Query No. 12

Subject: Revenue recognition in case of construction contracts.[1]

A. Facts of the Case

1. A public sector company (hereinafter referred to as the 'company'), listed in the stock exchanges at NSE and BSE, is engaged in the field of engineering, manufacture of equipments, erection and commissioning of power projects. In addition, the company is in the business of transportation, transmission and defence, etc. In power project business, the contracts received by the company are either Engineering, Procurement and Construction (EPC) contracts or Boiler, Turbine and Generator (BTG) Packages, where civil works and Balance of Plant (BOP) package items are not in the scope. The normal execution period of a contract ranges between 3 to 5 years. The scope of the contract includes supply of equipments, erection, commissioning, ensuring guaranteed output from the machines, completing the trial operation and synchronising the plant to the grid. The normal warrantee/guarantee period is between 18 to 24 months. The company has 15 manufacturing units, 4 power sector regions, service centers and regional offices besides project sites spread all over India and abroad. The responsibility of manufacturing units is engineering, manufacture and supply of the equipments as per the agreed specifications whereas the power sector regions/site offices are responsible for erections, commissioning, purchase of BOP items and civil works (for EPC contracts). Conducting trial operations and synchronising the power station to the grid are also the responsibility of the power sector regions.

2. The querist has stated that long-term construction contracts are obtained by the company's marketing wing which allocates the scope and value to various manufacturing units and regions/sites for execution. The units/regions bill the customer based on the Billing Break Up (BBU) agreed with the customer. The billing to the customer is based on agreed terms and conditions either based on BBU and in few contracts, on reaching certain milestones. According

[1] Opinion finalised by the Expert Advisory Committee on 12.08.2011.

to the querist, the billing value may not represent the true value of the despatches or the project progress at the site. The billing is mainly to ensure cash flows. Hence, the turnover for a period is arrived at after adjusting the value of works done to the billed amount through valuation adjustment account.

3. The accounting policy of the company for revenue recognition in respect of construction contracts is stated by the querist as below:

A. For construction contracts entered into on or after 01.04.2003

"Revenue is recognised on percentage completion method based on the percentage of actual cost incurred upto the reporting date to the total estimated cost of the contract."

4. The accounting practice in respect of construction contracts covered under Accounting Standard (AS) 7 (revised 2002), 'Construction Contracts' is as below:

For working out the percentage of completion, the following accounting practice is being followed from the financial year 2003-04. The percentage of completion is worked out based on actual cost incurred upto reporting period divided by total estimated cost of the contract. Total estimated contract cost is worked out based on actual cost incurred plus estimated remaining cost to complete the work at the end of the reporting period. Actual cost incurred upto reporting period is worked out as follows:

(a) By manufacturing units

Actual cost incurred for each contract is worked out based on actual cost incurred upto the reporting date in respect of items *manufactured and physically despatched to the project site* (emphasis supplied by the querist). Raw materials, stores and spares procured by the units and work in progress (WIP), which are not a despatchable unit are not considered as actual cost incurred for the purpose of working out the percentage of completion. Similarly, finished goods, which are lying at unit and not physically

despatched from manufacturing unit to project site are not considered for the purpose of calculating actual cost incurred for working out percentage of completion for revenue recognition. The costs incurred on above are recognised as inventory in the accounts.

(b) By power sector regions/sites

Actual cost incurred towards engineering, commissioning, etc. by region/site is considered for working out percentage of completion for revenue recognition. Further, items like steel, cement and bought-outs directly supplied from supplier to project site and billed to the customer are also considered as part of actual cost incurred for working out percentage of completion for revenue recognition. Cost incurred in design and drawings for a project till milestones as per billing schedule, is exhibited as Contract WIP and no revenue is recognised till such date. Actual costs incurred including manhours spent, engineering, designing cost, etc. are part of actual cost incurred upto the reporting period.

5. The querist has stated that in case of construction contacts covered under AS 7 (revised 2002), normally more than one manufacturing unit/region of the company are involved for execution of the contract. Each unit/region of the company recognises its revenue in respect of allocated scope of work in their books based on the above accounting practice. Since the percentage of completion with respect to a contract will differ for each unit/region of the company which is based on the progress of their scope of work, there is a need to work out the percentage of completion of a contract for the contract as a whole to recognise the revenue in line with the requirements of AS 7 (revised 2002). The total contract revenue, actual cost incurred upto the reporting period, estimated total cost at the end of the reporting period, etc. are consolidated based on the inputs given by units/regions involved in a contract to concerned business sector to work out the percentage of completion at the total contract level and any adjustment between revenue recognised by unit and revenue to be recognised at overall contract level is made by the business sector. The difference between the revenue recognised by the

unit/regions and revenue as worked out on consolidated level are recognised through valuation adjustment account in the accounts of business sector.

