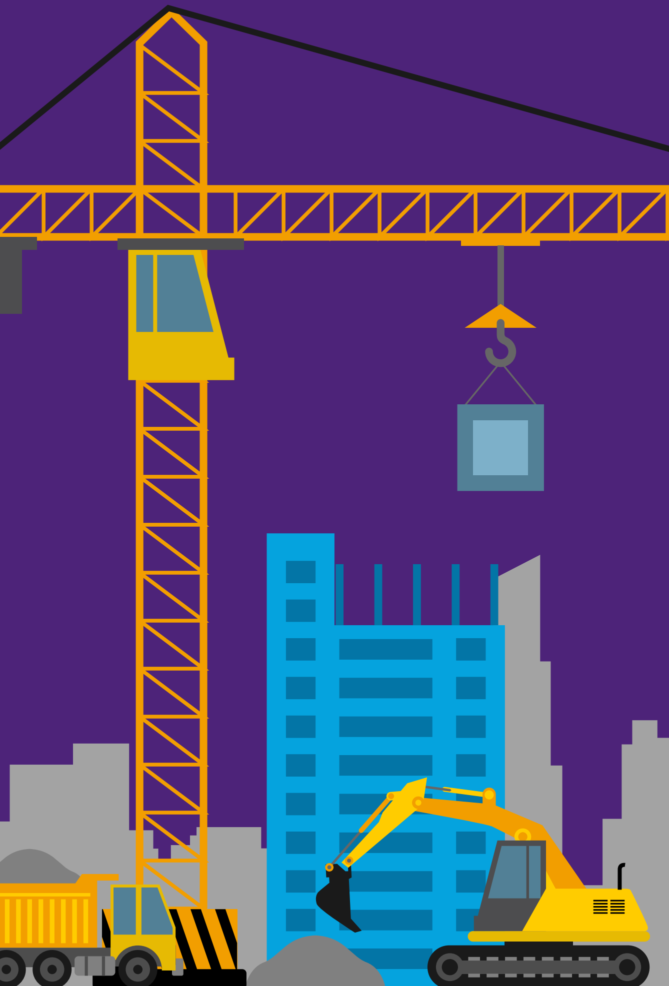
Construction contracts - income from surplus funds



This article aims to:

- Highlight an issue of classification of an item of income into ‘other operating revenue’ and ‘other income’ under current GAAP and Ind AS based on an EAC opinion
- Accounting of surplus funds under Ind AS 115, *Revenue from Contracts with Customers*.

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When an entity follows Ind AS, Part II of Schedule III to the Companies Act, 2013 (2013 Act) provides the format of the statement of profit and loss and specifically requires disclosure of aggregate of 'revenue from operations' and 'other income' on the face of the statement of profit and loss.

Further, note 2(A) to general instructions for the preparation of statement of profit and loss (Part II of Schedule III) requires separate disclosure in the notes, revenue from:

a. Sale of products
b. Sale of services and
c. Other operating revenues.

The aggregate of 'other income' has to be disclosed on the face of the statement of profit and loss. In accordance with the note 4 of general instructions for the preparation of statement of profit and loss 'other income' is required to be classified as:

a. Interest income (in case of a company other than a finance company)
b. Dividend income
c. Net gain/loss on sale of investments
d. Other non-operating income (net of expenses directly attributable to such income).

As mentioned above, revenue from operations and other income has been explained in the Schedule III but term 'other operating revenue' has not been defined under AS/Ind AS or 2013 Act. Lack of definition has resulted in practical issues relating to classification of an item of income into 'other operating revenue' and 'other income'.

The Institute of Chartered Accountants of India (ICAI) has issued a Guidance Note on the Schedule III to the 2013 Act (GN). The GN explains the term 'other operating revenue' and states that it includes revenue arising from a company's operating activities, i.e. either its principal or ancillary revenue-generating activities, but does not include revenue arising from the sale of products or rendering of services. Therefore, whether a particular income would be classified as 'other operating revenue' or 'other income' has to be decided based on the facts of each case and detailed understanding of the company's activities.

In this article, we aim to highlight the issue of classification of an item of income into 'other operating revenue' and 'other income' under AS as well as under Ind AS with the help of an opinion issued by the Expert Advisory Committee (EAC) (the committee) of the ICAI[1] on 'Accounting treatment of temporary income in relation to construction contract'.

Additionally, we will highlight the accounting of surplus funds when an entity would apply Ind AS 115.

Case study - Accounting treatment of temporary income in relation to a construction contract

A Ltd. (the company) is in the business of construction of warships. The contracts are awarded to A Ltd. on fixed price basis except certain variable components such as foreign exchange variation and cost of spares, etc. The terms of the contract are as follows:

- The payment for fixed price part is on the basis of completion of milestones. The payment terms for fixed price portion of the contract are generally spread over 10-12 milestones starting with initial payment of 10 per cent on signing of the contract.
- The payment for variable component is based on actual cost to A Ltd.

A Ltd. recognises revenue on the basis of percentage of completion method as per AS 7, *Construction Contracts.*

As the gestation period of the contracts for shipbuilding is longer, it so happens that during initial period when the funds are made available, such funds become temporarily surplus funds for A Ltd. However, in the later part of execution of the contract, the cost incurred on the project exceeds the stage payments received on the vessel leading to a negative cash flow. Further, the last stage payment of the project is deferred till one year after the delivery of the vessel.

Accordingly, A Ltd. deploys such surplus funds in short-term fixed deposits. The interest earned initially on the temporary surplus compensates to a certain extent for the period of deficit cash flow for A Ltd., especially at the later part of the execution of the project.

