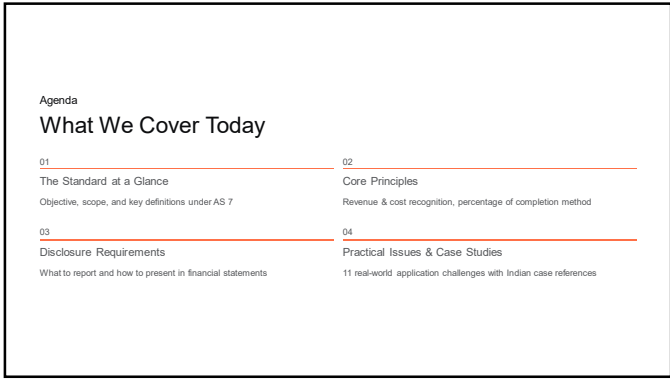
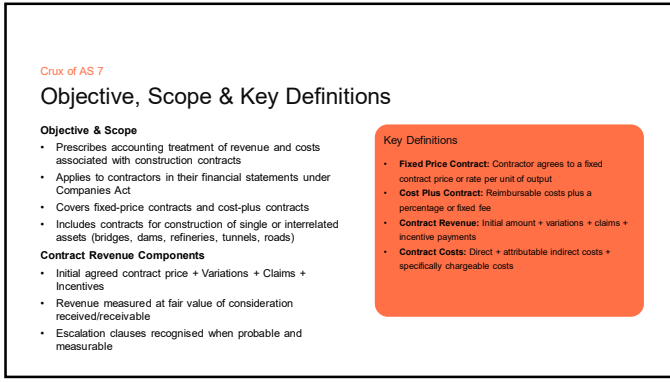


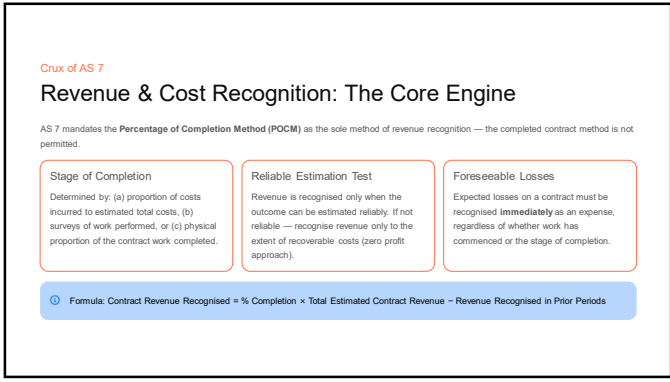
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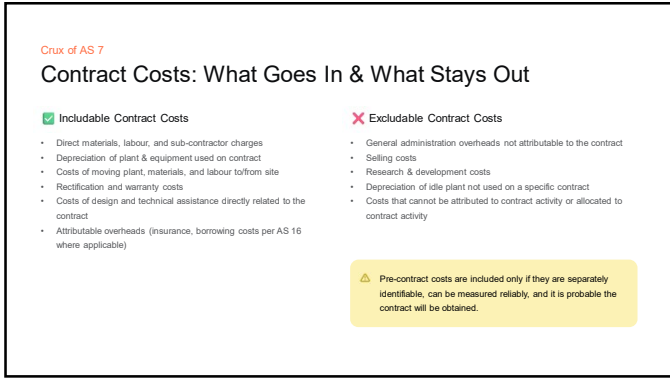
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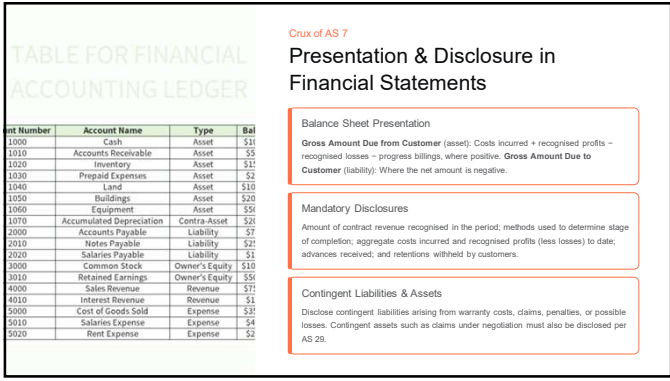
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Practical Issue 1

Determining Stage of Completion: The NHAI / Road Contractor Dilemma

Issue: Large road-building contractors in India (e.g., those executing NHAI EPC contracts) often face difficulty in determining stage of completion where physical surveys are impractical and milestones are not evenly spread. Using the cost-to-cost method may overstate completion if significant materials have been procured but not yet installed.

