CHAPTER 2

Presentation of delayed payment charges in the financial statements

This article aims to:

Provide guidance on accounting for Delayed Payment Charges (DPC) and covers a recent EAC opinion issued on the same topic.

Overview

Determination of transaction price is a critical step while accounting for revenue under Ind AS 115, *Revenue from Contracts with Customers*. 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, certain sales taxes). An entity needs to consider multiple factors while determining the transaction price of a contract, for example, the inclusion of a variable consideration, a financing component, etc.

As businesses and contracts evolve, further analysis would be needed for an entity to apply the requirements of Ind AS 115 to its own facts and circumstances and individual transactions.

In this context, recently, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) deliberated on the accounting for Delayed Payment Charges[1] (DPC) collected by a company from its customers[2].

This article aims to discuss some of the key factors considered by the EAC while opining on the accounting and presentation of DPC in the statement of profit and loss and the statement of cash flows.

Facts of the case

Company A (the Company) is engaged in the business of distribution of electric power to consumers. While charging tariff to its consumers, the company also collects DPC in case the consumers pay the tariff post the due date. The DPC is charged as per the tariff order of the State Electricity Regulatory Commission (SERC) Regulations.

The management of the Company believes that DPC is in the nature of penalty and is charged to customers in the normal course of business. It accounts for DPC in the year of its realisation, as 'Income from other operating activity' under Revenue from Operations and 'Cash flows from operating activities' in the statement of cash flows.

Considering these facts, the EAC opined on the presentation and disclosure of the DPCs received by the Company, in the statement of profit and loss and the statement of cash flows of the Company.

1. A delayed payment is a charge imposed by an entity on its customers on account of failure to meet the due date of payment for the supply of goods/services. Such payments costs an entity time and money that impacts its financial forecasts.
2. Query 12- Volume XLII- Accounting treatment of delayed payment charges

Overview of the EAC opinion - DPC on the basis of number of days of delay

The EAC considered the facts of the case and opined on the (1) presentation and disclosure of DPC in the statement of profit and loss, and (2) presentation of DPC in the statement of cash flows.

Presentation of DPC in the Statement of Profit and Loss

The EAC clarified that the accounting treatment including presentation and disclosure of an item of income/expense depends on its nature and not the nomenclature used for the same. Based on this, EAC evaluated the requirements of Ind AS 115 with regard to determination of transaction price of a contract, and assessed whether DPC would be presented and disclosed as a variable consideration or as a significant financial component in the contract. Please refer figure 1 on the next column for further deliberation on the same:

Figure 1

Presentation of DPC in the statement of profit and loss

Variable consideration
Considered as a part of operating revenue

- DPC is a charge to be paid by the customers towards delay in payment and is not towards exchange of promised goods and services to the customer
- DPC cannot be considered as a penalty, which is a variable consideration covered under paragraph 51AA of Ind AS 115

DPC is not variable consideration

Significant financing component
Considered as other income

- DPC are charges to the customers who have not paid the bill within due date as per the tariff schedule
- DPC are defined in terms of percentage per annum, which indicates that the same is directly linked with the passage of time and the quantum of the same depends on the timing of payment by the customers.

DPC would be a significant financing component in the contract*

* This would be the case if the financing component in the contract is significant and the practical expedient is not applied where time period between transfer of goods or services and payment being made is one year or less.

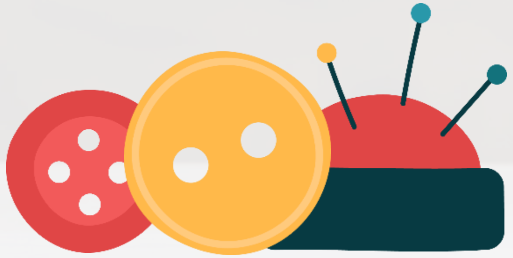
(Source: KPMG in India's analysis, 2023, read with EAC opinion- Query 12- Volume XLII- Accounting treatment of delayed payment charges)

Analysis

DPC as a variable consideration

Ind AS 115 provides that while determining the transaction price, an entity should adjust the promised amount of consideration for the effects of *inter alia*, variable consideration, such as discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalty, or other similar items. With regard to penalty clause in a contract, paragraph 51AA of Ind AS 115 states that in cases where penalty is inherent in the determination of transaction price, it should form a part of variable consideration.

