Work-in-progress in a Consultancy Organisation

Expert Advisory Committee

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A public sector undertaking registered under the Companies Act, 1956, is under the administrative control of the Ministry of Railways. The company provides services in all the facets of transportation engineering in India and abroad. It also exports rolling stocks and locomotives. It has income from consultancy fees, inspection, export sales, leases and other incomes.

2. The accounts of the company are audited by statutory auditors appointed by the Comptroller and Auditor General of India (C&AG) and reviewed by C&AG. During the course of audit of accounts for the financial year 2004-05, the statutory auditors expressed reservation that "the company is not having a system of identifying work-in-progress in respect of on-going contracts, thus, resulting into the accounts not being maintained on accrual system of accounting".

3. The querist has stated that revenue from leases, export sales, inspection, project management/construction supervision and time based consultancy fee contributes 80% of the business of the company leaving only a minor part of the consultancy fee based on stage completion projects. According to the querist, in 80% of the business of the company, expenditure is booked on matching concept basis. As per the querist, for consultancy projects, where stage payments are involved, consultancy fee is accounted for, as per international industry practice, on a stage billing basis and expenses are not carried forward as is the usual practice in the process or manufacturing industry.

4. The querist has further stated that the nature of consultancy projects, involving stage payments, generally undertaken by the company, by way of illustration are: (a) Feasibility Studies; (b) Traffic Studies; (c) Design & Detailed Engineering; (d) Environmental Impact Studies; (e) Systems Studies; etc. The stages of payment could include (a) Mobilisation fee; (b) Submission of Inception Report; (c) Collection/Compilation of data/preliminary design/drawing; (d) Submission of detailed analysis/drawing for client perusal; (e) Draft final report and (f) Final report. However, there could be additional/intermediary stages depending on the nature of assignment. According to the querist, consultancy projects involve no construction of asset(s).

5. According to the querist, such projects, except a few, are small in value but more in number. An analysis of major contracts of this nature which represent nearly 80% of such projects, was done to work out work-in-progress amount and it was found that Rs. 40 lakh was incurred on manpower and other costs as on 31st March, 2005, which is only 0.2% of the turnover of the company and 0.23% of the total expenditure (excluding extraordinary items), which is not material.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on the following issues:

(i) Whether work-in-progress is applicable to consultancy business.

(ii) If it applies, whether it is necessary to have a system to identify work-in-progress, where such projects are small in value and large in number, as the amounts involved are likely to be not material and results not commensurate with the efforts in terms of time and cost.

C. Points considered by the Committee

7. The Committee notes that paragraph 4 of Accounting Standard (AS) 7, 'Construction Contracts', issued by the Institute of Chartered Accountants of India, provides the following:

"4. For the purposes of this Statement, construction contracts include:

(a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

(b) contracts for destruction or restoration of assets, and the restoration

of the environment following the demolition of assets."

8. From the above, the Committee is of the view that AS 7 would apply to revenue recognition of consultancy fees received only in respect of those service contracts which are directly related to the construction of an asset. However, since the issue under consideration is the service of providing consultancy in relation to the engineering projects which involve no construction of asset(s), revenue should be recognised in accordance with the principles in this regard enunciated in Accounting Standard (AS) 9, 'Revenue Recognition', issued by the Institute of Chartered Accountants of India.

9. The Committee notes that in respect of transactions involving rendering of services, AS 9 provides that "performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished" (paragraph 12). The Standard explains the two methods of revenue recognition and the situations when the respective methods should be adopted in paragraph 7.1 which provides as below:

"7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) Proportionate completion method—Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) Completed service contract method—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable."

10. From the above, the Committee is of the view that the company needs to ascertain the nature of each of the consultancy projects undertaken by the company, especially with reference to the number of acts required for execution of the contract, since the method to be adopted for recognition of revenue, i.e., the proportionate completion method or the completed service contract method, would depend on the number of acts required to perform the consultancy contract. The stages of payment, as stated by the querist in paragraph 4 above, may not necessarily be the determining factor for the method to be adopted for recognition of revenue.

11. The consultancy projects, for which the proportionate completion method is applicable on the basis of considerations stated in paragraphs 9 and 10 above, the revenue is ordinarily recognised on the basis of the costs incurred till the stage of completion achieved. In such cases, there would be work-in-progress for incomplete stages of contract in respect of which no corresponding revenue is recognised till the date of completion of that stage. In cases where the completed service contract method is applicable on the basis of considerations stated in paragraphs 9 and 10 above, revenue is recognised on the substantial performance of the contract. The costs incurred in respect of such projects should be recognised as work-in-progress and carried forward to be expensed in the year in which the corresponding revenue is recognised.

12. With regard to the materiality aspect, raised by the querist in paragraph 5 above, the Committee notes that paragraph 4.3 of the Preface to the Statements of Accounting Standards, issued by Institute of Chartered Accountants of India, states, inter alia, that "The Accounting Standards are intended to apply only to items which are material". The Committee further notes that paragraph 17(c) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', explains 'materiality' as below:

"*c. Materiality*

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements."

13. The Committee also notes that paragraph 3 of Auditing and Assurance Standard (AAS) 13, 'Audit Materiality', issued by the Institute of Chartered Accountants of India, explains, inter alia, that, "Materiality depends on the size and nature of the item, judged

in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful". It further states, inter alia, in paragraphs 4 and 5 respectively, that "the assessment of what is material is a matter of professional judgement" and "the concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices".

14. From the above, the Committee is of the view that the threshold of materiality is applicable to all items of financial statements. If an information is not material, on the consideration of materiality as mentioned in the paragraphs 12 and 13 above, its accounting would not have any effect on the decisions of the users of the financial statements. Accordingly, it needs to be determined under the specific facts and circumstances of the company concerned as to whether work-in-progress related to consultancy projects, if not disclosed, can influence the decisions of the users of the financial statements. For this purpose, apart from the percentage of expenditure and turnover, other factors such as nature of the item, impact on profit/loss etc., should also be considered. Moreover, materiality concept should be seen with respect to the aggregate or the total amount of all the consultancy contracts rather than with respect to each individual contract.

D. Opinion

15. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 6 above:

(i) Work-in-progress is applicable to consultancy business as explained in paragraph 11 above.

(ii) Answer to this question would depend upon the considerations of materiality determined on the basis described in paragraph 14 above. ❐

Notes:

1. *The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.*
2. *The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.*