Exposure Draft

Guidance Note on Recognition of Revenue by Real Estate Developers

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Issued by

Accounting Standards Board

The Institute of Chartered Accountants of India

EXPOSURE DRAFT

GUIDANCE NOTE ON RECOGNITION OF REVENUE BY REAL ESTATE DEVELOPERS.

The following is the Exposure Draft of the Guidance Note on Recognition of Revenue by Real Estate Developers, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comments. The Board invites comments on any aspect of this Exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than ***December 13, 2011****. Comments can also be sent by e-mail at edcommentsasb@icai.org or asb@icai.org.*

1. Objective and Scope

Objective

1.1. The objective of this Guidance Note is to recommend the accounting treatment by enterprises dealing in 'Real Estate' as sellers or developers. The term 'real estate' refers to land as well as buildings and rights thereon. Enterprises who undertake such activity are generally referred to by different terms such as 'real estate developers', 'builders' or 'property developers'.

Scope

1.2. This Guidance Note covers all forms of transactions in real estate. An illustrative list of transactions which are covered by this Guidance Note is as under:

(a) Sale of plots of land without any development

(b) Sale of plots of land with development in the form of common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewerage tanks, water storage tanks, sports facilities, gymnasium, club house, landscaping etc.

(c) Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land.
(d) Acquisition, utilization and transfer of development rights.
(e) Redevelopment of existing buildings and structures.
(f) Joint development agreements for any of the above activities.

1.3 The Guidance Note primarily provides guidance on application of percentage of completion method as per Accounting Standard (AS) 7, *Construction Contracts*, in respect of transactions and activities of real estate which have the same economic substance as construction-type contracts. In respect of transactions of real estate which are in substance similar to delivery of goods, Accounting Standard (AS) 9, *Revenue Recognition*, is applicable.

1.4 Real estate transactions of the nature covered by Accounting Standard (AS) 10, *Accounting for Fixed Assets*, Accounting Standard (AS) 12, *Accounting for Government Grants*, Accounting Standard (AS) 19, *Leases*, and Accounting Standard (AS) 26, *Intangible Assets*, are outside the scope of this Guidance Note.

1.5 This Guidance Note should be applied to all transactions in real estate which are commenced or entered into on or after April 1, 2012. An enterprise may choose to apply this Guidance Note from an earlier date provided that it applies this Guidance Note to all transactions which commenced or were entered into on or after such earlier date. This Guidance Note supersedes the Guidance Note on Recognition of Revenue by Real Estate Developers, issued by the Institute of Chartered Accountants of India in 2006, when this Guidance Note is applied as above.

2. Definitions

2.1 ***Project*** Project is defined as "a group of units/plots/saleable spaces which are linked with a common set of amenities in such manner that unless the common amenities are made available and functional, these units /plots / saleable spaces cannot be put to their intended effective use".

A larger venture can be split into small projects if the basic conditions as set out above are fulfilled.

For example, a project may comprise a cluster of towers or each tower can also be designated as a project. Similarly, a complete township can be a project or it can be broken down into smaller projects.

2.2. ***Project Costs*** Project costs in relation to a project ordinarily comprise

(a) *Cost of land and cost of development rights* - All costs related to the acquisition of land or development rights in the land or property including cost of land, cost of development rights, registration charges, stamp duty, brokerage costs and incidental expenses.

(b) *Borrowing Costs* - Borrowing costs which are incurred directly in relation to a project or which are apportioned to a project in accordance with Accounting Standard (AS) 16, *Borrowing Costs.*

(c) *Construction and development costs* – These would include costs that relate directly to the specific project and costs that are attributable to project activity in general and can be allocated to the project.

2.3. Construction costs and development costs that relate directly to a specific project include:

(a) Land conversion costs, betterment charges, municipal sanction fee and other charges for obtaining building permissions;
(b) site labour costs, including site supervision;
(c) costs of materials used in construction or development of property;
(d) depreciation of plant and equipment used on the contract;
(e) costs of moving plant, equipment and materials to and from the project site;
(f) costs of hiring plant and equipment;
(g) costs of design and technical assistance that is directly related to the project;
(h) the estimated costs of rectification and guarantee work, including expected warranty costs; and
(i) claims from third parties.

2.4 The following costs should not be considered part of construction costs and development costs if they are material:

(a)Depreciation of idle plant and equipment
(b)Cost of unconsumed or uninstalled material delivered at site and
(c) Payments made to sub-contractors in advance of work performed

2.5. Costs that may be attributable to project activity in general and can be allocated to specific projects include:

(a) insurance;
(b) costs of design and technical assistance that is not directly related to a specific project; and

(c) construction or development overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of project activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to project activity in general and can be allocated to specific projects also include borrowing costs.

