WIRC Seminar on Accounting & Auditing Issues
Real Estate & Infrastructure Industry

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Contents

REAL ESTATE

Real Estate

- The Guidance Note ('GN') on Accounting for Real Estate Transactions was revised in 2012 by the Institute of Chartered Accountants of India and replaced the earlier GN on the subject
- The earlier GN laid emphasis mainly on price risk for determining the method of revenue recognition and in case the price risk is transferred, the GN permitted the recognition of revenue on a percentage of completion basis
- The revises GN covers in its scope the following types of transactions
  - Sale of plots of land (including long term sale type leases with and without development
  - Development and sale of residential and commercial units, independent houses, etc with or without an independent share in land
  - Acquisition of development rights
  - Redevelopment of existing buildings/structures
  - Joint development agreements for any of the above
- Applicable to all real estate projects commencing on or after April 1, 2012 and also to projects where revenue is being recognised for the first time on or after April 1, 2012.

Real Estate

- Contains definitions of various terms relevant to real estate transactions including
  - Project – states that within a large development, individual buildings or clusters can be a single project
  - Project cost – includes land cost, construction & development costs and borrowing costs; excludes general and admin, selling, R&D costs, depreciation on idle assets and unconsumed material from project costs
  - Also clarifies that insurance, borrowing costs, construction overheads and design costs are costs which can be attributed to project activity in general and hence can be allocated to specific projects.
- Project revenue defined separately
- The GN provides guidance in application of
  - AS 9 principles in cases of real estate transactions which are in substance similar to delivery of goods
  - Percentage completion method for recognising revenue, costs and profits from transactions and activities of real estate which have the economic substance of construction contracts
- Sections 4 deals with situations where AS 9 principles are applied and Section 5 deals with situations where AS 7 principles are applied

Real Estate – Revenue Recognition

- Section 4 states AS 9 (completed contract method) is applied when
  - Seller has transferred to the buyer all significant risks & rewards of ownership and seller retains no effective control on real estate to a degree usually associated with ownership
  - Seller has effectively handed over possession of the real estate;
  - no significant uncertainty exists regarding the amount of consideration that will be derived from the sale
  - not unreasonable to expect ultimate collection of revenue
  - further, where transfer of legal title is a condition to the buyer taking on significant risks and rewards of ownership & accepting significant completion of seller's obligation, revenue should not be recognised till title is transferred
- Significant judgement required for application of the above principles; for instance
  - price risk is transferred when sale agreement is entered into but developer continues to have involvement in the construction activity. Is there a difference if the real estate in question is a single unit (bungalow) v/s a residential building?
  - Other than price risk, buyer obtains rewards of ownership only when legal title is transferred

Real Estate – Revenue Recognition

- Section 5 states percentage completion method is followed when the economic substance is that of a construction contract and says indicators of the arrangement being a construction contract are
  - Project duration is for more than12 months
  - Features are common to construction contracts , ie land development, structural engineering, architectural design, etc
  - 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
  - The construction or development activities form a significant proportion of the project activity not unreasonable to expect ultimate collection of revenue
- Construction contract is defined in AS 7 as a "contract specifically negotiated for the construction of an asset or assets . . ". In a construction contract, normally the owner commissions the construction and has the ability to change the design of the construction and the owner would have the ability to change the developer
- Accordingly, method of revenue recognition to be applied may be a matter of significant judgement

Real Estate – Revenue Recognition

- Further, Section 5 of the GN specifies certain qualitative and quantitative thresholds for recognition of revenue under the percentage of completion method
  - Receipt of critical approvals for commencement of the project
  - Expenditure incurred is 25% or more of the construction & development costs - by implication means that for determination of percentage completion land costs and borrowing costs are to be excluded
  - 25% of the area is sold
  - 10% of revenue is collected
- The GN also further states that while determining stage of completion only construction/development costs are to be included, revenue is determined by including all project costs (ie including land and borrowing costs).
- For instance a project with a total cost of Rs 1,5000 comprising land Rs 1,000, construction cost of Rs 400 and interest of Rs 100 where expenditure incurred is entire land cost, Rs 200 of construction cost and Rs 20 of interest, stage of completion is 50%.
- Revenue would however computed based on entire project cost. Hence if the entire sale value is Rs 3,000, revenue would be Rs 1,500 and cost against this would be Rs 750.

