

Query No. 20

Subject: *Accounting clarification on revenue recognition under input method in respect of Manufactured Goods-ready for despatch.*¹

A. Facts of the Case

1. A public sector company (hereinafter referred to as ‘the company’) has a net worth of Rs. 31,400 crore as on 31.03.2019. The company is an integrated power plant equipment manufacturer engaged in design, engineering, manufacture, construction, testing, commissioning of power projects and also in servicing of a wide range of products and services for the core sectors of the economy viz. power, transmission, industry, transportation (Railways), renewable energy, oil & gas and defence. In power project business, the contracts received by the company are either EPC contracts (Engineering, Procurement & Construction) or BTG Packages (i.e. Boiler, Turbine and Generator packages). In case of BTG contracts, civil works and Balance of Plant (BOP) package items are not in the scope of the company. Power projects are long gestation period projects where the normal execution period of a contract ranges between 3 to 5 years. The scope of the company includes supply of equipment, erection, commissioning, synchronizing the plant to the grid, completing the trial operation and proving the guaranteed parameters. In respect to construction contracts, the company transfers control of goods or services to the customer and recognizes revenue over time based on input cost method.

2. The querist has provided following extracts of the accounting policies of the company:

Accounting Policy No.1(d)(i) states that:

“The Company uses input method based on cost approach in accounting for the revenue in respect of construction contracts. Use of input method requires the Company to estimate its costs relative to the total expected costs in the satisfaction of its performance obligation. The estimates assessed continually during the term of the contract and the company re-measures its progress towards complete satisfaction of its performance obligations satisfied over time at the end of each reporting period.

Company updates its estimated transaction price at each reporting period, to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period.”

As per Accounting Policy No.8 –

“Revenue is recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

In relation to construction and long term service contracts, the company transfers control of goods or services to the customer and recognizes revenue over the time.

Revenue is recognized using input method based on the cost approach. Progress towards complete satisfaction of performance obligation satisfied over time is re-measured at reporting period end.

Revenue from sale of goods and services is recognized on the transfer of control to the customer and upon the satisfaction of performance obligations under the contract.”

¹ Opinion finalised by the Committee on 10.2.2020.

3. The querist has referred to the following extracts of the Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers':

“31 An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.”

“35 An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3—B4);
- (b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or
- (c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

36 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs B6—B8 provide guidance for assessing whether an asset has an alternative use to an entity.”

“B6 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

B7 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

B8 A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting

assets that either have design specifications that are unique to a customer or are located in remote areas.”

- “37 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs B9—B13 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.”
- “B9 In accordance with paragraph 37, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:
- (a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or
 - (b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.
- B10 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity shall consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.
- B11 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration

promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

- B12 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:
- (a) legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer;
 - (b) relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; or
 - (c) an entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.
- B13 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.”

Measuring progress towards complete satisfaction of a performance obligation

- “39 For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity’s performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity’s performance obligation).
- 40 An entity shall apply a single method of measuring progress for each performance obligation satisfied over time and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.

Methods for measuring progress

- 41 Appropriate methods of measuring progress include output methods and input methods. Paragraphs B14–B19 provide guidance for using output methods and input methods to measure an entity’s progress towards complete satisfaction of a performance obligation. In determining the appropriate method for measuring

progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.”

“Input methods

B18 Input methods recognise revenue on the basis of the entity’s efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity’s efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis.”

“43 As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity’s measure of progress shall be accounted for as a change in accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.”

4. The querist has stated that in respect of construction contracts, the company designs and manufactures equipments which are meant for specific projects and are not interchangeable. Such designed and manufactured items, when complete, are stored at plant before these are despatched to the customer site. These are despatched based on the requirement at the site considering various issues related to proper storage at site, types of contracts being executed etc.

5. The querist has further stated that considering that such items are very specific to the project (as per design and specification of the project agreed with customer) and enforceable right to payment also exists as per the terms & conditions of the contract, the cost of ‘manufactured items-ready for dispatch’ (for projects), the readiness duly certified by a cross-functional committee at the respective Unit and endorsed by Head of the Unit, will also be considered as cost incurred for measuring the progress under input method for recognising revenue over time. These fulfill the conditions necessary for satisfaction of performance obligation as per the criteria of paragraph 35 (c) of Ind AS 115 for recognition of revenue over time.

6. The querist has also stated that such manufactured goods-ready for dispatch are based on design specifications that are unique to a particular project/customer. These will not have alternative use broadly under clause B8 of Ind AS 115. There is a practical limitation to direct such completed asset for another use as significant economic losses will have to be incurred to direct the asset for another use.

