

Query No. 29

Subject: Method of accounting to be followed.¹

A. Facts of the Case

1. An Institute (hereinafter referred to as 'the Institute') is an autonomous body set up in 1984 by the Reserve Bank of India (RBI), central financial institutions and public sector banks, with the objective of evolving and implementing scientific and fair processes of selecting bank personnel. Its principal activity is executing assessment, recruitment and placement projects for public sector banks, RBI, Securities and Exchange Board of India (SEBI), National Bank for Agriculture and Rural Development (NABARD), Regional Rural Banks (RRBs), Life Insurance Company (LIC) and General Insurance Companies, besides many Government organizations (e.g., Food Corporation of India (FCI), Employees' Provident Fund Organisation (EPFO), Public sector Undertakings (PSUs) and Cooperative Sector) and Admission Tests (CET).

2. The Institute is a society under the Societies Registration Act, 1860 and a Public Trust under the Bombay Public Trusts Act, 1950. The Governing Board of the Institute is currently headed by the Managing Director (MD) and Chief Executive Officer (CEO) of a leading public sector bank and comprises Chairman of the State Bank of India (SBI) and NABARD, MDs of public sector banks, Joint Secretary (OSD) from the Ministry of Finance, Executive Director of RBI and other eminent professionals. As the premier testing agency of banks conducting voluminous online mass-level tests, the Institute had about one and half crore candidates registered during the financial year 2019-20 for its recruitment tests across India.

3. The querist has stated that the Institute has been following the accounting practice of booking revenue and expenditure on 'contract completion basis'. Each examination assignment from clients is treated as a project and is backed by an MOU or Standard guidelines on project terms. The lead time is 2-3 months for execution of a project. During this period, the advances received from clients (80/90%) are kept in 'Advances Received' head and the expenditure on the project, such as, vendor payment are made under 'Advance Payments' head of account till completion of the project (conveying results to the clients). Thereafter, the revenue/expenditure is booked in the Profit and Loss Account.

4. The querist has further stated that sometimes, some of the projects undertaken in the fourth Quarter (Q4) of the financial year get spilled over to first quarter (Q1) of the following financial year as a result of the practice of following 'project completion method' of accounting.

In the above scenario, where projects undertaken in Q4 get spilled over to Q1 of the next financial year, the Institute needs to look at the projects with respect to the stages of its completion. The stages and the method of accounting for spill-over projects are detailed below:

1. Preliminary and Main Examinations

- a) The Preliminary examination is completed in one financial year, results are declared, the invoice is raised and the applicable GST is paid. However, the Main examination is spilled over to Q1 of the next financial year.
- b) The Preliminary examination is completed in one financial year, results are declared in Q1 of the following financial year and the main examination is also held in the next financial year.

¹ Opinion finalised by the Committee on 18.1.2021 to 20.1.2021.

2. Single Examination

The examination is held in one financial year and the result is declared in the Q1 of the following financial year.

5. In all of the above cases, the income and the expenditure is recognised in the year in which the project is completed in all respects upto the result declaration stage (in case of two stages, the result declaration of the main examination is considered). The income of the preliminary examination whose invoices are raised as mentioned at Serial No. 1 is transferred to 'Advance to Projects' account and the expenses in respect of the same are transferred to prepaid expenses.

6. The querist has mentioned that the income-tax (IT) authorities have assessed the Institute's tax liabilities; after reconciliation of mismatches in entries and taxes all these years. There were no issues with goods and services tax (GST) as well. However, the current statutory auditors during the course of audit in March 2020, have suggested switching over to 'Receipts Basis' method of accounting aligning with tax (IT/GST) laws. The querist has also sought another opinion from one of the audit firm and they have opined that the Institute should continue with the existing practice of accounting on accrual basis as it is in conformity with Accounting Standards and Income Computation and Disclosure Standards (ICDS).

B. Query

7. In view of above, the querist has sought the opinion of the Expert Advisory Committee as to whether the existing practice of the Institute of accounting on contract completion basis is appropriate or the Institute should switch over to receipt basis.

C. Points considered by the Committee

8. The Committee, while expressing its opinion has examined only the issues raised in paragraph 7 above as to whether the existing practice of revenue recognition on Contract Completion Basis is appropriate or the Institute should switch to receipt basis; and has not examined any other issue that may arise from the Facts of the Case, such as, disclosures under AS 1, AS 9 and other standards, etc. Further, the opinion issued is purely from accounting perspective and not from the perspective of legal interpretation of the Societies Registration Act, 1860, Bombay Public Trusts Act, 1950, Income-tax Act, 1961 or GST enactments, etc.