Real Estate – Revenue Recognition on other real estate transactions

- Sale of plots without any development - Recognised when the conditions specified in Section 4 of the GN are satisfied, ie on completion of sale
- Sale of developed plots – If the conditions of a construction contract (as described earlier are met), percentage completion method is applied
- Transactions with Multiple Elements – The GN states that the contract consideration should be split into separately identifiable components in the transaction. Further the consideration should be split based on the market value of each component (relative fair value v/s residual value approach). Relative fair value approach is required by IFRS; US GAAP requires residual value approach.
- Would the 80:20 schemes be multiple element transactions?

INFRASTRUCTURE

Infrastructure

- Accounting for infrastructure projects from the perspective of construction contractors is governed by Accounting Standard 7 – Construction Contracts, issued by the ICAI.
- AS 7 primarily deals with accounting for construction costs and revenues by construction contractors and requires determination of the stage of completion and the application of the percentage of completion method of revenue recognition
- Deals with the allocation of contract costs and revenues over the construction period which may span different accounting periods
- Under the standard the stage of completion is determined in the following ways
  - the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs – most commonly used method to determine stage of completion
  - surveys of work performed
  - completion of a physical proportion of the contract work
- All the above methods would give different outcomes of the revenue recognised during the period. The second and third method may result in front ending or backending revenue over the contract life

Infrastructure

- A common feature of the consideration received/receivable under construction contracts relates to variations and claims. In addition, in India, construction contracts have escalation clauses.
- Escalation – is the compensation to the contractor for changes in the cost of inputs (cement/steel) over the life of the construction contracts
- Compensation is generally determined based on the change in the wholesale price index at the time of tendering/inception of the contract to the time when the work is executed
- Escalation clauses are generally included in the contract document itself and hence may not need to separately go through the claims process
- Judgement may be required there may be a significant time gap between recognition as escalation revenue is recognised on an accrual basis but may be approved/paid later

Infrastructure

- A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract
- Variation revenue is recognised when
  - it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and
  - the amount of revenue can be reliably measured
- Uncertainty arises when variations are not approved or are oral and amounts recognised as variation revenue remain uncollected for significant amounts of time
- 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. Claims are only included in contract revenue when:
  - negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and
  - the amount that it is probable will be accepted by the customer can be measured reliably
- Implications on claim revenue recognition when contractors have arbitration/court awards in their favour, but which the customers litigate till all avenues are exhausted – is customer acceptance test for claims met?

IND-AS/IFRS

Presentation and Disclosures

- Presentation of financial statements as per IAS 1 including classification between current and non-current (Accounting Standards would over ride Schedule VI)
- No format of financial statements like Schedule VI. Only the minimum items to be disclosed on the face of the balance sheet and notes specified. Significant differences with revised Schedule VI
- Financial and non financial items cannot be merged in a single line on the balance sheet – eg prepaid expenses and deposits given
- Expenses in the profit and loss to be presented by nature or function.
- Restatement of financial statements for material errors & changes in accounting policies
- IFRS prescribes extensive disclosures as compared to Indian GAAP
  - Critical judgements made by the management
  - Key sources of estimation uncertainty
  - Capital management policy and data
  - Standards/ interpretations issued but not yet effective and their impact
  - Determination of fair values and key assumptions used about the same
  - Sensitivity analysis of fair values

