the effects of all of the following:

- Variable consideration
- Constraining estimates of variable consideration
- Existence of a significant financing component in the contract
- Non-cash consideration
- Consideration payable to a customer.

Variable consideration

Ind AS 115 addresses that an amount of consideration could vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items. Additionally, it recognises the penalties involved in a contract in case of delayed delivery. For instance, where an entity agrees to transfer control of a good or service in a contract with customer at the end of 30 days for INR1,00,000 and if it exceeds 30 days, the entity is entitled to receive only INR95,000. Such a reduction of INR5,000 would be regarded as a variable consideration.

Therefore, applying the principles of Ind AS 115 to the given case, the company would need to evaluate and apply judgement to reduce the amount of liquidated damages (as part of variable consideration) from the transaction price.

Further, the company would be required to update the estimated transaction price to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period.

Consider this…

- The accounting of liquidated damages would undergo a significant change under Ind AS *vis-à-vis* current GAAP.
- The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. Also, the impact of consideration payable to a customer is to be considered for determining the transaction price.
- Companies would need to apply the five-step model and accordingly, evaluate the penalties as part of the variable consideration while determining the transaction price.