WIRC REFRESHER COURSE ON ACCOUNTING STANDARDS 7, 9 and 12

CA YUSUF KAGALWALA

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INTRODUCTION

- SME (Level II and Level III) classification criteria – ICAI announcement 2013
    - Turnover – Less than 50 crores; or
    - Borrowings – Less than 10 crores.
- Applicability of AS 7, 9 and 12 to SMEs and SMCs

AS 7 - CONSTRUCTION CONTRACTS

STANDARD REFRESHER

- Accounting for construction contracts in the financial statements of enterprises undertaking such contracts.

- Applies to enterprises undertaking construction activities not as contractors but on their own account as venture of a commercial nature where the enterprise has entered into agreements for sale.

- **Construction contract** - contract for the construction of an asset or a combination of assets that together constitute a single project e.g. bridge, pipeline, refineries.

STANDARD REFRESHER (cont'd)

- 2 types of contracts – fixed price contract and cost plus contract
- Methods of accounting followed:

Percentage of Completion Method (PCM): Revenue is recognised as the contract activity progresses based on the stage of completion. Normally, profit is not recognised in fixed price contracts unless the work on a contract has progressed to a reasonable extent (20 to 25% of the work).

It is based on the proportion that costs incurred to date bear to the estimated total costs of the contract; and approval of % of work completed by Contractee.

Completed Contract Method: Costs and progress payments received are accumulated during the course of the contract but revenue is not recognised until the contract activity is substantially completed or fully completed.

STANDARD REFRESHER (cont'd)

- 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**.
- When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

- **Unbilled revenue** is the excess of calculated revenue as per PCM over actual progressive billing based on milestone. It is recognized as an **Asset**.
- **Unearned revenue** is the excess of actual billing done to contractee over the calculated revenue as per PCM method. It is accounted as a **liability**.

Disclosure in Financial Statements

- Amount of contract revenue recognised as revenue in the period;
- Methods used to determine contract revenue;
- Method used to determine the stage of completion of contracts in progress;
- Should disclose the following in case of contracts in progress:
  - ✓ Aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
  - ✓ Amount of advances received;
  - ✓ Amount of retentions.
- Gross amount due from customers for contract work as an asset; and
- Gross amount due to customers for contract work as a liability.

Sample Q&A

- **<u>Q1:</u>** XYZ Ltd. has undertaken bridge construction contract to be constructed in 3 years. Initial contract revenue Rs.900 crores. Initial contract cost Rs.800 crores.

Particulars	Year 1	Year 2	Year 3
Estimated contract cost	805	-	-
Increase in contract revenue	-	20	-
Estimated additional increase cost	-	15	-
Contract cost incurred upto	161	584	820

At the end of 2nd year cost incurred includes Rs.10 crores, for material stored at the sites to be used in 3rd year to complete the project.

Calculate the amount of revenue, expense and profit to be recognized in P&L for each of the 3 years.

Sample Q&A (cont'd)

- **A1:**

	Year 1	Year 2	Year 3
Initial revenue agreed	900	900	900
Variation	-	20	20
Total contract value (A)	900	920	920
Contract cost incurred upto the date of reporting (B)	161	584	820
Total estimated contract cost	805	820	820
Stage of completion (C)	20% (161/805*100)	70% (574/820*100)	100% (820/820*100)
Total Revenue (D) = (A)*(C)	180	644	920
Total Profit (D-B)	19	70 (less 10 crs material also)	100

AS 9 - REVENUE RECOGNITION

STANDARD REFRESHER

- This standard does not apply to:
  - Revenue arising from Construction Contracts – AS 7
  - Revenue arising from Hire Purchase or Lease Agreements – AS 19
  - Revenue arising from Government Grants or Other Similar subsidies – AS 12
  - Revenue of Insurance Companies arising from insurance business.

- **Revenue:**
  - **Gross inflow** of cash, receivables or other consideration
  - Course of the ordinary activities of an enterprise
  - From **sale of goods**, **rendering of services**, and **use by others of enterprise resources yielding interest, royalties and dividends**.
  - In **agency relationship**, revenue is the **amount of commission** and not the gross inflow of cash, receivables or other consideration.