Practical Guidance: The ICAI has clarified that mere procurement of materials does not constitute contract activity. Costs of uninstalled materials should be excluded from both numerator and denominator of the cost-to-cost ratio unless the materials were manufactured specifically for the contract. A combination of surveys and cost method may be employed with consistent application.

Common Error: Including material procurement costs in % completion calculation, leading to premature revenue recognition and overstated profits in early periods.

Best Practice: Use physical completion surveys certified by a site engineer as the primary method; use cost-to-cost only as a cross-check for fixed-price EPC contracts.

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Practical Issue 2

Treatment of Variations & Claims: L&T and Infrastructure Contractors

Major EPC contractors like Larsen & Toubro regularly face disputes on variation orders and claims from clients such as government bodies and PSUs. AS 7 permits inclusion of variation amounts in contract revenue only when (a) it is probable the customer will approve the variation and (b) the amount can be measured reliably.

Variation Orders

Include in revenue only if approved or virtually certain to be approved. Unapproved variations — disclose as contingent asset under AS 29.

Claims Against Customers

Recognise only when negotiations have reached an advanced stage and it is probable the claim will be accepted. Do not recognise merely on submission of a claim.

Incentive Payments

Include only when performance standards are sufficiently advanced that it is probable the specified performance criteria will be met or exceeded.

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Practical Issue 3

Foreseeable Losses: Real Estate & Infrastructure Downturns

The Scenario

During 2012–2016, several mid-size construction companies executing residential and commercial projects experienced significant cost overruns due to steel and cement price escalations, labour shortages, and regulatory delays (environmental clearances).

Many companies deferred recognition of foreseeable losses, citing uncertainty in final cost estimates — a practice questioned by auditors and ICAI guidance.

AS 7 Requirement

When it is probable that total contract costs will exceed total contract revenue, the expected loss must be recognised immediately as an expense — irrespective of the stage of completion.


Audit Red Flags

- Revised cost estimates not updated in workings
- Loss-making contracts not identified separately
- Management override on provisions citing "recovery likely"
- No sensitivity analysis on material price escalation clauses

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Practical Issue 4

Combining & Segmenting Contracts: Real Estate Developers as Contractors



This issue commonly arises when a developer-cum-contractor executes multiple towers under a single township project with a single agreement but separate pricing and delivery schedules per tower.


- 1 **Single Agreement Presumption**
Entities often treat the entire project as one contract for convenience, deferring losses in profitable towers against loss-making ones.
- 2 **AS 7 Segmentation Test**
Each asset (tower) shall be treated as a separate contract if: separate proposals were submitted per asset and each asset was subject to separate negotiation.
- 3 **Implication**
Segmenting contracts prevents cross-subsidisation of losses, ensuring each contract's foreseeable loss is recognised promptly and independently.

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Practical Issue 5

Pre-Contract Costs: Bid Costs & Mobilisation Expenses

How to Prepare Tender Documents



AS 7 Position

Pre-contract costs (bid costs, feasibility studies, tendering expenses) may be included in contract costs only if:

- They can be separately identified and reliably measured
- It is probable that the contract will be obtained

If expensed when incurred and the contract is subsequently obtained, they cannot be reinstated as contract costs. Consistency of policy is critical.

Capitalising pre-contract costs when contract award is uncertain constitutes a departure from AS 7 and requires disclosure.

Common Practice (Incorrect): Many Indian contractors capitalise all bid preparation, tender submission, and site mobilisation costs as "contract work-in-progress" regardless of whether the contract is awarded, thereby inflating assets.

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Practical Issue 6 & 7

Borrowing Costs & Related Party Contracts


Bank	AS 16	AS 17	AS 18	AS 19	AS 20	AS 21
Indian Overseas Bank	8.4	8.55	8.7	8.85	9.0	9.15
ICICI Bank	8.2	8.3	8.4	8.5	8.6	8.7
Bank of Baroda	8.1	8.25	8.4	8.55	8.7	8.85
Bank of India	8.1	8.25	8.4	8.55	8.7	8.85
Punjab National Bank	8.1	8.25	8.4	8.55	8.7	8.85
State Bank of India	8.1	8.25	8.4	8.55	8.7	8.85
Axis Bank	8.1	8.25	8.4	8.55	8.7	8.85
HDFC Bank	8.1	8.25	8.4	8.55	8.7	8.85
State Metropolitan Bank	8.1	8.25	8.4	8.55	8.7	8.85

Borrowing Costs (AS 16 Interface)

Borrowing costs directly attributable to construction contracts that meet the definition of a "qualifying asset" under AS 16 must be capitalised. However, where the contractor finances working capital for multiple short-cycle contracts, allocating borrowing costs to individual contracts is complex. The ICAI guidance note recommends allocating based on average contract value or duration-weighted basis with consistent disclosure.