In this case it was noted that the transaction price was fixed at the rate or price specified by the SERC for the electricity supplied. DPC is a charge paid by the customers towards delay in payment based on the number of days of delay and is not towards exchange of promised goods and services to the customer.



Additionally, penalty covered in paragraph 51AA refers to the penalty paid by an entity to its customers based on its own performance of the contract. However, since DPC is a levy on customers for default on their part, it cannot be considered as a penalty covered under variable consideration as per the requirements of Ind AS 115.

Accordingly, the DPC would not be accounted for as a variable consideration that would need to be incorporated in the transaction price of the contract.

Significant financing component in a contract

Part A- Financing component should be separated or included as a part of revenue

A contract contains a significant financing component if the timing of payments agreed upon by the parties to the contract, provides either of them with a significant benefit of financing the transfer of goods or services to the customer. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract. As per Ind AS 115, the consideration amount should be adjusted for the effect of significant financing component to determine the transaction price.

Ind AS 115 provides a practical expedient, which if availed, does not require an entity to adjust the transaction price for the effects of a significant financing component if the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. Additionally, it is clarified that the significance of a financing component should be considered at a contract level and not at a portfolio level.

A contract with significant financing component has two distinct economic characteristics –

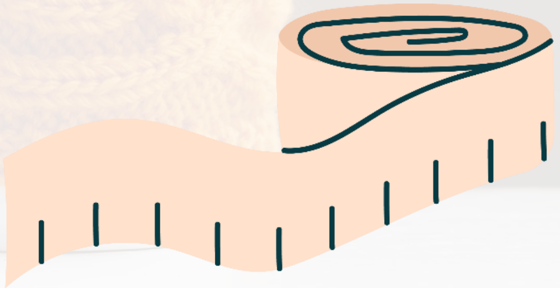
Figure 2: Economic characteristics of a contract with a significant financing component

Total transaction price

Consideration for transfer of goods or services + Consideration for the financing arrangement

(Source: KPMG in India's analysis, 2023 read with Ind AS 115)

Basis the above bifurcation, such contracts need to be accounted for and presented separately[3].



3. A contract with a customer that has a significant financing component would be separated into a revenue component (for the notional cash sales price) and a loan component (for the effect of the deferred or advance payment terms)- as an interest expense or interest income.

In the current case, the terms for late payment from the due date of payment are expressly provided in the tariff schedule, which is binding on both the buyer as well as the Company. Further, the DPC is defined in terms of percentage per annum (and varies with the number of days of delay), which indicates that the same is directly linked with the passage of time and the quantum of the same depends on the timing of payment by the customers. Thus, the amount of consideration varies due to difference in timing of payments (as the consideration will increase with increase in timing of payment). Therefore, considering the requirements of Ind AS 115, EAC was of the view that the DPC was of the nature of financing component and if such component is significant at the contract level, considering the facts and circumstances of the Company and specific requirements of Ind AS 115, the Company should not consider the same as part of its transaction price and revenue.

However, as a practical expedient, if the Company expects, at contract inception, that the period between when it transfers the promised good or service to a customer and when the customer pays for that good or service will be one year or less, it **need not make adjustments** for the effects of significant financing component while recognising revenue.

Part B- Presentation and disclosure of financing component

As per the guidance note on Schedule III-Division II, whether a particular income constitutes “other operating revenue” or “other income” is based on the facts of each case and detailed understanding of a company’s activities. It would also depend on the purpose for which the asset is acquired or held[4].

In this regard, EAC considered that the business of the Company is distribution of power. Accordingly, levy and collection of DPC is not the intended or ancillary activity of the Company. Thus, although income from DPC arises during the course of normal operating activities of the Company of sale of goods and services, the same cannot be considered to arise from or on account of such goods or services or from other operating activities as these are essentially due to delay in payment for such goods or services (viz., receivables) and therefore DPC is over and above the receivables for goods or services or the output of other operating activities.