STANDARD REFRESHER (cont'd)

- Revenue recognition is mainly concerned with timing of recognition in P&L.
- Transfer of property in goods along with transfer of significant risks and rewards to buyer
- In specific industries such as agricultural crop harvesting and mineral ores extraction, performance may be substantially complete prior to execution of revenue transaction. Such amounts though not revenue, may be recognized in P&L and appropriately disclosed.
- In case of sale of goods, performance is achieved when: (i) seller has transferred to buyer the property in goods or all significant risks and rewards of ownership and retains no effective control of the goods transferred; and (ii) no significant uncertainty exists regarding amount of consideration from sale of goods.
- In case of rendering of services, performance is measured under completed service contract or proportionate completion method; and achieved when no significant uncertainty exists regarding amount of consideration from sale of goods.

STANDARD REFRESHER (cont'd)

When to recognise Revenue in following cases?

- Delivery delayed at buyer's request but buyer accepts title/billing.
- Consignment Sales
- Guaranteed Sales i.e. delivery is made giving the buyer unlimited right of return.
- Sale/Repurchase Agreement
- Freight on incomplete Voyage
- Advertising and insurance agency commission
- Franchisee fees of Training Institute
- Interest Income
- Dividend from Investments

Accounting for Real Estate Transactions

- Guidance Note on Accounting for Real Estate Transactions (Revised 2012) issued by ICAI to recommend the accounting treatment by enterprises dealing in 'Real Estate' as sellers or developers.
- Transitional provisions:
  - Projects commencing on or after 1st April 2012
  - Projects which have commenced earlier but where revenue is being recognized for the 1st time on or after 1st April 2012
  - Option to apply this GN from an earlier date provided the GN is applied to all transactions after the chosen (earlier) date
- Covers all types of real estate transactions – land, plots with and without development, development agreement, building and without development, development agreement, building, TDR, etc.

Accounting for Real Estate Transactions (cont'd)

- Project is smallest group of unit / plot/ saleable space which are linked with a common set of amenities in such a manner that unless the common amenities are made available and functional, the units / plot / space cannot be put to their intended effective use
- This Guidance Note provides guidance for application of:
  - Principles of AS 9 in respect of sale of goods for recognising revenue, costs and profits from transactions of real estate which are **in substance similar to delivery of goods** where the revenues, costs and profits are recognised when the revenue recognition process is completed; and
  - Percentage completion method for recognising revenue, costs and profits from transactions and activities of real estate **which have the same economic substance as construction contracts**.

Cut-off procedures

❖ Manufacturing company
- ✓ Delivery Challan
- ✓ Purchase Order report

❖ Trading entity
- ✓ Bill of Lading
- ✓ Delivery note at port of destination
- ✓ Lorry receipt

❖ Service entity
- ✓ Certificate of completion of service from client

Q&A – Practical issues

Q1: Mr. A entered into an agreement to sell a property before 31st March 2020 and received an advance of 50% as on that date. Final deed & Registration is pending on balance sheet date. Mr. A has recognised revenue on 31st March 2020. After Balance sheet date but prior to finalization, if the Agreement is cancelled, what treatment is to be accounted as on 31st March 2020? Whether treatment given is correct?

A1: As per para 11 of AS 9,

"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 ……"

Q&A – Practical issues (cont'd)

A1 (cont'd):

In the discussed scenario, since the agreement is already finalized subject only to signing of final deed & registration as at 31st March 2020, the seller has **transferred to the buyer the property** and **significant risks and rewards of ownership have been transferred** and the **seller still retains effective control** of the property on behalf of the Buyer. Hence, the accounting of revenue for year ended 31 March 2020 is a **correct treatment.**

However, the subsequent event of cancellation of agreement before finalization of accounts, provides additional details on an event already existing on balance sheet date. Taking the same into account, **the revenue recognition impact should be reversed in year ended March 31, 2020.**

AS 12 – ACCOUNTING FOR GOVERNMENT GRANTS

STANDARD REFRESHER

- **Government grants** are assistance by government in **cash or kind** to an enterprise for **past or future compliance with certain conditions**. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

- Government grants are sometimes called by other names such as **subsidies, cash incentives, duty drawbacks,** etc.

