

## Applicability of revised AS 7 to enterprises undertaking construction activities on their own account as a venture of commercial nature

*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 company is a joint sector enterprise promoted jointly by West Bengal Housing Board and another private sector company. The company is engaged in the business of developing mass scale housing projects, which, inter alia, include development of small commercial complexes (hereinafter collectively referred to as 'housing projects').

2. The aforesaid activities are undertaken by the company on its own account and not on contractual basis, i.e., on a project being conceived, designs and drawings are finalised, land is procured, some initial developmental activities are carried out by the company, and thereafter flats/commercial spaces (shop, office, etc.) are offered to the public for booking/sale through advertisements followed by allotment of the same usually by way of lottery to the successful allottees (eventual owners). Allotment is documented by way of an allotment letter to each allottee. The letter bears reference to the brochure (i.e., offer document), which, inter alia, contains various terms and conditions. Consideration for a flat/commercial space is payable in a phased manner normally linked to various stages of completion of construction. Major construction activities pertaining to buildings are usually undertaken after allotment process as aforesaid is over. After completion of construction, possession of flats/commercial spaces is handed over to the respective allottees followed by execution of deeds/other legal documents in their favour evidencing ownership of properties.

3. The company has, hitherto, been recognising revenue under percentage of completion method and valuing

*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 21 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.*

work-in-progress in its books of account as per Accounting Standard (AS) 7, 'Accounting for Construction Contracts', issued by the Institute of Chartered Accountants of India in December 1983, as the said Standard was also applicable to enterprises undertaking construction activities not as contractors but on their own account as a venture of commercial nature.

4. AS 7 has recently been revised and the same comes into effect in respect of all contracts entered into during accounting periods commencing on or after 01.04.2003, for the purpose of preparation of the financial statements of the contractors. The revised AS 7 is silent about its applicability to construction activities undertaken by enterprises on their own account and not as contractors.

### B. Query

5. In the light of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (a) Whether the revised AS 7 would be applicable to the company for accounting for new housing projects, which may be undertaken by the company on or after 01.04.2003 on the same business model as mentioned in the facts of the case.
- (b) In case revised AS 7 is not applicable to the company, whether the company can value its inventories in accordance with Accounting Standard (AS) 2, 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India, considering the definition of inventory as 'an asset in the process of production for the purpose of sale', i.e., whether the activity of developing housing projects on its own account as a commercial venture by the company can be construed as a production activity.
- (c) If the activities of the company cannot be considered as a production activity and consequently AS 2 is also not applicable, which Accounting Standard should be followed for recognition of revenue and valuation of its construction work-in-progress?

### C. Points considered by the Committee

6. The Committee notes that Accounting Standard (AS) 7, 'Accounting for Construction Contracts', issued by the Institute of Chartered Accountants of India in December 1983, states in paragraph 1 that "The Statement also applies to enterprises undertaking construction activities of the type dealt with in this Statement not as contractors but on their own account as a venture of a commercial nature where the enterprise has entered into agreements for sale". Therefore, the Standard was applicable to the activities carried on by the company as stated in paragraphs 1 and 2 above. The Committee also notes that the revised Accounting Standard (AS) 7, 'Construction Contracts', issued by the Institute of Chartered Accountants of India in 2002, does not contain the aforesaid sentence contained in the pre-revised AS 7. On the other hand, paragraph 1 of revised AS 7, clearly states that, "***This Statement should be applied in accounting for construction contracts in the financial statements of contractors.***" Therefore, the Committee is of the view that the revised AS 7 is not applicable to such enterprises.

7. On the basis of the above, the Committee is of the view that for the purpose of recognition of revenue and valuation of inventories by the company in question, the principles as contained in Accounting Standard (AS) 9, 'Revenue Recognition' and Accounting Standard (AS) 2, 'Valuation of Inventories', respectively, would be applicable.

8. The Committee notes that the term 'inventories' has been defined in paragraph 3 of AS 2 as below:

***"Inventories are assets:***

- (a) held for sale in the ordinary course of business;***
- (b) in the process of production for such sale; or***
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."***

9. The Committee notes that the activities carried on by the company under consideration as explained in paragraphs 1 and 2 above, cannot be construed as rendering of services. The construction activities carried on by the company are of the nature of production activities. Accordingly, in terms of the above definition of the term 'inventories', the Committee is of view that the company should value the completed projects as inventories held-for-sale in the ordinary course of business; the semi-finished housing projects as inventories in the process of construction for such sale; and materials and supplies held for use in the housing projects as inventories in the form of materials or supplies to be

consumed in the construction process.

10. In respect of recognition of revenue by the company, the Committee notes paragraphs 10 and 11 of AS 9, which state as below:

***"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.***

***11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:***

- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and***
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."***

11. The Committee is of the view that revenue should be recognised by the company in respect of its housing projects only when the conditions in respect of sale of goods as aforesaid are satisfied.

### D. Opinion

12. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

- (a) The revised AS 7 would not be applicable to the company for accounting for new housing projects which are undertaken by the company during the accounting periods commencing on or after 1.4.2003.
- (b) The activity of developing housing projects on its own account as a commercial venture by the company is of the nature of production activity and, therefore, should be construed as such. The inventories should be valued by the company in accordance with AS 2 as explained in paragraph 9 above.
- (c) AS 2 is relevant for valuation of inventories including construction work-in-progress and not for recognition of revenue. AS 9 would be relevant for recognition of revenue. ■