AS-7 & GUIDANCE NOTE ON REAL ESTATE ACCOUNTING

REAL ESTATE SUMMIT

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Guidance Note on Accounting for Real Estate Transactions

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Introduction

- Real Estate transactions are unique since :

a) Spread over more than one accounting period

b) Diverse formats in the transaction structures

- AS-9 does not provide clarity on timing and basis of revenue recognition – hybrid of sale of goods and services
- Specific challenges:

a) Timing for transfer of risks and rewards

b) Need for substantial estimation e.g. project costs, percentage completion etc.

Objective and Scope

- To recommend the accounting treatment by enterprises dealing in ‘Real Estate’ as sellers or developers.
- ‘Real Estate’ refers to land as well as buildings and rights in relation thereto.
- Terms such as ‘real estate developers’, ‘builders’ or ‘property developers’ are synonymous with real estate

Objective and Scope

- **Transactions within Scope**:

a) Sale of plots of land (including long term sale type leases) without any development.

b) Sale of plots of land (including long term sale type leases) with 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, 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, utilisation and transfer of development rights.

e) Redevelopment of existing buildings and structures.

f) Joint development agreements for any of the above activities

Identification of Project

- Identification of project is important as POCM will be applied project wise.
- Project is defined as smallest group of units / plots / saleable area which are linked with a common set of amenities. Unless such amenities are available and functional, the said units can not be put to their intended effective use.
- It is advisable to split / divide larger ventures into smaller projects so that POCM can be easily applied. Generally, larger the unit there will be difficulty in applying POCM.

Identification of Project – Practical Issues

- Developer Limited has purchased big plot of land measuring 200 acres and has a plan to develop 10 big tower buildings for commercial and residential purposes.

➢ It will have to construct common road for movement of vehicles inside the plot.

➢ As a part of contract it has accepted to provide common club house facility to each flat owner.

Identification of Project- Practical Issues

- It has also promised to develop sports and swimming facilities to the members. For this, it has tied up with the third party who will provide this facility and third party can also allow outsiders to use such facilities after collecting charges, subject to condition that outside members cannot be more than 500.
- Parking areas and energy back-up is common for each set of two towers. It also provides additional parking space on payment of Rs.5 lacs per parking area.
- Jogging track and children park will be common facility for all the towers for which specific area is earmarked.

- In the above circumstances, what should be considered as project ?
- **It may be important to note that identification of unit for the purpose of project is generally left to the developer, subject to certain broad parameters. <u>It is not an accounting policy choice</u>**

Identification of Project – Practical Issues

- Construction of 10 petrol pumps at a different locations. It may be one contract but assets are not inter-related and so to be treated as separate contracts.

- Contract for constructing a Hotel and connected restaurants, health club, swimming pool where lumpsum price is fixed. As the assets are interrelated and negotiation is combined, it has to be treated as one single contract.

Project Costs

Project cost comprises of :

- **Cost of land and development rights**. It also includes rehabilitation cost, registration charges, stamp duty, brokerage etc.
- **Borrowing costs** – in accordance with AS-16. It also means that interest cost for the period of abnormal stoppage of work cannot be part of project cost. Foreign Exchange difference on loan to the extent considered as interest under para 4 (e) of AS – 16 will be part of this.
- **Construction and Development Cost** – includes cost directly related to specific projects and allocated cost which may be attributable to project activity in general.

Project Costs

Construction and Development cost related to a specific project include:

- Land conversation cost
- Site labour cost
- Cost of material
- Depreciation of plant and equipment
- Freight cost for transfer of material
- Cost of hiring equipment
- Cost of design and technical assistance
- Expected warranty, rectification and guarantee cost
- Any claim from third parties.
- Insurance
- **Normal administrative and general overheads allocated to a project – should be based on normal level of project activity. (e.g. Insurance, design and technical assistance costs, construction and development overheads etc.)**

Project Costs

- In case of **slum rehabilitation projects**, the cost of rehabilitation will be the cost of land which is available to developer for new construction.
- Cost of sample model flat, how to be treated ?
- To determine whether it is available for sale subsequently.

Project Costs

Exclusions:

- General administrative cost
- Selling cost
- Research and development costs
- Depreciation of idle plant and equipment
- Cost of unconsumed or uninstalled material delivered at site
- Payments made to sub-contractors in advance of work performed.
- **Marketing cost though directly relating to a project can not be considered as part of project cost**

Project Revenue

- Project revenues include revenue on sale of plots, undivided share in land, sale of finished and semi-finished structures, consideration for construction, consideration for amenities and interiors, consideration for parking spaces and sale of development rights. (**Hybrid of goods and services**)
- 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 revision as events occur and uncertainties are resolved. Therefore, the amount of project revenue may increase or decrease from one reporting period to the next

Accounting Principles

- Real estate sales take place in different ways and may be subject to different terms / forms:

a) sale of developed or undeveloped land, construction,

b) development or sale of units not completed, sale of completed units

- For recognition of revenue it is important to determine whether significant risks and rewards associated with the ownership is transferred in substance.
- For such determination terms and conditions of the agreement is important.
- In case of real estate transactions, the buyer and seller usually enters into agreement at initial stage of construction.