6. The querist has further stated that percentage of completion is worked out based on the actual cost incurred upto the reporting period based on the above as a percentage to the total estimated cost of the contract. The percentage as worked out is multiplied with the total estimated contract revenue to determine revenue upto the reporting period. The same is recognised as revenue upto the reporting period.

7. The disclosures made in the notes to accounts pursuant to AS 7 (revised 2002) have been stated by the querist as follows:

(a) Contract revenue recognised for the year as per AS 7 (revised 2002)

(b) In respect of contract in progress at the end of the year

-Cost incurred and recognised profit (less recognised losses)

-Amount of advance received

-Amount of retentions (deferred debts)

(c) In respect of dues from customers after appropriate netting off

-Gross amount due from customer for the contract work as an asset

-Gross amount due to customer for the contract work as a liability

-Contingencies

The following note is also given:

> "The estimates of total costs and total revenue in respect of construction contracts entered on or after 1st April, 2003 in accordance with Accounting Standard (AS) 7 (revised 2002), 'Construction Contracts' are reviewed and updated periodically during the year by the management and necessary adjustments are made in the current year's account."

8. During the audit of annual accounts for the financial year 2009-10, the querist has informed that the Government audit has raised the following queries:

(a) Revenue in respect of construction contracts is to be recognised on percentage of completion method based on the percentage of actual cost incurred upto the reporting date to the total estimated cost of the contract as per the significant accounting policy of the company. However, in contravention to its accounting policy, the company is considering the ratio of cost of despatches to the total estimated cost instead of the ratio of actual cost incurred upto reporting date to the total estimated cost for recognition of revenue from construction contracts.

(b) The Government audit is of the view that the cost of steel/cement purchased at project sites specific to the projects which has been billed to the customers as per BBU and in respect of which certain percentage of the money is also collected, is not to be treated as cost incurred, since these materials have not been put to use/or consumed in the construction activities. In the view of the Government audit, these materials are required for future activity of civil and structural work to be done subsequently and cannot be considered as cost incurred for working out percentage of completion for revenue recognition.

(c) Further, the Government audit is of the view that the estimated contract revenue and estimated contract cost in respect of construction contracts covered under AS 7 (revised 2002) are dynamic in nature and undergo series of changes in executing the contract, i.e., for projects which existed at opening of financial year and continuing at the end, there is a change in the estimated contract revenue and estimated cost of a contract due to factors given below, which have an effect on the turnover and profit for the year. In the view of the Government audit, in terms of paragraph 37 of AS 7 (revised 2002) it is a change in accounting estimate and

the impact should have been disclosed in the accounts considering the requirements of AS 7 (revised 2002) and Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

9. The company has expressed its views as follows:

(a) In case of manufacturing units

Paragraph 26 of AS 7 (revised 2002) reads as follows:

> "A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress."

Actual cost incurred towards purchase of raw material, stores, spares etc., work in progress at the manufacturing units, as well as finished goods at stores, not physically despatched from manufacturing units to project sites are for future activity and hence, cannot be considered as part of actual cost incurred in ascertaining the percentage of completion. Therefore, accounting treatment of showing these as part of inventory, contract WIP/finished goods is in order.

The wording of the accounting policy, i.e., 'actual cost incurred' is in line with the words used in AS 7 (revised 2002) and it should not be linked with the cost of purchases of raw material, stores and cost incurred on WIP/finished goods, etc.

(b) Power Sector Regions

As per paragraph 30 of AS 7 (revised 2002), the cost of materials delivered to a contract site has to be excluded from the contract costs, unless the materials have been made (purchased) specifically for the contract.

The cost incurred on steel, cement procured by power sector regions lying at project site is specifically for the project for which risks, rewards and ownership are on customer and billing is made to customer and the money is being realised.

Therefore, considering the same for calculation of actual cost incurred is in line with AS 7 (revised 2002). Further, since the ownership of the material has been transferred to the customer and the material is lying at the customer site under their custody, the same cannot be shown as inventory in the accounts of the company.