7. According to the querist, though the raw material and work in progress lying at plant may be specific to project but at that stage, there are possibilities of alternative use of such items during the manufacturing process, i.e., until the work is substantially completed. Hence, the management does not consider the conditions under paragraph 35(c) of Ind AS 115 completely fulfilled in respect of such items and therefore, such items are shown as part of inventory and not considered for measuring progress for revenue recognition under input method.

8. The inclusion of cost of manufactured items- ready for dispatch referred in paragraph 5 above is considered appropriate by the company considering the experience of issues relating to site storage, changes in the market scenario, types of contracts being executed etc.

B. Query

9. On the basis of above, the opinion of Expert Advisory Committee has been sought as to whether the approach of the entity for measuring the progress for revenue recognition is appropriate and is in line with Ind AS.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to whether the approach of the company of determination of cost incurred to include the cost of internally manufactured and completed items and equipments which are ready for despatch to customer while measuring progress towards complete satisfaction of a performance obligation under cost-based input method so as to recognize revenue over time under Ind AS 115 is correct or not. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, revenue recognition with regard to any other item either manufactured/completed or work-in-progress/inventory, measurement of revenue, other aspects of Ind AS 115, including, whether there are single or multiple distinct performance obligations, whether it is appropriate to recognize revenue over time in the extant case and whether the company fulfills the conditions under paragraph 35(c) of Ind AS 115, whether inputs method of measure of progress is appropriate in the extant case, etc.

11. The Committee notes from the Facts of the Case that in the extant case in respect of items manufactured for certain specific construction contracts for which the issue has been raised, the company's performance does not create an asset with alternative use to the company and the enforceable right to payment also exists as per the terms and conditions of the contract. Accordingly, in respect of such contracts, the conditions necessary for satisfaction of performance obligation as per the criteria of paragraph 35(c) of Ind AS 115 for recognition of revenue over time get fulfilled and therefore, the company recognises revenue over time for these contracts. Without getting into the examination of the above criteria being fulfilled or not and the accounting treatment being followed by the company in this regard, the Committee notes that as per the Standard, when it is determined that a performance obligation is satisfied over time, an entity is required to select a method to measure progress so as to recognise revenue over time. In this context, the Committee notes that the company has selected input method based on cost incurred to measure progress. The issue now, is with regard to the approach of determination of cost incurred to include the cost of internally manufactured and completed items and equipments which are ready for despatch to customer while measuring progress under cost-based input method so as to recognize revenue over time under Ind AS 115.

12. With regard to the approach of inclusion of cost of items/equipments manufactured and ready for dispatch in the 'cost incurred' under input method of measuring progress towards satisfaction of performance obligation under the contract, the Committee notes paragraphs 39, 41, 42, B14 and B18 as follows:

“39 For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity's performance obligation).”

“Methods for measuring progress

41 Appropriate methods of measuring progress include output methods and input methods. Paragraphs B14–B19 provide guidance for using output methods and

input methods to measure an entity's progress towards complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

42 When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.”

“B14 Methods that can be used to measure an entity's progress towards complete satisfaction of a performance obligation satisfied over time in accordance with paragraphs 35–37 include the following:

- (a) output methods (see paragraphs B15–B17); and
- (b) input methods (see paragraphs B18–B19).”

“B18 Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis.”

The Committee notes from paragraph 39 of Ind AS 115 that an entity should recognise revenue over time by measuring the progress towards complete satisfaction of performance obligation and while measuring progress, the objective is to depict an entity's performance in transferring control of goods or services promised to a customer. Paragraph B18 states that under input method, revenue is recognised on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation, for example, costs incurred relative to the total expected inputs/cost to the satisfaction of that performance obligation. Further, the Committee notes that in the extant case, the conditions of paragraph B 19 of Ind AS 115 are not met as these items and equipments are manufactured and designed internally by the company for specific projects and are not simply procured from a third party. Rather, cost of these items, since reflect the company's efforts or inputs to the satisfaction of performance obligation as per the contract with the customer, the cost incurred thereon should be included in the measure of progress of the performance.

D. Opinion

13. On the basis of above, the Committee is of the opinion on the issues raised in paragraph 9 above, the approach of the company with regard to the inclusion of the cost of manufactured and completed items and equipments that are ready for dispatch to customer's site as 'cost incurred' under inputs method of measuring the entity's progress towards complete satisfaction of a performance obligation is correct under Ind AS 115, as discussed in paragraph 12 above.