Accounting Principles

- If agreement for sale is legally enforceable which signifies transferring of significant risks and rewards, it is considered as satisfying condition of revenue recognition. **It may be possible that legal title is not transferred or the possession is not handed over.**
- It is important to determine economic substance of the transaction considering:

a) Agreement

b) Understanding between the parties

c) Conduct of the parties

- If transaction is in substance a construction contract, POCM shall be applied as per the provisions in GN (discussed later).

Accounting Principles

- Following will be akin to sale of goods and hence it need to be accounted as per the principles of AS -9 at a point of time.

a) Sale of undeveloped land

b) Sale of TDR

c) Sale of constructed units

- Sale of land with significant development or under construction units will fall under 'Construction contract' and for recognising revenue POCM shall be applied.

Accounting

- In the above cases, following conditions should be satisfied before revenue is recognised :
  - Transfer of significant risk and rewards
  - Seller retains no effective control of the real estate to a degree associated with ownership
  - Seller has effectively handed over possession of real estate unit
  - No significant uncertainty regarding the amount of consideration
  - Not unreasonable to expect ultimate collection of revenue.

- If transfer of legal title is condition precedent to transfer of significant risk and reward, revenue needs to be recognised only at a point of time of legal title transfer.

Accounting Principles

- POCM shall be applied in case of following indicators :

a) Duration of project is more than 12 months (project commencement and completion dates in different periods)
b) Most features are common to construction contracts
c) Individual units are interdependent upon or interrelated to completion of common amenities.
d) Construction / development activities form a significant proportion of the project activity.

Accounting Principles

- Following conditions have to be collectively satisfied before POCM can be applied :

a) Reliable estimation of total project revenues

b) It is probable that the economic benefits will flow to the enterprise

c) The reliable measurement of future project cost for completion and stage of project completion.

Accounting Principles

Before any revenue is recognised under POCM following events should have happened :

- **Critical approvals** should have been received such as environment clearance, approval of plans and design, title to land or rights to development, change in use of land etc. – **Implications under RERA need to be considered**
- Project should have reached reasonable level of development i.e. **25% of construction and development cost, other than land cost and borrowing cost should have been incurred.**
- At least 25% of the saleable project area should have been secured by contracts with buyers.
- At least 10% of the contract consideration as per the **legally enforceable document** should have been realised and it is reasonable to expect that the balance amount will be recovered as per the payment terms in the contract.
- For this purpose, each contract shall be considered separately and it should not be applied on overall basis.

Accounting Principles

- Revenue and Cost of project has to be recognised as per 'Percentage of Completion Method'.
- Under this method, the revenue and costs are recognised with reference to the stage of completion of the project activity at the reporting date.
- For computation of revenue and stage of completion, the entire project cost including land cost and borrowing cost should be considered. **One may apply other methods such as technical estimation, survey of work to determine stage of completion**.
- However, **revenue recognition should not exceed the revenue computed as per the 'project cost incurred' method.** It means that revenue recognition under another method can be lower but cannot exceed revenue as per project cost incurred method.

Accounting Principles

- Under this method, profit is recognised to the extent of work performed, subject to commencement criteria and profit and loss gives indication of work performed during the period.
- Expected loss on the project should be recognised as an expense on each Balance Sheet date, irrespective of stage of completion.
- Revenue recognised should not exceed the estimated total revenue from eligible contracts / other legally enforceable agreements.
- For this purpose 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 for such contracts.**
- It means that i**n case of default in payment, whole of that contract can not be considered for revenue recognition. It also means that revenue earlier booked for such contracts will have to be reversed. ICAI may have to clarify this issue, as it is too harsh provision to reverse revenue earlier booked, specially to the extent money is realised against the contracts.**

Accounting Principles

- POCM is applied on a cumulative basis for each reporting period on the basis of current estimate of project revenues and project costs. Any **change in the estimate is accounted in the period of change**.
- The change in estimate also include **changes on account of cancellation of contracts or part of the area subsequently earmarked for own use.** In such case revenue previously recognised should be reversed and cost incurred will be considered for capitalisation of fixed assets.

Acquisition of TDRs

- When TDRs are acquired by the builder / developer and utilised in the real estate project, the cost of acquisition will be part of the project cost.
- When TDRs are acquired by way of agreeing to construct built-up area, cost of acquisition shall be amounts spent on construction of built-up area.
- Where TDRs are acquired by way of giving up of rights over existing structure, it should be recorded as per fair market value or the net book value of the portion given up whichever is less.