Further, supply of steel/ cement material at site are construed as contract activity and recognition of revenue is in line with paragraph 21 of AS 7 (revised 2002) which, inter alia, states that "***when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.***"

(c) Disclosure

The contract execution period in respect of long term contracts is between 36 months to 60 months, the estimated contract revenue and contract cost do have a lot of uncertainty at the initial stages and the estimates are refined as the project progresses based on the detailed engineering, bill of quantities, latest price trends of inputs and project deliverables, unforeseen contingencies, addition/deletion to the scope, modification required, site constraints, exchange rate fluctuations and so on and these changes do impact estimated contract revenue and estimated cost.

The increase/decrease in the estimated contract revenue and estimated contract cost is bound to happen in case of long term contract due to increase/ decrease in the prices of steel, cement and other input cost, etc. These are not a change in accounting estimates.

Further, as per paragraph 37 of AS 7 (revised 2002), the effect of change in estimates of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as per AS 5. It does not mention about disclosure. Disclosure requirements are given under paragraphs 38 to 44 of AS 7 (revised 2002) which are being complied by the company as stated in the earlier paragraphs. Hence, further disclosures as per AS 5 in addition to disclosure as per AS 7 (revised 2002) are considered not required.

B. Query

10. In view of the above facts, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) In the case of manufacturing units, whether the practice of cost of manufactured items despatched to project site alone being considered as 'cost incurred' without considering the cost of raw material in stocks, works in progress at the plant, finished goods at stores as cost incurred is in line with the revenue recognition principle as per AS 7 (revised 2002). Also, whether the wording of the accounting policy of the company is in line with the revenue recognition principle as per AS 7 (revised 2002).

(b) In the case of erection sites, whether the cost of cement and steel procured and delivered at the project site, specific to the project, in respect of which billing has been done as per the BBU agreed with the customer can be considered as 'cost

incurred' in working out the percentage of completion as per AS 7 (revised 2002) and whether the same is in line with the revenue recognition principle as per AS 7 (revised 2002).

(c) Whether change in estimated revenue and estimated cost due to reasons explained in paragraph 9(c) above at the end of the reporting period in respect of long term contracts executed over a longer period needs to be disclosed as 'change in estimates' as per AS 5.

C. Points Considered by the Committee

11. The Committee notes that the basic issues raised in the query relate to determination of contract cost incurred in the facts and circumstances of the company for calculating the stage of completion while recognising contract revenue and disclosure of the effects of changes in estimated contract revenue and estimated contract cost. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, determination of turnover, recognition of revenue at unit/region level and at consolidated level, combining and segmentation of contracts, propriety of considering change in scope of contract as change in accounting estimates, etc. Further, the Committee, while answering the query has laid down the broad principles of determining the 'contract cost incurred'. The Committee further presumes that the construction contracts in the context of which the query has been raised are those that involve both manufacture of equipments at the manufacturing units of the company and erection and commissioning, etc., at the project sites. The Committee also presumes from the Facts of the Case that it is at the company level that the contract cost incurred has to be determined and not at the manufacturing unit/project sites level.

12. At the outset, the Committee wishes to point out that contract cost incurred should be seen from the overall contract perspective irrespective of the fact that performance of the construction contract involves processing/performance of various activities at different locations,

viz., manufacturing units, project sites, etc. As regards the determination of 'contract cost incurred', the Committee notes the following paragraphs of AS 7, notified under the Companies (Accounting Standards) Rules, 2006 relating to recognition of contract revenue and expenses:

> ***"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."***
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> "29. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:
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> (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
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> (b) surveys of work performed; or
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> (c) completion of a physical proportion of the contract work.
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> Progress payments and advances received from customers may not necessarily reflect the work performed.
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> 30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:
>
> (a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract."

13. The Committee notes that paragraph 21 of AS 7 requires recognition of contract revenue by reference to the stage of completion of the contract activity at the reporting date, when the outcome of the contract can be estimated reliably. Paragraph 31 of AS 7 deals with recognition of contract revenue when the outcome of the contract cannot be estimated reliably. Thus, percentage of completion method should be followed only when the outcome of the contract can be estimated reliably. Since the company, in the extant case, is following percentage of completion method, the Committee presumes that outcome of the construction contract in this case can be estimated reliably.

14. The Committee notes from the above-reproduced requirements of AS 7 that determination of contract costs incurred for calculating stage of completion depends upon the performance of contract activity rather than mere incurrence of cost. Costs that relate to future activity are to be recognised as 'work-in-progress'. As to what can be considered as performance of contract activity depends upon the facts and circumstances of the case. Every activity performed in relation to a contract may not lead to completion of a stage or milestones. Accordingly, a judgement is to be exercised by the management while determining contract costs incurred considering various factors, such as, terms and specifications of the contract, identifiability with the contract, achievement of milestone in relation to the contract, etc.

