Revenue Recognition by Real Estate Developers

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Guidance Note on Recognition of Revenue by Real Estate Developers

(The following is the text of the Guidance Note on Recognition of Revenue by Real Estate Developers, issued by the Council of the Institute of Chartered Accountants of India.)

INTRODUCTION

1. The term 'real estate' refers to land as well as building. This Guidance Note recommends principles for recognition of revenue arising from real estate sales by the enterprises engaged in such activities (commonly referred to as 'real estate developers', 'builders' or 'property developers').

APPLICATION OF REVENUE RECOGNITION PRINCIPLES PRESCRIBED IN AS 9 TO REAL ESTATE SALES

2. For recognition of revenue in case of real estate sales, it is necessary that all the conditions specified in paragraphs 10 and 11 of Accounting Standard (AS) 9, *Revenue Recognition*, as reproduced below, are satisfied:

"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

3. The real estate sales take place in a variety of ways and may be subject to different terms and conditions as specified in the agreement for sale. Accordingly, the point of time at which all significant risks and rewards of ownership can be considered as transferred, is required to be determined on the basis of the terms and conditions of the agreement for sale. In case of real estate sales, the events, such as, transfer of legal title to the buyer or giving possession of real estate to the buyer under an agreement for sale, usually, provide an evidence to the effect that all significant risks and rewards of ownership have been transferred to the buyer. It may, however, be noted that 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 all significant risks and rewards of ownership to the buyer provided the agreement is legally enforceable and subject to the satisfaction of all the following 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:

(a) The significant risks related to the real estate have been transferred to the buyer; in case of real estate sales, price risk is generally considered to be one of the most significant risks.

(b) The buyer has a legal right to sell or transfer his interest in the property, without any condition or subject to only such conditions which do not materially affect his right to benefits in the property.

4. Once the seller has transferred all the significant risks and rewards of ownership to the buyer and other conditions for recognition of revenue specified in paragraphs 10 and 11 of AS 9 are satisfied, any further 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. Accordingly, in case the seller is obliged to perform any substantial acts after the transfer of all significant risks and rewards of ownership, revenue is recognised by applying the percentage of completion method in the manner explained in AS 7, *Construction Contracts*.

5. Paragraph 9.2 of AS 9 provides as follows:

"9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments."

Accordingly, in case it is unreasonable to expect ultimate collection, the revenue recognition is postponed to the extent of uncertainty involved.

RECOMMENDATIONS

6. Revenue in case of real estate sales should be recognised when all the following conditions are satisfied:

(i) 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;

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

(iii) it is not unreasonable to expect ultimate collection.

7. The determination of point of time when all significant risks and rewards of ownership are transferred depends on the facts and circumstances of each case considering the terms and conditions of the agreement. In case of real estate sales, all significant risks and rewards of ownership are normally considered to be transferred when legal title passes to the buyer (e.g., at the time of the registration, with the relevant authorities, of the real estate in the name of the buyer) or when the seller enters into an agreement for sale and gives possession of the real estate to the buyer under the agreement. All significant risks and rewards of ownership are also considered to be transferred, if the seller has entered into a legally enforceable agreement for sale with the buyer and all the following conditions are satisfied even though the legal title is not passed or the possession of the real estate is not given to the buyer:

(a) The significant risks related to real estate have been transferred to the buyer. In case of real estate, price risk is generally considered to be one of the most significant risks.

(b) The buyer has a legal right to sell or transfer his interest in the property, without any condition or subject to only such conditions which do not materially affect his right to benefits in the property.

8.When the seller has transferred to the buyer all significant risks and rewards of ownership, it would be appropriate to recognise revenue at that stage subject to fulfillment of other conditions specified in paragraph 6 above, provided the seller has no further substantial acts to complete under the contract. However, in case the seller is obliged to perform any substantial acts after the transfer of all significant risks and rewards of ownership, revenue should be recognised on proportionate basis as the acts are performed, i.e., by applying the percentage of completion method in the manner explained in Accounting Standard (AS) 7, *Construction Contracts*. An example is a building or other facility on which construction has not been completed though all significant risks and rewards of ownership have been transferred pursuant to the fulfillment of conditions stated in paragraph 7 above. Another example is of a land which is yet to be developed though the seller has transferred all significant risks and rewards of ownership of the land to the buyer through an agreement for sale as per paragraph 7 above.

9.Whether the seller retains no effective control of the real estate transferred to a degree usually associated with ownership also depends on the facts and circumstances of each case considering the terms and conditions of the agreement. The nature and extent of continuing involvement of the seller should be assessed to determine whether the seller retains effective control. In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership are not transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period.