9. The Committee notes that from accounting perspective, the issue raised by the querist involves two questions: firstly whether the Institute should follow cash/receipt basis of accounting or the accrual basis of accounting and secondly, whether if accrual basis of accounting is followed, whether it should recognise revenue on the basis of completed service contract method or proportionate completion method.

10. With regard to the first question relating to the cash/receipt basis of accounting vis-a-vis accrual basis of accounting, the Committee notes that the Institute in the extant case is a Society under the Societies Registration Act, 1860 and a Public Trust under the Bombay Public Trusts Act, 1950. The Committee notes that the Societies Registration Act does not provide anything in respect of basis of accounting or accounting standards to be followed. Further, although the Bombay Public Trusts Act is also silent on these aspects, it provides as follows:

“32. Maintenance of accounts.--

(1) Every trustee of a public trust shall keep regular accounts.

(2) Such accounts shall be kept in such form as may be approved by the Charity Commissioner and shall contain such particulars as may be prescribed.

33. Balancing and auditing of accounts.--

(1) The accounts kept under section 32 shall be balanced each year on the thirty-first day of March or such other day, as may be fixed by the Charity Commissioner.

(2) *The accounts shall be audited annually by a person who is a chartered accountant within the meaning of the Chartered Accountants Act, 1949 or by such persons as the State Government may, subject to any conditions, authorize in this behalf:*

...”

“34. Auditor’s duty to prepare balance sheet and to report irregularities, etc.--

(1) *It shall be the duty of every auditor auditing the accounts of a public trust under section 33 to prepare a balance sheet and income and expenditure account and to forward a copy of the same along with a copy of his report to the trustee, and to the Deputy or Assistant Charity*

Commissioner of the region or sub-region or to the Charity Commissioner, if the Charity Commissioner required him to do so.

(Emphasis supplied by the Committee.)

The Committee notes from the above that the Bombay Public Trusts Act, 1950 requires inter alia that the accounts shall be audited annually by a member of the Institute of the Chartered Accountants of India and the accounts of a public trust shall comprise of a Balance Sheet and Income and Expenditure Account.

Further, the Committee notes that the ‘Preface to the Statements of Accounting Standards’ (revised 2004), issued by the Institute of Chartered Accountants of India (ICAI) provides as follows:

“3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

3.4 The term ‘General Purpose Financial Statements’ includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public. References to financial statements in this Preface and in the standards issued from time to time will be construed to refer to General Purpose Financial Statements.”

Further, with regard to the applicability of Accounting Standards issued by the ICAI to the Society and Trust, the Committee also notes that paragraph 40 of Technical Guide on

Accounting for Not-for-Profit Organisations (NPOs), issued by the Research Committee of the ICAI, states as follows:

“40. As far as non-company NPOs (including trusts, societies registered under the Societies Registration Act, 1860) carrying on even a very small proportion of commercial, industrial or business activities are concerned, Accounting Standards, formulated by the Institute of Chartered Accountants of India, are mandatory for the members of the Institute in the performance of their attest functions as per the relevant announcements made by the Institute of Chartered Accountants of India from time to time.”

From the above, the Committee notes that even NPOs which are formed as trusts/societies, if carrying on commercial, industrial or business activities are required to follow Accounting Standards issued by the ICAI.

From the activities undertaken by the Institute in the extant case, it is amply clear that it is carrying out commercial and business activities. Thus, on a harmonious reading of the above requirements, the Committee is of the view that the Institute should follow the Accounting Standards issued by the ICAI, which are based on accrual basis of accounting, for its general purpose financial statements. In this context, the Committee also notes the following paragraphs of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI:

“12. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.”

“22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.”

From the above, the Committee notes that the objective of financial statements will be met only when these are prepared using accrual basis of accounting. Accordingly, the Committee is of the view that the Institute in the extant case should follow accrual basis of accounting rather than receipt/cash basis.

11. With regard to the method of recognition of revenue to be followed, the Committee notes the following paragraphs of Accounting Standard (AS) 9, ‘Revenue Recognition’, issued by the ICAI:

“7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

- (i) ***Proportionate completion method***—Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an

indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

- (ii) ***Completed service contract method***—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.”

