

## ***Guidance note on accounting for real estate transactions (Ind AS compliant companies)***

June 2016



***News alert***

## Background

The Ministry of Corporate Affairs (MCA) vide notification dated 30 March 2016 issued the Companies (Indian Accounting Standards) Amendment Rules, 2016. The amendment rules omitted Ind AS 115, 'Revenue from contracts with customers' and replaced it with Ind AS 11, 'Construction contracts' and Ind AS 18, 'Revenue'. These standards are aligned with the present International Accounting Standards (IAS) on the subject matter, except that the International Financial Reporting Interpretations Committee (IFRIC) Interpretation 15, 'Agreements for the construction of real estate', which provides guidance to determine whether an agreement for the construction of real estate is within the scope of IAS 18, 'Revenue' or IAS 11 'Construction contracts', was not incorporated. Instead, a footnote in Ind AS 18 stated that for real estate developers, revenue shall be accounted for in accordance with the guidance note (GN) on the subject matter to be issued by the Institute of Chartered Accountants of India (ICAI).

On 10 May 2016, the ICAI issued the GN on accounting for real estate transactions for entities to whom Ind AS is applicable.

The objective of the GN is to recommend the accounting treatment to be followed by the entities dealing in real estate as sellers or developers. The term real estate refers to land as well as buildings and rights in relation thereto. This alert highlights the key provisions of the GN.

This GN for Ind AS compliant companies is substantially similar to the GN on accounting for real estate transactions issued by the ICAI in 2012.

## Scope

The GN covers all forms of transactions in real estate. It lays down an illustrative list of transactions which are included in its scope:

- a) Sale of plots of land (including lease of land on finance lease under Ind AS 17, 'Leases') without any development
- b) Sale of plots of land (including lease of land on finance lease under Ind AS 17, 'Leases') with development, including development in the form of common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewage tanks, water storage tanks, sports facilities, gymnasium, club house and landscaping
- c) Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land
- d) Acquisition, utilisation and transfer of development rights
- e) Redevelopment of existing buildings and structures
- f) Joint development agreements for any of the above activities

It is to be noted that the scope of the GN includes finance leasing of land by real estate developers/sellers. Revenue from such lease transactions will be accounted for in accordance with the principles of the GN.

## ***Accounting for real estate transactions***

### **(a) Transactions which are in substance delivery of goods**

In respect of the real estate transactions, which are in substance similar to the delivery of goods, principles enunciated in Ind AS 18, 'Revenue', are to be applied. For example, the sale of plots of land without any development would be covered by the principles of Ind AS 18. These transactions are similar to the delivery of goods where the revenues, costs and profits are recognised, when the revenue recognition process is completed. As per the GN, revenue recognition is completed when the following conditions of para 14 of Ind AS 18 are satisfied:

- (i) The entity has transferred to the buyer the significant risks and rewards of ownership of the real estate.
- (ii) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the real estate sold.
- (iii) The amount of revenue can be measured reliably.
- (iv) It is probable that the economic benefits associated with the transaction will flow to the entity.
- (v) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

In cases where the transfer of a legal title is a condition precedent to the buyer taking on the significant risks and rewards of ownership and accepting significant completion of the seller's obligation, revenue should not be recognised till such time the legal title is validly transferred to the buyer.

### **(b) Transactions which are in substance construction type contracts**

In the case of real estate transactions which have the same economic substance as construction contracts, the GN draws upon the principles enunciated in Ind AS 11. Some indicators of construction type contracts highlighted in the GN are as follows:

- (i) The duration of such projects is beyond 12 months and the project commencement date and project completion date fall into different accounting periods.
- (ii) Most features of the project are common to construction contracts, namely land development, structural engineering, architectural design, and construction.
- (iii) While individual units of the project are contracted to be delivered to different buyers, these are interdependent upon or interrelated to completion of a number of common activities and/or provision of common amenities.
- (iv) The construction or development activities form a significant proportion of the project activity.

In case of real estate contracts, which are in substance construction type contracts, real estate developers/sellers need to assess whether significant risks and rewards related to ownership are transferred to the buyer. The point of time at which all significant risks and rewards can be considered transferred is required to be determined on the basis of the terms and conditions of the agreement of sale. In such cases, the seller usually enters into an agreement for sale with the buyer at initial stages of construction. This agreement for sale is also considered to have the effect of transferring all significant risks and rewards of ownership to the buyer, provided the agreement is legally enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards, even though the legal title is not transferred or the possession of the real estate is not given to the buyer. Once the seller has transferred significant risks and rewards to the buyer, any acts on the real estate performed by the seller are in substance performed on behalf of the buyer in the manner similar to a contractor. Revenue in such cases is recognised by applying the percentage of completion method (POCM) on the basis of the methodology explained in Ind AS 11, 'Construction contracts'. It may be noted that there are certain important differences between POCM as explained in the GN and as per Ind AS 11.

In case of real estate sales, the seller usually enters into an agreement for sale with the buyer at initial stages of construction. This agreement for sale is also considered to have the effect of transferring significant risks and rewards of ownership to the buyer, provided it is enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards, even though the title or possession of the asset has not been transferred to the buyer.