10. In case of real estate sales, since normally the amount of consideration is specified in the agreement, no significant uncertainty exists regarding the amount of the consideration that will be derived from the sales.

11. For determining whether it is not unreasonable to expect ultimate collection, a seller should consider the evidence of the buyer’s commitment to make the complete payment. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time all significant risks and rewards of ownership are transferred to the buyer, revenue recognition is postponed to the extent of uncertainty involved. For example, when the aggregate of the payments received, including the buyer’s initial down payment, or continuing payments by the buyer, provide insufficient evidence of the buyer’s commitment to make the complete payment, revenue is recognised only to the extent of realisation of the consideration provided other conditions for recognition of revenue are satisfied.

12. An enterprise should disclose the accounting policy regarding recognition of revenue arising from the real estate sales, including the timing of transfer of significant risks and rewards of real estate which is the subject matter of sale.

DISCUSSION PAPER
ON
TAX ACCOUNTING STANDARDS

OCTOBER 2011

Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes

1. Background

1.1 Section 145 of the Income-tax Act, 1961 („the Act‟) provides that the method of accounting for computation of income under the head "Profits and gains of business or profession" and "Income from other sources" can either be the cash or mercantile system of accounting. The Finance Act, 1995 empowered the Central Government to notify Accounting Standards for any class of assessees or for any class of income. Explaining the reason for introduction of this provision, it was stated that there is flexibility in the standards issued by the Institute of Chartered Accountants of India (ICAI) which makes it possible for an assessee to avoid the payment of correct taxes by following a particular system and therefore, there is an urgent need to standardize one or more of the alternatives in various standards so that income for tax purpose can be computed precisely and objectively.

1.2 Since the introduction of these provisions, two Accounting Standards relating to disclosure of accounting policies and disclosure of prior period and extraordinary items and changes in accounting policies have been notified. In July 2002, the Central Government had constituted a committee on formulation of Accounting Standards under the Act [„the Committee (2002)‟].

1.3 The Committee (2002) submitted its final report in November 2003 which contained the following main recommendations:

(i) It would be impractical for a tax payer to maintain two sets of books of account – one in accordance with the Accounting Standards issued by the ICAI and another set in accordance with the Accounting Standards to be notified under the Act. The Committee (2002), therefore, recommended that the Accounting Standards issued by the ICAI should be notified under the Act without any modifications.

(ii) Appropriate legislative amendments should be made to the Act to prevent any scope for leakage of revenue on account of notification of Accounting Standards issued by the ICAI.

1.4 The recommendations of the Committee (2002) could not be implemented because of the following:-

(i) The implementation of the recommendation of the Committee (2002) would have required extensive amendment to the Act resulting in complexity and litigation, and would have negated the concept of notification of accounting standards under the Act to provide certainty.

(ii) As the Accounting Standards issued by ICAI keep on evolving /changing by way of issue of new standards, interpretation and revision, it would have been cumbersome for the Ministry of Finance to keep track of all changes in the Accounting standards issued by the ICAI and to move simultaneous amendments to the Act.

1.5 There have been significant developments since the Committee (2002) submitted its report, notable among them are:

(i) The Government of India, through the Ministry of Corporate Affairs (MCA), has notified twenty eight Accounting Standards issued by the ICAI, under the Companies Act, 1956.

(ii) The Government of India has decided to converge Indian Accounting Standards with the International Financial Reporting Standards (IFRS). In February, 2011, the MCA, being the nodal agency for this convergence, has placed thirty five Indian Accounting Standards converged with International Financial Reporting Standards (termed as IND AS) on its website.

(iii) In the absence of notification of Accounting Standards under the Act, uncertainty and litigation continues on various accounting related issues such as accounting for construction contracts, foreign exchange fluctuations and government grants.

2. New Accounting Standards Committee

2.1 The Central Board of Direct Taxes (CBDT) constituted a new Accounting Standard Committee („the Committee‟) comprising of departmental officers and professionals vide Order No. 134/48/2010-SO (TPL) dated 20th December 2010. The terms of reference of this Committee are as under:

i) to study the harmonization of Accounting Standards issued by the ICAI with the direct tax laws in India, and suggest Accounting Standards which need to be adopted under section 145(2) of the Act along with the relevant modifications;

ii) to suggest method for determination of tax base (book profit) for the purpose of Minimum Alternate Tax (MAT) in case of companies migrating to IFRS (IND AS) in the initial year of adoption and thereafter; and

iii) to suggest appropriate amendments to the Act in view of transition to IFRS (IND AS) regime.

3. Main recommendations of the Committee

3.1 The Committee submitted its Interim Report in August 2011. The main recommendations of the Committee with regard to the first term of reference are as under.