DPC being a financing component, if it is significant and the practical expedient is either not applied or not applicable as per the requirements of Ind AS 115, the same cannot be considered as ‘Other Operating Revenue’ under the head ‘Revenue from Operations’ in the Statement of Profit and Loss; rather the same should be presented as **‘other income’ in the Statement of Profit and Loss**.

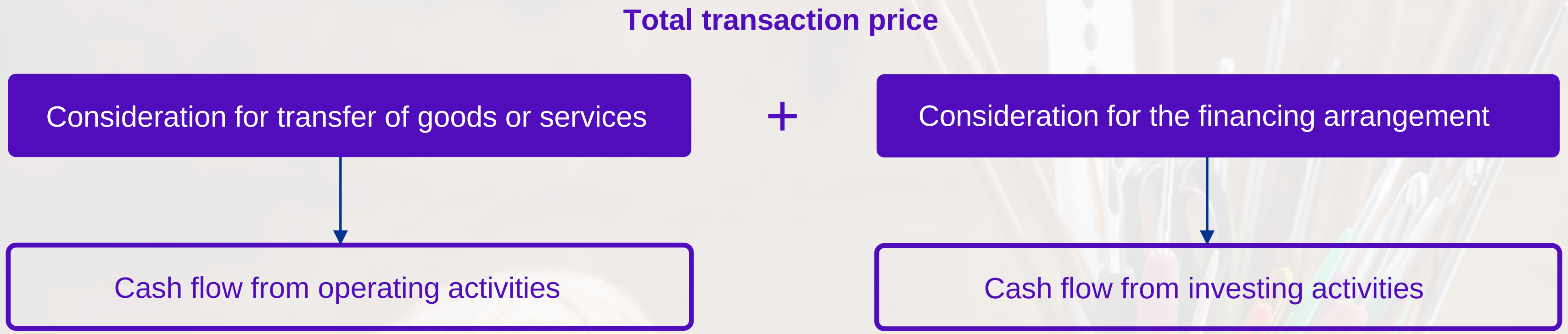
4. For example, lease of property does not fall under the category of operating activities for a manufacturing company and hence the income on such a transaction should be classified as other income and not other operating revenue. However, in case of a real estate company the lease of one of its properties should be treated as other operating revenue since the same arises on account of the company’s main operating activity.

Presentation of DPC in the Statement of Cash Flows

Ind AS 7, *Statement of Cash Flows* establishes the principles for classification of interest and dividend in case of financial institutions and other entities. From the perspective of a financial institution, cash flows arising from interest paid and interest and dividends received should be classified as cash flows arising from operating activities. However, there is no consensus in classification of these cash flows for other entities. For such entities, it is appropriate that cash flows arising from interest paid should be classified as cash flows from financing activities[5] while interest and dividends received should be classified as cash flows from investing activities[6].

Further, Ind AS 7 clarifies that a single transaction may include cash flows that are classified differently.

Figure 3: Bifurcation of cash flows of a transaction including a significant financing component



(Source: KPMG in India's analysis, 2023, read with Ind AS 7)

Accordingly, in the current case, as given in Figure 3 above, the cash flows arising from the customers on account of sale of goods and services would form part of cash flows from operating activities, whereas cash flows on account of DPC need not necessarily be cash flows from operating activities. Since DPC represents the financing component of the contract, it would be akin to return earned on the Company's resources that it has unintentionally invested (i.e. return on its receivables)[7]. Accordingly, this would be classified as cash flows from investing activities.

Disclosure of DPC which is a flat charge, in the cash flow statement

In a separate query[8], EAC clarified that delayed payment charges which are fixed, irrespective of the number of days of delay should be further evaluated by the company while determining their presentation in the cash flow statement. Where such charges in substance represent a compensation for time value of money, they should be presented as 'cash flows from investing activities', and where it represents compensation for some other element (say penalty), it should be considered and presented as 'cash flows from operating activities'.

5. This is because they are costs of obtaining financial resources
6. This is because they are returns on investments
7. It is to be noted that Ind AS 7 does not differentiate between investments made by the entity out of its own will or intent and those which are circumstantial, i.e., arising out of circumstances, as is in the current case.
8. EAC query 18- Volume XXXIX- Disclosure/classification of late payment interest charges collected from customers in the statement of cash flows.