Once the seller has transferred the significant risks and rewards to the buyer, any further acts by the seller on the real estate asset are in substance similar to a contractor. Revenue in such case is recognised by applying POCM.

## Application of POCM

### Definition of a project

A project is the smallest group of units/plots/saleable spaces which are linked with a common set of amenities in such a manner that unless the common amenities are made available and functional, these units/plots/saleable spaces cannot be put to their intended effective use. The definition of a project is very critical under the GN, since it determines when the threshold for recognising revenue is achieved and also the manner in which POCM is applied. The manner in which a project is defined may have a significant impact on the revenue, cost and profit that is to be recognised.

For example, if the entire township is considered as a project, then it is likely that the threshold limit for recognising revenue is achieved much later compared to when each building in the township is identified as a project.

### POCM

POCM is applied when the *outcome of a real estate project can be estimated reliably* and when all the following conditions are satisfied:

- a) Total project revenues can be estimated reliably.
- b) It is probable that the economic benefits associated with the project will flow to the entity.
- c) The project costs to complete the project and the stage of project completion at the reporting date can be measured reliably.
- d) The project costs attributable to the project can be clearly identified and measured reliably so that the actual project costs incurred can be compared with prior estimates.

In addition to the above conditions, *there is a rebuttable presumption that the outcome of a real estate project can be estimated reliably* and that revenue should be recognised under POCM only when the following events are completed:

- a) All critical approvals necessary for commencement of the project have been obtained (e.g. environmental and other clearances, approval for plans, design, and title to land).
- b) When the stage of completion of the project reaches a reasonable level of development. A reasonable level of development is not achieved if the expenditure incurred on the project construction and development is less than 25% of the expected project construction and development costs. Such costs would exclude land costs but include borrowing costs.
- c) At least 25% of the sale project area is secured by the contracts or agreements with the buyer.

- d) At least 10% of the contract consideration as per agreements of sale or any other enforceable documents are realised at the reporting date in respect of each of the contracts, and it is reasonable to expect that the parties to such contracts will comply with the payment terms. For example, if there are 10 agreements of sale and 10% of gross amount is realised in case of eight agreements, revenue can be recognised with respect to these eight agreements only.

When POCM is applied, project revenue and projects costs associated with the real estate project should be recognised as revenue, and expenses by reference to the stage of completion of the project activity at the reporting date. For the computation of revenue, the stage of completion is arrived at with reference to the entire project costs incurred, including land costs. However, land costs are not included to determine whether the thresholds mentioned above for recognising revenue is achieved.

Costs incurred that relate to future activity on the project, and payments made to subcontractors in advance of work performed under the subcontract are excluded and matched with revenues when the activity or work is performed.

Accordingly, it is important that real estate entities maintain details and monitor these specific quantitative thresholds before recognising revenue as project activity progresses at each reporting period.

The recognition of the project revenue by reference to the stage of completion of the project activity should not exceed the estimated total revenues from eligible contracts. 'Eligible contracts' mean contracts where at least 10% of the contracted amounts have been realised and there are no outstanding defaults of the payment terms in such contracts.

This is an important provision within the GN, requiring real estate entities to maintain complete and reliable information of customer defaults.

The receivables arising from real estate contracts will also require provisioning for impairment based on the expected credit losses model specified under Ind AS 109, 'Financial instruments'.

Furthermore, where there is a significant time lag between when the construction service is provided and the consideration is received, entities may also need to consider whether any discounting of consideration to its fair value is required.

Further, similar to Ind AS 11, when it is probable that total project costs will exceed total eligible project revenues, the expected loss should be recognised as an expense immediately.

The GN does not prohibit other methods of determination of stage of completion, for example, surveys of work done and technical estimation. However, computation of revenue with reference to other methods of determination of stage of completion should not, in any case, exceed the revenue computed with reference to the 'project costs incurred' method.

The project costs incurred method is considered as the preferred method.

## Other matters

The GN also provides guidance in respect of the following areas, which are generally similar to the provisions of the GN on accounting for real estate transactions issued by the ICAI in 2012:

- Accounting for transferable developmental rights
- Accounting for multiple element arrangements in a contract
- Disclosures in the financial statements of real estate seller developer

### Key differences between GN and IFRIC 15 under IFRS

- IFRIC 15 under IFRS provides a different criteria to assess whether revenue can be recognised during the construction period. The following factors prescribed by IFRIC 15 for revenue recognition under POCM are not considered by the GN:
  - (i) Ability of the buyer to specify major structural elements of the real estate design
  - (ii) Transfer of control and significant risks and rewards of the ownership of the work in progress in its current state as construction progresses (i.e. continuous transfer of risks and rewards)
- IFRIC 15 does not provide any quantitative thresholds for application of POCM.
- IFRIC 15 does not prescribe any preferred method to determine the stage of completion. The GN considers the 'project cost incurred' method as the preferred method.

When applied in practice, the above can result in a significant difference between real estate revenue recognised under Ind AS and IFRS.



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