Disclosures

- The amount of project revenue recognised as revenue in the reporting period
- The methods used to determine the project revenue recognised in the reporting period
- The method used to determine the stage of completion of the project.
- **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

b) The amount of advances received

c) The amount of work in progress and the value of inventories

d) Excess of revenue recognised over actual bills raised (unbilled revenue).

AS-7 Construction Contracts

- **Introduction and Scope**
- **Definitions**
- **Combining and Segmenting Contracts**
- **Contract Revenue and Contract Costs**
- **Disclosures**

Introduction and Scope

- Deals with accounting for construction contracts in the financial statements of enterprises undertaking such contracts (hereafter referred to as ‘contractors’)
- Term ‘Contractors’ not defined – understood as reporting entities engaged in contracting activities
- Also applies to enterprises undertaking construction activities of the type dealt with in the Standard not as contractors but on their own account as a venture of a commercial nature where the enterprise has entered into agreements for sale
- The feature which characterizes a construction contract is the fact that the date at which the contract is secured and the date when the contract activity is completed fall into different accounting periods
- The specific duration of the contract performance is not used as a distinguishing feature of a construction contract

Introduction and Scope

- A construction contract is a contract for the construction of an asset or of a combination of assets which together constitute a single project. Examples of activity covered by such contracts include the construction of bridges, dams, ships, buildings and complex pieces of equipment
- Contracts for the provision of services to the extent that they are directly related to a contract for the construction of an asset e.g. contracts for the services of **project managers and architects and for technical engineering services** related to the construction of an asset
- Construction of **both tangible and intangible assets is covered** e.g. software development contracts undertaken for specific customization of customer requirements are also construction contracts with scope of the Standard. However, software contracts for supply of products developed in-house with minimum customization fall within the scope of AS-9 as supply of goods

Introduction and Scope

- In case of **property development contracts judgement is required as to whether to apply AS-7 or the Guidance Note**

a) Where a contract relates to a building under construction prior to the identification of a buyer the purchaser would not have specifically negotiated for the construction of the property hence would be accounted for as a real estate development contract

b) If the developer is building a property totally as per the buyers design it is to be accounted for as a construction contract. However, if the buyer has merely selected the design proposed by the developer it would not be in the nature of a construction contract.

Definitions

- **Construction Contract**
- **Fixed Price Contract**
- **Cost – Plus Contract**

Construction Contract

- **A construction contract** is a contract specifically negotiated for the construction of an asset or a **combination of assets** that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use

Types of Contracts

- **A fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses
- **A cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

Combining and Segmenting Contracts

- When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified

- **It is not an accounting policy choice but mandatory if the above criteria are satisfied**

Combining and Segmenting Contracts

- A contractor submits two separate bids for construction of a 10 mile stretch of road in which is included a bridge
- The tender document is structured such that road construction contract and bridge construction contract is separately awarded
- The same contractor wins the bid for both contracts though he had submitted separate proposals
- The terms and conditions are included in one legal document
- Separate accounting to be done – cost system top ensure segregation of costs

Combining and Segmenting Contracts

- A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence

- **It is not an accounting policy choice but mandatory if the above criteria are satisfied**

Combining and Segmenting Contracts

- A contractor submits a single bid for construction of a 10 mile stretch of road in which is included a bridge
- The bridge is in a separate local authority district from the road and the two local authorities have agreed to work together on both the parts though separate contracts are signed though negotiated as a single package
- Combining is required since the contracts are performed in a sequence – if performance is separated by a long period of time resulting in a differing economic environment separate accounting may be applied

Combining and Segmenting Contracts

- A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset.
- The construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue

- Contract revenue comprises of:

(a) the initial amount of revenue agreed in the contract; and

(b) **variations in contract work, claims and incentive payments**: (i) to the extent that it is probable that they will result in revenue; and (ii) they are capable of being reliably measured.

- It is measured at the consideration received or receivable
- The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events

Contract Revenue- Variations

- A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract, which may lead to an increase or a decrease in contract revenue.
- Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract.
- A variation is included in contract revenue when: (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and (b) the amount of revenue can be reliably measured
- In many cases judgement is involved as to whether a variation will be approved by the customer which involves negotiations in which case the amount of variation included in contract revenue is on estimated basis

Contract Revenue- Variations

- Contractor is involved in constructing a residential building for a statutory authority
- Original plan was for constructing 5 floors
- After one year decision was taken to add 2 floors for which approvals have been taken
- The revised agreement is pending signing though the contractor is principally in agreement with the variation as proposed
- The variation is included in contract revenue since: - (a) approval has been obtained; and (b) amount of revenue from the variation can be reliably measured

Contract Revenue- Claims

- A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price.
- A claim may arise from customer caused delays, errors in specifications or design, and disputed variations in contract work.
- The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations.
- Claims are only included in contract revenue when: (a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and (b) the amount that it is probable will be accepted by the customer can be measured reliably.