Related Party Contracts

Group companies awarding construction contracts to subsidiary contractors at cost-plus arrangements require scrutiny. The terms must reflect arm's-length pricing. Auditors must verify that the cost-plus fee is not set artificially to shift profits and that contract terms (duration, payment) are commercially reasonable. AS 18 disclosures are mandatory in addition to AS 7 requirements.



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Practical Issues 8 & 9

Retention Money & Advance Receipts: Balance Sheet Classification

Retention Money

Customers typically withhold 5–10% of each running bill as retention, released post defects liability period. **AS 7 treatment:** Retention is part of contract revenue already recognised; it is simply a receivable with deferred collection. It must be presented as a **trade receivable** — not netted against the gross amount due from customers. Showing retention as a contingent asset is incorrect and misleading.

Advance Receipts (Mobilisation Advances)

Mobilisation advances received from clients are often incorrectly netted against "work-in-progress." Per AS 7, advances received must be presented as a **liability (advance from customers)** until contract activity justifies their recognition against progress billings. Premature netting suppresses liabilities and inflates net contract assets — a frequent finding in peer reviews of infrastructure company audits.

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Practical Issues 10 & 11

Service Contracts & BOT Arrangements: Boundary of AS 7

Issue 10: Service Concession (BOT)

Build-Operate-Transfer (BOT) arrangements — prevalent in India's road and port sectors — raise the question of whether the construction phase is governed by AS 7 or the Guidance Note on Service Concession Arrangements. The ICAI's Guidance Note clarifies that **AS 7 applies to the construction phase only, whilst the operation phase is governed separately.** Revenue from the construction phase recognised under POCM must be carved out from toll/concession fee revenue.

Issue 11: IT & Engineering Service Contracts

Long-term software development or engineering consulting contracts are often mistakenly accounted under AS 9 (Revenue Recognition) rather than AS 7. AS 7 applies when the contract specifically involves **construction, restoration, or installation** of an asset to the buyer's design specification. Pure service contracts (design only, consulting) fall under AS 9. The distinction has significant P&L impact, particularly where milestones differ from physical completion.

🔗 ICAI clarification (2007): AS 7 applies to contracts where the output is a tangible constructed asset, regardless of the industry of the contractor.

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Key Takeaways

Summary & Practitioner's Checklist

1 Apply POCM Consistently

Completed contract method is not permitted. Document the basis of stage of completion determination every year-end with supporting evidence.

2 Recognise Losses Immediately

Loss-making contracts must be identified at the entity level. Resist management pressure to defer loss recognition pending "final negotiations."

3 Variations & Claims: Probability Test

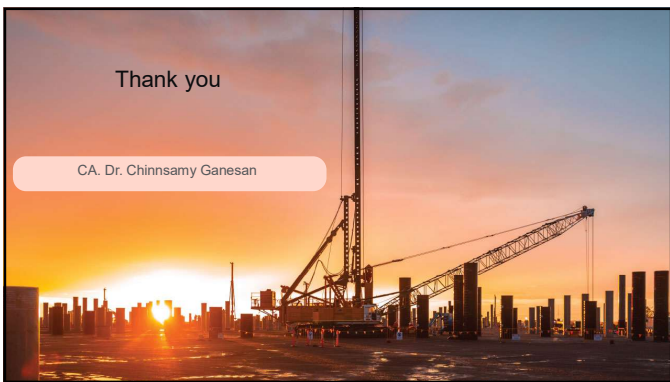
Apply strict probability assessment before including unapproved variations or claims in contract revenue. Contingent assets require AS 29 disclosure.

4 Balance Sheet Presentation

Gross amounts due from/to customers, retentions, and advances must each be presented correctly — netting is not permitted under AS 7.

🔗 For complex contracts — particularly in infrastructure, real estate, and BOT — obtain management's revised cost estimates in writing at each reporting date and independently assess their reasonableness.

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