Issue

A Ltd. needs to assess whether the interest earned on deposits of temporary surpluses of milestone payments should be considered as 'other operating revenue' or 'other income' to be presented in the statement of profit and loss

1. EAC opinion issued by ICAI in January 2018.

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Guidance under AS

The classification of income would also depend on the purpose for which the particular asset is acquired or held. For example, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is continuously engaged in leasing of real estate properties, then the rent arising from leasing of real estate is likely to be classified as 'other operating revenue'. However, if a consumer products company which owns a 10 storied building, gives one of the floors in the building temporarily on rent, then lease rent would not be classified as 'other operating revenue'; rather, it would be classified as 'other income'.

With respect to other income, the GN provides that all kinds of interest income for a company other than a finance company should be disclosed under 'other income'. Examples of other income are interest on fixed deposits, interest from customers on amounts overdue, etc.

Accordingly, in the given case, since A Ltd. is engaged in construction of warships, the amount of interest income from temporary investments of milestone payments cannot be classified as 'other operating revenue'; rather the same should be classified as 'other income'.

Guidance under Ind AS – presentation of other income

The Ind AS based Schedule III to the 2013 Act (Division II) and Ind AS 1, *Presentation of Financial Statements* also provide similar basis (as explained in AS) of classification of an income into 'other operating revenue' and 'other income'.

Further, the Ind AS Transition Facilitation Group (ITFG) in its Bulletin 13 (Issue 5)[2] also clarified that disclosure of income in the financial statements should be governed by the GN on Ind AS Schedule III. According to the GN on Ind AS Schedule III, interest income for financial assets measured at amortised cost and for financial assets measured at Fair Value Through Other Comprehensive Income (FVOCI), calculated using effective interest method, should be presented in separate line items under 'other income'.

Therefore, the interest income from surplus funds would be presented as other income (as per opined in the committee's decision).

Treatment under Ind AS 115 - Significant financing component in a contract

In this case, A Ltd. is in the business of construction of warships and would need to consider the new standard on revenue recognition i.e. Ind AS 115. This standard is 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 as follows:

- **Step 1:** Identify the contract with the customer
- **Step 2:** Identify the performance obligations in the contract
- **Step 3:** Determine the transaction price
- **Step 4:** Allocate the transaction price to the performance obligation in the contract
- **Step 5:** Recognise revenue when (or as) the entity satisfies a performance obligation.

At step 3, an entity has to determine its transaction price. This step also requires an entity to consider the effects of a significant financing component in the contract. In the case of significant financing, an entity should adjust the promised amount of the consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.

The objective for adjusting the promised amount of consideration for a significant financing component is that an entity should recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (i.e. the cash selling price).

In a construction contract, it is common that certain amount is received as an advance from customer in the initial period. Also certain amount is withheld as retention money based on the terms of the contract, which is not paid until the satisfaction of conditions specified in the contract or until the defects, if any, have been rectified.

The new standard also includes a practical expedient that allows entities to not account for a significant financing

2. ICAI-ITFG Clarifications' Bulletin 13 dated 16 January 2018.

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component if the period between the payment and performance is 12 months or less. For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for the performance is one year or less.

In the given case, if the period between milestone payments and performance is more than one year then it should evaluate if it has received any significant benefit of financing. A Ltd. has received advance payments from the customer for providing promised goods or services, then it would need to evaluate whether the payment terms provide it with a significant benefit of financing. While making such an evaluation judgement is to be exercised and consideration be given to factors such as whether the arrangement has been entered in the normal course of business, the advance payment is per typical payment terms within industry and having a primary purpose other than financing, it is a security for future supply of limited goods or services or other relevant factors depending on facts and circumstances of each case.

Therefore, A Ltd. would need to firstly consider the period between the performance and payment for that performance. For contracts where revenue is recognised at a point in time, the period considered would be between transfer of control of the good and the payment. For over-time contracts, the analysis is the same as for point-in-time. However, the amount being financed will change over time as the entity performs its obligations under the contract. This is because only the portion of the property not yet transferred to the customer is still being financed.

Apart from period between performance and payment, the effect of deferred and advance payments would also need to be considered. Advance payments from the customer lead to higher amount of revenue being recognised than contract price because the entity accepts a lower amount in return for financing. The entity would recognise interest expense related to the financing component and a corresponding liability/ revenue.

However, deferred payments reflect that the entity provides finance to the customer and therefore, the amount of revenue recognised would be less than the contract price and the entity needs to recognise the difference as finance income.

The effects of financing (i.e. interest revenue or interest expense) are to be recognised separately from revenue from contracts with customers in the statement of profit and loss.

In some circumstances, there could be retention money that would be paid by the customer on completion of obligation under the contract. In such cases, Ind AS 115 explicitly states that a contract would not have significant financing payments. However, advance or deferred payments by a customer are not exempted from the evaluation for time value of money.

Therefore, an entity would need to consider the time value of money of both advance and deferred payments to determine the existence of significant financing component in a contract.

Consider this

- The statement of profit and loss specifically requires disclosure of aggregate of 'revenue from operations' and 'other income' on the face of the statement of profit and loss.
- Whether a particular income constitutes 'other operating revenue' or 'other income' has to be decided based on the facts of each case and detailed understanding of the company's activities.
- Under the new revenue standard (i.e. Ind AS 115), companies would be required to evaluate the existence of significant financing component in a contract, particularly in contracts involving advance or deferred payments.
- If it is concluded that a significant financing component is present, then resultant interest income (when the customer pays in arrears) or interest expense (when the customer pays in advance) would not be presented as revenue; rather these would be recognised as finance income or expense in the statement of profit and loss.

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