15. As regards the cost of items of raw material, work-in-progress and finished goods, purchased or manufactured and lying at stores or at manufacturing site, or at project site, the Committee is of the view that it should be seen whether these can be considered as 'contract cost incurred' applying the judgement based on the considerations stated in paragraph 14 above, viz., identifiability with the contract, i.e., whether these can be considered to be specific for a construction contract as per its specifications, achievement of milestone in relation to the contract, etc. In this regard, the Committee notes from paragraph 30 of AS 7 that there is no restriction in considering supply of materials to the customer site as 'actual contract cost

incurred', which are manufactured/ purchased specifically for the contract. However, in case of items which are not manufactured/ purchased specifically for the contract e.g., the items which are commonly used across various contracts, the cost of such items if only delivered at the contract site should not be considered unless these are used/installed/applied during contract performance.

16. In view of the above, the Committee is of the view that the practice of the company to consider the cost of manufactured items despatched to the project site alone as 'cost incurred' is not correct since mere event of despatch cannot be considered as a completion of a stage and may not trigger revenue recognition. The Committee is of the view that it is performance of the contract activity rather than despatch of items from one location to another that should be considered while determining stage of completion.

17. The Committee notes from the Facts of the Case that materials, such as, steel and cement are directly supplied from the supplier to the project site and billed to the customer, however, these have not yet been applied or used. The Committee is of the view that mere billing to the customer or even receipt of money from the customer cannot be a sole criterion for considering an item as 'contract cost incurred' for determining the stage of completion. As regards whether steel and cement procured and delivered at the contract site can be considered to be specific as being argued in the Facts of the Case, the Committee is of the view that these items are general in nature for a construction activity and cannot be said to be specific for a project even though supplied directly at the contract site. Accordingly, these should be considered for determining 'cost incurred' only when these have been used/ applied for performance of contract activity. Till that time, these should be considered as 'Work in Progress'.

18. With regard to disclosure requirements of effect of change in estimated contract revenue and contract cost, the Committee notes the following paragraphs of AS 7 and AS 5 notified under the Rules (revised 2002) in respect of change in estimates:

AS 7

"37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods."

AS 5

27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

The Committee notes that the change in contract costs affecting the percentage of completion is inherent in construction business. The effect of change in either costs or revenue shall be a change in estimate to be accounted in accordance to AS 5 read with AS 7 (revised 2002). The querist's argument that no disclosure is required as AS 7 is silent does not hold good and not appropriate. The Committee further notes that AS 7 (revised 2002) requires the change in estimate to be accounted as per AS 5, which covers both recognition and disclosure. Accordingly, the effect of change in the estimated contract revenue and cost, which has or is expected to have a material effect in the current period or subsequent periods needs to be disclosed as per the requirements of AS 7 as well as AS 5. However, if it is impracticable to quantify the amount of change, this fact should be disclosed.

D. Opinion

19. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

(i) It is the performance of contract activity rather than despatch of items from one location to another that should be considered while calculating stage of completion, which is determined with reference to the contract costs that contribute to the performance of contract activity rather than the total cost incurred upto the reporting date as discussed in paragraph 14 above. Accordingly, the practice of the company of considering the cost of items merely despatched to the project site is not correct. The wording of the accounting policy of the company seems to be in line with the principles of AS 7. However, the application of this policy should be modified on the lines indicated above in paragraphs 14 and 17 above.

(ii) As regards steel and cement procured and delivered at the contract site, it should be seen whether these can be considered as 'contract cost incurred' applying the judgement based on the considerations stated in paragraphs 14 and 15 above. Mere billing to the customer cannot trigger considering a cost as 'contract cost incurred'. These items are general in nature for a construction activity and cannot be said to be specific for a project even though supplied directly at the contract site. Accordingly, these should be considered for determining 'contract cost incurred' only when these have been used/ applied for performance of contract activity. Till that time, these should be considered as 'Work in Progress'.

(iii) Change in estimates on account of changes in estimated contract revenue and costs should be disclosed in accordance with AS 5 read with AS 7. Accordingly, the effect of change in the estimated contract revenue and cost, which has or is expected to have a material effect in the current period or subsequent periods needs to be disclosed as

per the requirements of AS 7 as well as AS 5. However, if it is impracticable to quantify the amount of change, this fact should be disclosed.