“9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.”

12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.”

4.2 Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

4.3 Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.”

On the basis of above, the Committee notes that as per the requirements of AS 9, where the performance consists of execution of single act or when the services are performed in more than a single act but the services yet to be performed are so significant that without their execution the performance cannot be deemed to have been completed, then revenue is recognised when the final act is complete and service becomes chargeable. However, where the contract involves execution of more than one act, revenue should be recognised proportionately by reference to the performance of each act or degree of completion of service under the contract. Under this method, revenue is recognised in the Statement of Profit and Loss on the basis of stage of completion/work performed irrespective of the fact whether or not payment has been received or settled (provided other conditions of revenue recognition are also being fulfilled). Similarly, costs are also recognised in the Statement of Profit and Loss for the period in which the work to which they relate are performed. Thus, both costs and revenue are recognised with reference to the work performed, i.e., stage of completion, which may be determined in a variety of ways, such as, surveys of work performed, completion of a physical proportion of the contract work, etc., depending on the nature of the contract and whichever method reliably measures the work performed.

12. In the above context, the Committee notes that in the extant case, each assignment is treated as a single project and is backed by MoU/Standard guidelines on project terms with a lead time of 2-3 months and project is treated as complete on completion of conveying results to the clients. Further, both revenue and related expenses are being deferred till the declaration of results. Till that time, receipts from the customers are recognised as ‘advances’. Similarly, the payments made to contractors on account of expenses incurred are also considered as advance/pre-paid expenses.

The Committee notes from the copy of the MoU with the clients provided by the querist for the perusal of the Committee that, both projects/ assignments involving preliminary and main examinations as well as single examination involve execution of many activities, such as, preparing application link on the basis of advertisement provided by client, designing drafts of call letter, designing suitable tests, conduct of online examinations for both preliminary and main examinations, preparation of merit list and score list, etc. which will be undertaken by the Institute through its service provider(s) and for which various costs would be incurred from time to time. Further, in case of projects/ assignments involving preliminary and main examinations, billing will be done separately for these two examinations. Accordingly, the Committee is of the view that the Institute in the extant case should analyse the nature of each assignment/ project considering the terms and conditions of the contract/ MoU, especially with reference to the number of acts required to complete the assignment/contract, various stages of performance involved in its execution/completion, the incidence of costs relating to various acts, etc. to determine the appropriate method of recognition of revenue. Particularly, in case of projects/assignments involving preliminary and main examinations, the Committee wishes to point out that there are at least two distinct acts involved for execution of the project/ assignment, which may be considered as stages of performance under proportionate completion method unless completed contract method is more appropriate considering the significance/materiality of the acts yet to be performed in relation to the transaction as a whole (for example, conveying results to the clients) that performance cannot be deemed to have been completed until the execution of those acts, as discussed above. In this context, the Committee wishes to point out that the stages of payment, is not the sole determining factor for the method to be adopted for recognition of revenue. The stages of payment may serve as a guidance to determine the relative significance of the acts involved in execution of the assignment/project.

Further, in cases where the completed contract method is applicable on the basis of considerations stated above, revenue is recognised on the substantial performance of the contract and further the costs incurred in respect of such contracts should be recognised as work in progress and carried forward to be expensed in the year in which the corresponding revenue is recognised.

However, if the process involves various acts/ stages/ milestones and each of such acts/ stages/ milestones is significant/ material in relation to the execution of the assignment/project, the Institute should recognise the revenue by following proportionate completion method.

13. The Committee also wishes to mention that nature of individual contracts may vary; hence variations from contracts to contracts should also be factored into while determining the method of revenue recognition from the contract. Thus, it is possible that even for same type of activities, there are two different methods of revenue recognition for two different types of contract considering the requirements of AS 9.

D. Opinion

14. On the basis of the above, the Committee is of the view that accrual basis of accounting should be continued to be followed by the Institute as discussed in paragraph 10 above. Further with regard to method of accounting, the Committee is of the view that the Institute in the extant case should analyse the nature of each assignment/project considering the terms and conditions of the contract/MoU, especially with reference to the number of acts required to complete the assignment/contract, various stages of performance involved in its execution/completion, the incidence of costs relating to various acts, etc. to determine the appropriate method of recognition of revenue, as discussed in paragraphs 11 and 12 above.