Contract Revenue- Incentives

- Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded e.g. early completion of the contract.
- Incentive payments are included in contract revenue when: (a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (b) the amount of the incentive payment can be measured reliably.

Contract Costs

Costs that relate directly to the specific contract	• Site labour costs, including site supervision; • costs of materials used in construction; • depreciation of plant and equipment used on the contract; • costs of moving plant, equipment and materials to and from the contract site; • costs of hiring plant and equipment; • costs of design and technical assistance that is directly related to the contract; • the estimated costs of rectification and guarantee work, including expected warranty costs; and • claims from third parties **Incidental income for sale of surplus /**

Contract Costs

Costs that are attributable to contract activity in general and can be allocated to the contract on a systematic and rational basis based on the normal level of construction activity	• insurance; • costs of design and technical assistance that is not directly related to a specific contract; and • construction overheads • **borrowing costs under AS-16 as reduced by investment income from temporary investment of surplus funds like advances from customers**
Costs that are specifically chargeable to the customer under the terms of the contract m	• general administration and development costs for which reimbursement is specified in the terms of the contract • **Costs to be excluded:** a) general administration costs for which reimbursement is not specified in the contract; b) selling costs; c) research and development costs for which

Contract Costs – Pre Contract Costs

Cost incurred in securing a contract	• costs that relate directly to a contract and which are incurred in securing the contract are included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained (e.g. costs to bid for a contract) • **costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period**

Recognition of Contract Revenue and Costs

- **Estimating the Outcome of a Contract**
- **Estimating the Stage of Completion**
- **Recognition of Contract Losses**
- **Recognition of Contract Revenue**
- **Recognition of Contract Costs**

Estimating the Outcome of a Contract

- When the outcome of a construction contract can be **estimated reliably**, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the **stage of completion of the contract** activity at the reporting date, based on whether it is a **fixed price contract or cost plus contract (see subsequent slides)**
- An **expected loss** on the construction contract should be recognised as an expense immediately as discussed subsequently

Estimating the Outcome of a Contract- Fixed Price Contract

- Total contract revenue can be measured reliably;
- It is probable that the economic benefits associated with the contract will flow to the enterprise;
- Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- The contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates

Estimating the Outcome of a Contract- Cost Plus Contract

- It is probable that the economic benefits associated with the contract will flow to the enterprise; and
- The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Outcome Cannot be Reliably Measured (Zero Profit Method)

- Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- Contract costs should be recognised as an expense in the period in which they are incurred.
- **An expected loss on the construction contract should be recognised as an expense immediately**

Estimating the Stage of Completion

- For both fixed price and cost plus contracts the percentage of completion needs to be ascertained
- Modes of ascertaining the percentage of completion:

a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

b) surveys of work performed; or

c) completion of a physical proportion of the contract work

- Progress payments and advances received from customers may not necessarily reflect the work performed

Estimating the Stage of Completion

- Selection of measurement method to be based on surrounding circumstances and the nature of the business
- Main contractor normally hires services of an architect to certify progress and survey the work performed
- Sub –contractors would generally rely on cost completion method or physical proportion of the work
- Only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

b) advance payments made to sub-contractors

Recognition of Contract Losses

- When it is probable that total contract costs will exceed total contract revenue, 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 contract; (b) the stage of completion of contract activity; or (c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract

Recognition of Contract Revenue

- If it is probable that future economic benefits will flow to the entity and their amount can be **estimated reliably**
- An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes: (a) each party's enforceable rights regarding the asset to be constructed; (b) the consideration to be exchanged; and (c) the manner and terms of settlement
- Changes in estimates to be accounted in accordance with AS-5
- Based on **percentage of completion method**, whereby contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed
- If subsequently any amount is irrecoverable the same should be charged off
- The revenue so recognized should be included as a part of "Turnover" / "Operating revenue"

Recognition of Contract Costs

- Contract costs are generally recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed
- Contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as **contract work in progress**
- **Examples of costs where recovery is not probable:**

a) which are not fully enforceable;

b) the completion of which is subject to the outcome of pending litigation or legislation;

c) relating to properties that are likely to be condemned or expropriated;

d) where the customer is unable to meet its obligations; or

e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

Disclosures

- Amount of contract revenue recognised as revenue in the period
- Methods used to determine the contract revenue recognised in the period
- Methods used to determine the stage of completion of contracts in progress
- Aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date
- Amount of advances received
- Retention money
- Gross amount due from customers for contract work as an asset
- Gross amount due to customers for contract work as a liability.

Questions
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