2.6 ***Project revenues*** - Project revenues include revenue on sale of plots, undivided share in land, sale of finished and semi-finished structures, consideration for construction, consideration for extra amenities and interiors, consideration for parking spaces and sale of development rights.

Project revenues are measured as the consideration received or receivable. The measurement of project revenues is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of project revenue may increase or decrease from one reporting period to the next.

3. Accounting for Real Estate Transactions

3.1 Real estate activities and transactions take diverse forms. While some are for sale of land (developed or undeveloped), others are for construction, development or sale of units that are not complete at the time of entering into agreements for construction, development or sale.

3.2 The typical features of most construction/development of commercial and residential units have all features of a construction contract – land development, structural engineering, architectural design and construction – are all present. The nature of these activities are such that often the date of commencement and the date when the activity is completed usually fall into different accounting periods. It is not unusual for such activities to spread over two or more accounting periods.

3.3 This Guidance Note requires application of:

- Percentage completion method for recognizing revenue, costs and profits from transactions and activities of real estate which have the same economic substance as construction-type contracts; and
- Principles of AS 9 in respect of sale of goods for recognizing revenue, costs and profits from transactions of real estate which are in substance similar to

delivery of goods where the revenues, costs and profits are recognised when the earning process is completed.

3.4 The application of either of the methods described in paragraph 3.3 above requires a careful analysis of the elements of the transaction, agreement, understanding and conduct of the parties to the transaction to determine the economic substance of the transaction. The economic substance of the agreement is not influenced or affected by the structure and/or legal form of the transaction or agreement.

4. Application of Percentage Completion Method

4.1 The percentage completion method should be applied in the accounting of all real estate transactions/activities where the economic substance is similar to construction-type contracts. Some indicators of such transactions/activities are:

(a) The period of such projects is in excess of 12 months and the project commencement date and project completion date fall into different accounting periods.
(b) Most features of the project are common to construction-type contracts, viz., land development, structural engineering, architectural design, construction, etc.
(c) 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.
(d) The construction or development activities form a significant proportion of the project activity.

4.2 This method 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 enterprise;
(c) the project costs to complete the project and the stage of project completion at the reporting date can be measured reliably; and
(d) the project costs attributable to the project can be clearly identified and measured reliably so that actual project costs incurred can be compared with prior estimates.

When the outcome of a project can be estimated reliably, project revenues and project costs associated with the project should be recognised as revenue and expenses respectively applying the percentage of completion method in the manner detailed in paragraphs 4.3 to 4.8 below.

4.3 Revenue recognition under the percentage completion method is applied only when all the following conditions are fulfilled:

(a) All critical approvals necessary for commencement of the project have been obtained. These include, wherever applicable:
  (i) Environmental and other clearances.
  (ii) Approval of plans, designs, etc.
  (iii) Title to land or other rights to development/construction.

(b) When the stage of completion of each project reaches a reasonable level of development. There is a rebuttable presumption that a reasonable level of development is not achieved if the expenditure incurred on project costs is less than 25 % of the construction and development costs as defined 2.2 (c) read with paragraphs 2.3 to 2.5.

(c) Atleast 25% of the estimated project revenues are secured by contracts or agreements with buyers.

(d) Atleast 10 % of the total revenue as per the agreements of sale or any other legally 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 in the contracts.

4.4 When the outcome of a real estate project can be estimated reliably and the conditions stipulated in paragraphs 4.2 and 4.3 are satisfied, project revenue and project 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.

4.5 The project costs which are recognised in the statement of profit and loss by reference to the stage of completion of the project activity are matched with the revenues recognised resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. Costs incurred that relate to future activity on the project and payments made to sub-contractors in advance of work performed under the sub-contract are excluded and matched with revenues when the activity or work is performed. This method provides useful information to the extent of contract activity and performance during a period.

4.6 The recognition of project revenue by reference to the stage of completion of the project activity should not at any point exceed the estimated total revenues from 'eligible contracts'/other legally enforceable agreements for sale. 'Eligible contracts' means contracts/agreements specified in paragraph 4.3 where atleast 10% of the contracted amounts have been realised and there are no outstanding defaults of the payment terms in such contracts. Where the recognition of revenue due to this condition is lower than the revenue determined by reference to the stage of completion, the project costs to be matched with such revenue are also proportionately adjusted.

4.7 When it is probable that total project costs will exceed total project revenues, the expected loss should be recognised as an expense immediately. The amount of such a loss is determined irrespective of:

(a) whether or not work has commenced on the project or

(b) the stage of completion of project activity;

4.8 The percentage of completion method is applied on a cumulative basis in each reporting period to the current estimates of project revenues and project costs. Therefore, the effect of a change in the estimate of project costs, or the effect of a change in the estimate of the outcome of a project, is accounted for as a change in accounting estimate. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

5. Application of principles of AS 9 in respect of sale of goods to a real estate project

5.1 The application of principles of AS 9 in respect of sale of goods requires recognition of revenues on completion of the transaction/activity when the earnings process in respect of a real estate project is completed as explained in paragraph 5.2 below.