3.2 Since the Accounting Standards to be notified under section 145(2) of the Act would need to be in harmony with the provisions of the Act, the Accounting Standards issued by the ICAI cannot be notified without modification. The notified Accounting Standards should provide specific rules, which would enable computation of income with certainty and clarity. To ensure horizontal equity and uniformity, the notified Accounting Standards would also need elimination of alternatives, to the extent possible. Accordingly, separate Accounting Standards should be notified under Section 145(2) of the Act.

3.3 It would be burdensome for affected tax payers to maintain two sets of books of account i.e. one in accordance with the Accounting Standards issued by the ICAI/notified under the Companies Act, 1956; and another in accordance with the Accounting Standards notified under the Act. Accordingly, the Accounting Standards notified under the Act should be made applicable only to the computation of taxable income and a taxpayer should not be required to maintain books of account on the basis of Accounting Standards notified under the Act.

3.4 Two different sets of Accounting Standards may cause confusion for taxpayers and other stakeholders. Accordingly, the Accounting Standards notified under the Act should be termed as "Tax Accounting Standards" (TAS) to distinguish them from the Accounting Standards issued by the ICAI/notified under the Companies Act, 1956.

3.5 Since the TAS are based on the mercantile system of accounting, the TAS should be applicable to all tax payers who follow the mercantile system of accounting, and should not be applicable to those taxpayers who follow the cash basis of accounting.

3.6 As the TAS are intended to be in harmony with the provisions of the Act, it should be expressly provided in the TAS, that in case of conflict, the provisions of the Act shall prevail over the TAS.

3.7 Currently, the starting point for computation of income under the head "Profits and gains of business or profession" and "Income from other sources" is the income as per the financial statements. Since the provisions of the TAS may not be the same as the corresponding provisions used for preparation of the financial statements, a reconciliation between the income as per the financial statements and the income as computed per the TAS should be presented.

4. Draft TAS

4.1 Draft of the TAS on Construction Contracts and Government Grants, recommended by the Committee, are annexed hereto. Draft of other TAS will be issued for comments/suggestions by all stakeholders in due course.

4.2 Comments/suggestions are invited on the recommendations of the Committee and draft of the TAS annexed hereto. The comments/suggestions may be e-mailed at dirtpl3@nic.in by 11th November, 2011.

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Tax Accounting Standard [TAS]
Tax Accounting for Construction Contracts

Preamble

This Tax Accounting Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of account.

In the case of conflict between the provisions of the Income-tax Act, 1961(„the Act‟) and this Tax Accounting Standard, the provisions of the Act shall prevail to that extent.

Scope

1. This Tax Accounting Standard should be applied in determination of income for a construction contract of a contractor.

Definitions

2 (1) The following terms are used in this Tax Accounting Standard with the meanings specified:

(a) 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 and includes :

(i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;

(ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

(b) 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 may be subject to cost escalation clauses.

(c) A **"cost plus contract"** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a mark up on these costs or a fixed fee.

(d) **"Retentions"** are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

(e) **"Progress billings"** are amounts billed for work performed on a contract whether or not they have been paid by the customer.

(f) **"Advances"** are amounts received by the contractor before the related work is performed.

2(2) Words and expressions used and not defined in this Tax Accounting Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.

3. A construction contract may be negotiated for the construction of a single asset. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

4. Construction contracts are formulated in a number of ways which, for the purposes of this Tax Accounting Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price.

Combining and Segmenting Construction Contracts

5. The requirements of this Tax Accounting Standard shall be applied separately to each construction contract except as provided for in paragraphs 6, 7 and 8 herein. For reflecting the substance of a contract or a group of contracts, where it is necessary, the Tax Accounting Standard should be applied to the separately identifiable components of a single contract or to a group of contracts together.

6. Where 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.

7. 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.

8. Where a contract provides for the construction of an additional asset at the option of the customer or is 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 having regard to the original contract price.

Contract Revenue

9. Contract revenue shall comprise of:

(a) the initial amount of revenue agreed in the contract, including retentions; 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.

10. Where contract revenue already recognised as income is subsequently written off in the books of accounts as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.

Contract Costs

11. Contract costs shall comprise of :

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract;

(c) such other costs as are specifically chargeable to the customer under the terms of the contract; and

(d) allocated borrowing costs in accordance with the Tax Accounting Standard on Borrowing Costs.

These costs shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.

12. Costs that cannot be attributed to any contract activity or cannot be allocated to a contract shall be excluded from the costs of a construction contract.

13. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. Costs that are incurred in securing the contract are also included as part of the contract costs, provided

(a) they can be separately identified; and

(b) it is probable that the contract shall be obtained.

When 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.

14. Contract costs that relate to future activity on the contract are recognised as an asset. Such costs represent an amount due from the customer and are classified as contract work in progress.