- Government grants should not be recognised until:

  - There is **reasonable assurance** that the enterprise will comply with the conditions attached to them;
  - The benefit has already been earned; and
  - Ultimate collection of the grant is certain.

STANDARD REFRESHER (cont'd)

- In certain circumstances, the grant is recognised in the income statement of the period in which it becomes **receivable** and wherever appropriate, such grants may be treated as an **'extraordinary' grant**. Such circumstances may arise when a government grant is –

- Awarded for the purpose of giving immediate financial support to an enterprise with no further related costs; or
- Receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period.

- **Non-monetary government grant:** If the government grant is in the form of non-monetary assets given at concessional rates, the asset is recorded at the **acquisition cost** and the assets given free of cost are recorded at a **nominal value i.e. Rs. 1.**

STANDARD REFRESHER (cont'd)

❖ **Capital Grant related to fixed assets:**

➢ **Grants related to Depreciable Assets**

- **OPTION I – DEDUCTION FROM COST**

Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a **deduction from the gross value** of the assets concerned in arriving at their book value.

Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a **nominal value**.

- **OPTION II – DEFERRED INCOME**

Alternatively, government grants related to depreciable fixed assets may be treated as **deferred income** which should be recognised in the profit and loss statement on a systematic and rational basis **over the useful life of the asset**, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged

STANDARD REFRESHER (cont'd)

- **Grant related to Non –Depreciable Assets**

- Grants related to non-depreciable assets should be credited to **CAPITAL RESERVE** under this method.
- However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be **credited to income over the same period over** which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

STANDARD REFRESHER (cont'd)

- **Grant related to Revenue**
- Government grants related to revenue should be recognized on a systematic basis in the profit and loss statement.
- Over the periods necessary to match them with the related costs which they are intended to compensate.
- Such grants should either be shown separately under 'other income' or deducted in reporting the related expense

- **Grant related to Promoter contribution**
- Where the government grants are of the nature of promoter's contribution, they are treated as capital reserve which can be neither be distributed as dividend nor considered as deferred income

STANDARD REFRESHER (cont'd)

❖ **Refund of Grants**

➢ Refund of grants related to revenue:

- The amount refund should be adjusted against any unamortized 'deferred government grants', if any.
- The remaining balance amount of refund should be charged to Profit and Loss Account.

➢ Where a grant which is in the nature of promoter's contribution becomes refundable on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

➢ Refund of grant related to specific assets:

- The refundable amount should be recorded by increasing the book value of the asset. Here the depreciation on the revised book value is provided prospectively over the residual useful life of the asset, or
- The refundable amount should be recorded by reducing the capital reserve, or the refundable amount should be adjusted with unamortized deferred income, as may be appropriate.

Disclosure in Financial Statements

- **Following disclosures are appropriate:**

- The **accounting policy adopted for government grants**, including the methods of presentation in the financial statements, and
- The **nature and extent of government grants** recognized in the financial statements.
- Grants of non-monetary assets given at a **concessional rate or free of cost**.
- The **deferred income** is suitably disclosed in the balance sheet.
- Government grants that become refundable should be accounted for as an **extraordinary item in the Profit & Loss account.**

Sample Q&A

- **Q1:**

XYZ Ltd has setup its business in a backward area which entitles the company to receive from the Government a subsidy of 20% of the cost.

Having fulfilled all the conditions under the scheme, the company on its investment of INR 100 crore in capital assets received INR 20 crore from the Government in January, 2017.

Company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2017.

Whether this action is justified or not?

Sample Q&A (cont'd)

- **<u>A1:</u>**

- As per para 10 of AS 12, where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof.
- The grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.
- In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue.
- Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.
- **The correct treatment is to credit the subsidy to capital reserve.**

THANK YOU