

Income Computation & Disclosure Standards

III - Construction Contracts

IV - Revenue Recognition

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Need for & Background

- ❖ notification No.32/2015, F. No. 134/48/2010-TPL, dated 31st March, 2015 shall come into force w.e.f. 1st April, 2015, shall accordingly apply to A.Y. 2016-17 and subsequent assessment years.

Need for & Background

- ❖ Indian Accounting Standards (Ind AS) shall be the accounting standards applicable to classes of companies specified in rule 4.
- ❖ Companies (Indian Accounting Standards) Rules, 2015. Which came into force on 1 April, 2015
- ❖ Impact at Macro level
- ❖ ICDS 1 omits **prudence** as a concept to be followed

ICDS 4 - Revenue Recognition

- ❖ Common preamble
- ❖ Not for maintenance of books
- ❖ In case of conflict with the act the act shall prevail – implications
- ❖ Requirement for being able to reliably measure the revenue is also omitted
- ❖ 4#4 - reasonable certainty of ultimate collection retained
- ❖ 'claim for escalation, export incentive revenue recognition .. shall be postponed to the extent of uncertainty involved'
- ❖ interest would have the meaning as assigned in the IT act

ICDS 4 – Terms Used

- ❖ Revenue” is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person’s resources yielding interest, royalties or dividends. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.
- ❖ For Commission – positive implications for TDS - clearly only on net income

ICDS 4 – Terms Used

- ❖ **Sale of Goods** - revenue shall be recognised when 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. where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership, revenue in such a situation shall be recognised at the time of transfer of significant risks and rewards of ownership to the buyer.
- ❖ Eg. Where goods are identified & earmarked but not shipped

ICDS 4 – Terms Used

- ❖ Services - Revenue from service transactions shall be recognised by the percentage completion method.
- ❖ Mandatory –
- ❖ Revenue is matched to costs incurred in reaching the stage of completion, resulting in the determination of revenue, expenses and profit which can be attributed to the proportion of work completed.

Implications for Listed Companies

- ❖ IND AS 18 # 9 Revenue shall be measured at the fair value of the consideration received or receivable.

Appendix E - Illustrative examples - # 8

- ❖ “Instalment sales, under which the consideration is receivable in instalments. Revenue attributable to the sales price, exclusive of interest, is recognised at the date of sale. The sale price is the present value of the consideration, determined by discounting the instalments receivable at the imputed rate of interest. The interest element is recognised as revenue as it is earned, using the effective interest method.”

Example – Sale by Deferred Consideration

An enterprise sells an item of equipment for Rs. 100,000 with annual instalments of Rs. 20,000 due for 5 years under zero% financing arrangement

Year	Principal Amount O/s	Interest elements @ 10%	Principal element	Total payment
End of Yr 1	75,816	7,581	12,419	20,000
End of Yr 2	63,397	6,340	13,660	20,000
End of Yr 3	49,737	4,974	15,026	20,000
End of Yr 4	34,711	3,471	16,529	20,000
End of Yr 5	18,182	1,818	18,182	20,000
TOTAL		24,184	75,816	100,000
Sale	IND AS 75,816	AS 1,00,000	Tax implication Deferment of interest income	
Interest income	24,184	-		

Other Contentious Areas

- ❖ Sale and repurchase agreements
- ❖ Subscriptions to publications and similar items - When the items involved are of similar value in each time period, revenue is recognised on a straight-line basis
- ❖ Servicing fees included in the price of the product. – Free warranty – inclusion of item in revenue.
- ❖ Origination fee & Commissions in Financial Asset acquisition
- ❖ In a service transaction – fee is the revenue element – not the entire consideration
- ❖ Goods on Approval & Stores policy of return within certain time.

DISCLOSURE

12. Following disclosures shall be made in respect of revenue recognition, namely:

- a) in a transaction involving sale of good, total amount not recognised as revenue during the previous year due to lack of reasonably certainty of its ultimate collection along with nature of uncertainty;
- b) the amount of revenue from service transactions recognised as revenue during the previous year;
- c) the method used to determine the stage of completion of service transactions in progress; and
- d) for service transactions in progress at the end of previous year:
 - i. amount of costs incurred and recognised profits less recognised losses upto end of previous year;
 - ii. the amount of advances received; and
 - iii. the amount of retentions.