5.2 The completion of the earnings process is usually identified when the following conditions are satisfied:

(a) The seller has transferred to the buyer all significant risks and rewards of ownership and the seller retains no effective control of the real estate to a degree usually associated with ownership;

(b) The seller has handed over possession of the real estate forming part of the transaction;

(c) No significant uncertainty exists regarding the amount of consideration that will be derived from the real estate sales; and

(d) It is not unreasonable to expect ultimate collection.

5.3 Where transfer of 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 legal title is validly transferred.

6. Accounting for sale of land or plots

A. Sale of plots of land without any development

Revenue from sale of land or plots should be recognised when all the conditions in paragraph 5.2 above met

B. Sale of developed plots

Where the development activity is significant and if the projects meet the criteria specified in paragraph 4.1 above, the percentage completion method is used to account for such sales.

7. Sale of development rights

7.1 Development rights are generally acquired in different ways as mentioned hereunder:

(a) Direct purchases.
(b) Development and construction of built-up area.
(c) Giving up of rights over existing structures or open land.

7.2 When development rights are acquired by way of direct purchases or on development or construction of built up area, cost of acquisition would be the cost of purchases or amount spent on development or construction of built-up area, respectively. Where development rights are acquired by way of giving up of rights over existing structures or open land, the development rights should be recorded either at fair value or at the net book value of the portion of the asset given up. For this purpose, fair market value may be determined by reference either to the asset or portion thereof given up or to the fair value of the rights acquired whichever is more clearly evident.

7.3 When development rights are utilised in a real estate project by an enterprise, the cost of acquisition should be added to the project costs.

7.4 When development rights are sold or transferred, revenue should be recognised when both the following conditions are fulfilled:

(a.) title to the development rights is transferred to the buyer and
(b.) it is not unreasonable to expect ultimate realisation of proceeds.

8. Transactions with multiple elements

8.1 An enterprise may contract with a buyer to deliver goods or services in addition to the construction/development of real estate (e.g. property management services, sale of decorative fittings, rental in lieu on unoccupied premises, etc.). In such cases, the contract should be split into separately identifiable components including one for the construction and delivery of real estate units.

8.2 The consideration received or receivable for the contract should be allocated to each component on the basis of the fair value of each component.

8.3 The accounting of each of the components should be in accordance with paragraph 3.3 above.

9. Disclosure

9.1 An enterprise should disclose:

(a) the amount of project revenue recognised as revenue in the reporting period;

(b) the methods used to determine the project revenue recognised in the reporting period; and

(c) the method used to determine the stage of completion of the project.

9.2 An enterprise should also disclose each of the following for projects in progress at the end of the reporting period:

(a) the aggregate amount of costs incurred and profits recognised (less recognised losses) to date; and

(b) the amount of advances received;

Illustration

Total saleable area	- 20,000 Sq ft
Estimated Project Revenue	- Rs 800 Lakhs
Estimated Project Costs (This comprises land costs of Rs 300 Lakhs and construction costs of Rs 300 Lakhs)	- Rs 600 Lakhs
Work completed till end of reporting period (This includes land cost of Rs 300 lakhs and construction cost of Rs 60 Lakhs)	- Rs 360 Lakhs
Total Area Sold till the date of reporting period	- 5000 Sq. ft.
Total Sale Consideration as per Agreements of Sale executed	- Rs 200 Lakhs
Amount realised till the end of the reporting period	- Rs 50 Lakhs
Percentage of completion of work	- 60 % of total project cost Including land cost or 20 % of construction cost

At the end of the reporting period the enterprise will not be able to recognise any revenue as reasonable level of construction, which is 25 % of the total construction cost, has not been achieved, though 10 % of the agreement amount has been realized.

Continuing the illustration:

If the work completed till end of reporting period is (This includes land cost of Rs 300 Lakhs and construction cost of Rs 90 lakhs)	- Rs 390 Lakhs
Percentage of completion of work would be	- 65 % of total project cost or 30 % of construction cost

The enterprise would be able to recognise revenues at the end of the accounting period. The revenue recognition and profits would be as under:

Revenue recogniszed - (65 % of Rs 200 lakhs as per Agreement of Sale)	- Rs 130 Lakhs
Proportionate cost of revenue (600/800 x130)	- Rs 97.50 Lakhs
Income from the project	- Rs 32.50 Lakhs
Work in progress to be carried forward (Rs 390 lakhs – Rs 97.50 Lakhs)	- Rs 292.50 Lakhs