

# **Exposure Draft**

## **Guidance Note on Revenue from Operations in case of Contractors**

*(Last date of comments: August 31, 2020)*



**Research Committee**  
**The Institute of Chartered Accountants of India**  
*(Set up by an Act of Parliament)*  
**New Delhi**



## **Exposure Draft**

### **Guidance Note on Revenue from Operations in case of Contractors**

*Research Committee of the Institute of Chartered Accountants of India invites comments on any aspect of this Exposure Draft of the 'Guidance Note on Revenue from Operations in case of Contractors'. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.*

*Comments should be submitted in writing to the Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, to be received not later than **August 31, 2020**. Comments can also be sent by e-mail at [research@icai.in](mailto:research@icai.in).*

*(The following is the text of the 'Guidance Note on Revenue from Operations in case of Contractors', issued by the Council of the Institute of Chartered Accountants of India and comes into effect in respect of accounting period commencing on or after 1<sup>st</sup> April, 20XX. Pursuant to the issuance of this Guidance Note, the Guidance Note on Turnover in case of Contractors issued in 2008 stands withdrawn.)*

#### **Introduction**

1. This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, *Construction Contracts* (Revised 2002) and Ind AS 115 Revenue from Contracts with Customers, can be considered as Revenue from Operations for presentation in Schedule III to Companies Act, 2013'.

2. AS7 (Revised 2002) deals, *inter-alia*, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as 'percentage of completion method'). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognized as revenue in the statement of profit and loss in the accounting period in which the work is performed.

3. The paragraph dealing with the 'Objective' of AS 7 (Revised2002) provides as follows:

#### **"Objective**

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognized as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria."

From the above, it may be noted that AS 7 (Revised 2002) deals, *inter alia*, with the allocation of contract revenue to the accounting periods in which construction work is performed.

4. Further, paragraphs 21, 31 and 37 of AS 7(Revised2002) provide as follows:

***"21 When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized***

*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 recognized as an expense immediately in accordance with paragraph 35.”*

*“31. When the outcome of a construction contract cannot be estimated reliably:*

- (a) revenue should be recognized only to the extent of contract costs incurred of which recovery is probable; and*
- (b) contract costs should be recognized as an expense in the period in which they are incurred.*

*An expected loss on the construction contract should be recognized as an expense immediately in accordance with paragraph 35.”*

### **37. Changes in Estimates**

“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 recognized in the statement of profit and loss in the period in which the change is made and in subsequent periods.”

From the above, it may be noted that the recognition of revenue as per AS 7 (revised 2002) may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 reproduced above) depending on whether the outcome of the construction contract can be estimated reliably or not. When the outcome of the construction contract can be estimated reliably, the revenue is recognized inclusive of profit and when the same cannot be estimated reliably, it is recognized exclusive of profit. However, in either case it is considered as revenue as per AS 7 (Revised 2002).

5. 'Revenue' is a wider term. For example, within the meaning of Accounting Standard (AS) 9, *Revenue Recognition*, the term 'revenue' includes revenue from;

- sales transactions,
- rendering of services and
- from the use by others of enterprise resources yielding interest, royalties and dividends.

6. Ind AS 115 replaces existing Ind AS 11 Construction Contracts vide MCA notification dated 28.03.2018. Ind AS 115 is applicable from April 1, 2018 i.e. FY 18-19.

The core principle of Ind AS 115 is that revenue needs to be recognised when an entity transfers the control of goods and services to customers at an amount that the entity expects to be entitled. Ind AS 115 is based on a five-step model shown below:

1. Identify the Contract with the Customer - Assess whether the contract is within the scope of Ind AS 115. "Customer" is now a defined term
2. Identify the Performance Obligations- Determine whether the goods and services in the contract are distinct
3. Determine the Transaction Price- Determine fixed and variable consideration
4. Allocate the Transaction Price- Allocate based on a relative stand-alone selling price basis using acceptable methods
5. Recognize Revenue when (or as) Performance Obligations are satisfied- Recognise revenue at a point in time or over the period of time based on performance obligations

Under Ind AS 115, revenue should be recognised over time if either of the following conditions is met:

- i. Buyers take all the benefits of the property as real estate developers construct the property.
- ii. Buyers obtain physical possession of the property.

iii. The property unit to be delivered is specified in the contract and real estate entity does not have an alternative use of the unit; the buyer does not have the discretion to terminate the contract and the entity has right to payment for work completed to date.

In case none of these conditions is met, revenue would be recognised at a point in time when the control of the property is passed on to the customer.

7. As per Ind AS 115 Revenue from Contract with Customers, revenue is defined as income arising in the course of an entity's ordinary activities.

The term '**Revenue from Operations**' is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognized in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7 (revised 2002) and Ind AS 115, by whatever nomenclature described in the financial statements, is considered as '**Revenue from Operations**'.

## **Recommendation**

8. The amount of contract revenue recognized as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002) and Ind AS 115, should be considered as Revenue from Operations for presentation in Schedule III to Companies Act, 2013'.