Recognition of Contract Revenue and Expenses

15. 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.

16. The recognition of revenue and expenses by reference to the stage of completion of a contract is referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

17. The stage of completion of a contract shall be determined with reference to:

(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 are not determinative of the stage of completion of a contract.

18. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract.

19. During the early stages of a contract, where the outcome of the contract cannot be estimated reliably contract revenue is recognised only to the extent of costs incurred. The early stage of a contract shall not extend beyond 25 % of the stage of completion.

Changes in Estimates

20. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Where there is change in estimates, the changed estimates shall be used in determination of the amount of revenue and expenses in the period in which the change is made and in subsequent periods.

Disclosure

21. A person shall disclose:

(a) the amount of contract revenue recognised as revenue in the period; and

(b) the methods used to determine the stage of completion of contracts in progress.

22. A person shall disclose the following for contracts in progress at the reporting date:

(a) Amount of costs incurred and recognized profits (less recognized losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

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Accounting Policies Followed by some of the Real Estate Companies

Unitech Ltd.

1(i) Revenue from real estate projects is recognized on 'Percentage of Completion Method' of accounting. Revenue comprises the aggregate amounts of sale price in terms of the agreements entered into and is recognized on the basis of percentage of actual costs incurred thereon, including proportionate land cost and total estimated cost of projects under execution, subject to such actual costs being 20 percent or more of the total estimated cost.
(ii) Where aggregate of the payment received provide insufficient evidence of buyers' commitment to make the complete payment, revenue is recognized only to the extent of realization.
(iii) The estimates of the saleable areas and costs are reviewed periodically by the management and any effect of changes in estimates is recognized in the period such changes are determined. However, when the total project cost is estimated to exceed total revenues from the project, the loss is recognized immediately.
2. The interest on delayed payment and maintenance charges are accounted for on realization due to uncertainty of recovery of the same.
3. The Sale proceeds of the Investments held in the Subsidiaries, Joint Ventures and Associates developing Real Estate Projects are included in real estate revenue, net of cost.

Orbit Corporation Ltd.

Income from real estate sales is recognised on the transfer of all significant risks and rewards of ownership to the buyers and it is not unreasonable to expect ultimate collection and no significant uncertainty exists regarding the amount of consideration.
Determination of revenues under the percentage of completion method necessarily involves making estimates by the Company. Revenue from construction and project related activity is recognised by applying Percentage Completion Method (PCM) to sale of tenements. Percentage of completion is determined as a proportion of cost incurred to date (excluding property acquisition cost) to the total estimated project cost (excluding property acquisition cost). Project becomes eligible for revenue recognition when the percentage of completion of project exceeds 25%.

Oberoi Realty Ltd.

The Company follows the Percentage of Project Completion Method for its projects. Under this method, the Company recognises revenue in proportion to the actual cost incurred as against the total estimated cost of the project under execution subject to completion of construction work to a certain level depending on the type of the project.
Cost of Land and / or Development Rights is not included in computing the percentage of project completion.
Revenue is recognised on execution of either an agreement or a letter of allotment.
The estimates relating to percentage of completion, costs to completion, area available for sale etc. being of a technical nature are reviewed and revised periodically by the management and are considered as change in estimates and accordingly, the effect of such changes in estimates is recognised prospectively in the period in which such changes are determined.
Revenue is recognised net of indirect taxes.

DLF Ltd.

Revenue from constructed properties, other than SEZ projects,is recognised on the percentage of completion method”. Total sale consideration as per the duly executed, agreements to sell /application forms (containing salient terms of agreement to sell), is recognised as revenue based on the percentage of actual project costs incurred thereon to total estimated project cost, subject to such actual cost incurred being 30 per cent or more of the total estimated project cost. Estimated project cost includes cost of land/ development rights, borrowing costs, overheads, estimated construction and development cost of such properties.

The estimates of the saleable area and costs are reviewed periodically and effect of any changes in such estimates is recognised in the period in which such changes are determined. However, when the total project cost is estimated to exceed total revenues from the project, loss is recognised immediately.

Cost of revenue

Cost of constructed properties other than SEZ projects, includes cost of land (including cost of development rights/land under agreements to purchase), estimated internal development costs, external development charges, borrowing costs, overheads, construction costs and development/ construction materials, which is charged to the profit & loss account based on the percentage of revenue recognised as per accounting policy no. - 7 above, in consonance with the concept of matching costs and revenue. Final adjustment is made upon completion of the specific project.

Unbilled receivables

Unbilled receivables disclosed under Schedule 11 - “Other Current Assets” represents revenue recognised based on Percentage of completion method (as per para no. 7a and 7b above), over and above the amount due as per the payment plans agreed with the customers.