Case Study 1

- ❖ Mr P is a businessman, who purchases large tracts of land, divides them into subplots and sells them to persons to construct houses/offices thereon. For this purpose he carries on basic operations such as levelling, fencing etc. He also undertakes to assist in subdivision and registration of plots so as to facilitate transferred to the ultimate purchasers.
- ❖ In carrying out these transactions, he has received significant amount as advances which he has placed in fixed deposit, pending payment of the balance consideration payable by him to various sellers.
- ❖ Would he be entitled to set off the interest on fixed deposits owned by him, against the purchase consideration and other expenses incurred by him to render the land capable of being sold.

Case Study 1 Contd

- ❖ In the interim period he is also tied up with the nearby resort owner to provide parking space to the clients of the resort. He receives lump sum consideration from the resort owner. What would be the treatment of this sum received by him.
- ❖ **Which ICDS would apply to him ?**
- ❖ Would the answer be different if instead of merely selling plots of land, he carries on business as a developer and sells constructed row-houses to the prospective buyers.

ICDS 3 - Construction Contracts

- ❖ Applicability

- ❖ Contract Revenue

9. Contract revenue shall be recognised when there is reasonable certainty of its ultimate collection.

11 Where contract revenue already recognised as income is subsequently written off in the books of accounts as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.

Salient Provisions - ICDS 3

- ❖ **Contract Costs**
- ❖ **Recognition of Contract Revenue and Expenses**
- ❖ The stage of completion of a contract shall be determined with reference to:
 - a. the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
 - b. surveys of work performed; or
 - c. completion of a physical proportion of the contract work. Progress payments and advances received from customers are not determinative of stage of completion of a contract.

CONSTRUCTION CONTRACT ICDS 3

- ❖ Requires the recognition of revenue on this basis.
- ❖ The requirements of that Standard shall mutatis mutandis apply to the recognition of revenue and the associated expenses for a service transaction.

Illustration re: Transition Provisions

Projects for which Completed Contract basis is used till AY 15-16
Figures indicating % of work completed IN RESPECTIVE YEAR

AY	12-13	13-14	14-15	15-16	16-17	Cumulative upto AY16-17
Project A	10 %	10%	10%	10%	10%	50 %
Project B	5%	15%	15%	40%	20%	95%
Project C	NIL	NIL	15%	12%	40%	67%
Project D	NIL	NIL	NIL	10 %	10%	20%

Case Study 2

- ❖ Informatics Ltd is a company engaged in providing turnkey IT solutions including consultancy on hardware configuration, hardware planning supply and installation as well as development of incidental software of a specialised nature.
- ❖ They have received a large contract from a PSU encompassing all the above activities. For the purpose of more economic execution, Informatics Ltd has outsourced a part of the software assignment to third-party specialists. This is 30% of the contract value.
- ❖ While implementation of the hardware part has run into some problems, payments have been made to the software developers. Expenditure incurred on hardware is to the tune of 40% of contract value.
- ❖ Software cost paid to third-party is 28% of the contract value and only balanced 2% is payable to them. The software development work is virtually complete but testing and client approval which is a necessary milestone as per the contract with the client PSU is pending due to pendency of hardware installation and licence issues.
- ❖ **What would be the implications in terms of revenue recognition and contract work in progress in light of the ICDS.**

Case Study 3

- ❖ A contractor X is executing a contract for construction of a flyover. While the work is in progress, certain changes in the road safety legislation applicable w.e.f Aug 2016 indicate that additional work would have to be done by X for completion of the flyover. The contract provides that such incremental work will be executed by the contractor in accordance with directions of the State Government.
- ❖ The broad parameters of the additional compensation due to the contractor are provided in the contract itself - but this clause is subject to the said consideration being mutually agreed upon by the parties to the contract.
- ❖ **To what extent and when would X be required to recognise the possible revenue of Rs 500 Lakhs (which cannot be reliably estimated at this stage- since agreement has not been reached on the nature of work to be executed, it is time for completion etc).**