Some key thoughts in respect on real estate

- The IND AS's in their current form contain certain exceptions/carve outs from IFRS
- Some of these significantly affect Real Estate entities and include
  - IFRIC 15 – Real Estate Sales
  - Fair value model not permitted for investment property
- Implications of these and other carve outs?
- However, other standards could affect accounting in typical real estate transactions

IFRIC 15 overview- Real Estate Sales

- An agreement meets the definition of a construction contract when the buyer is able to specify the major structural elements of the design of real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability)
- An agreement in which buyers have only a limited ability to influence the design of the real estate, eg to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of IAS 18.
- Based on the above, percentage method for recognition of revenue can be followed only if there is continuous transfer of property to the buyer. If not, revenue is recognised only on a completed project basis.
- <u>Under IND AS, revenue would continue to be recognised on a percentage of completion basis.</u>

Real estate sales – Implications of IFRIC 15

Indian GAAP and IND-AS				INR million
Particulars	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Revenue	100	100	100	100
Cost of sale	60	60	60	60
Administrative cost	10	10	10	10
Profit/ (loss)	**30**	**30**	**30**	**30**

IFRS				INR million
Particulars	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Revenue	0	0	0	400
Cost of sale	0	0	0	240
Administrative cost	10	10	10	10
Profit/ (loss)	**(10)**	**(10)**	**(10)**	**150**

Ind AS has carve-out w.r.t application of IFRIC 15 – POCM may continue

What is investment property

- **Investment property** is property (land or a building-or part of a building-or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes; or sale in the ordinary course of business.

- **Owner-occupied property** is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

Investment property accounting

	Indian GAAP (Rs.)	IFRS (Rs.)	
		Cost option	Fair value option*
Building (cost price - 100,000)			
Year 1	95,000	95,000	100,000
Year 2	90,000	90,000	135,000
Year 3	85,000	85,000	155,000
Year 4	80,000	80,000	125,000
Depreciation/ Fair value gain/ (loss)			
Year 1	(5,000)	(5,000)	0
Year 2	(5,000)	(5,000)	35,000
Year 3	(5,000)	(5,000)	20,000
Year 4	(5,000)	(5,000)	(30,000)

* Only under IFRS. IND-AS does not permit fair value accounting for investment property.

Mixed use property would need to be split accounted – inventory, investment property and PPE as appropriate

Transfers between owner-occupied assets, investment property and inventory

Transfer from	Transfer to	Date of transfer & value*
► Investment property	► Owner occupied property	► When owner occupation commences ► Transfer at fair value on date of transfer ► Change in fair value taken to P&L
► Owner occupied property	► Investment property	► As above, except change in value taken to equity (revaluation surplus)
► Investment property	► Inventory	► Transferred when property starts to be redeveloped for sale ► Fair value <u>at</u> date of transfer is cost of inventory; difference to p&l
► Inventory	► Investment property	► Transferred when leasing commences ► Transferred at fair value <u>on</u> date of transfer; difference to p&l

* **IND AS all transfers at cost**

IFRIC 12 – Service Concession Agreements

This Interpretation gives guidance on the accounting by operators for public-to-private service concession arrangements.

This Interpretation applies to public-to-private service concession arrangements if:

  - the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
  - the grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.

- The operator shall recognise and measure revenue in accordance with IASs 11 and 18 for the services it performs.
- The nature of the consideration determines its subsequent accounting treatment – whether it is a financial asset or an intangible asset
- The ICAI has issued an exposure draft of a GN on this subject which is similar to IFRIC 12

Example of a Service Concession Arrangement – Toll project

Assumptions

- Company has obtained a service concession arrangement for 12 yrs (2 yrs construction + 10 yrs operation)
- Total toll revenues expected are Rs 1,000 over 10 yrs
- Total cost is expected to be Rs 800 (Rs 600 for construction and Rs 200 in the operations phase)
- The total concession period profit of Rs 200 would need to be split into that attributable to construction and that attributable to maintenance (assume that construction profit out of this is Rs 150 and operation profit is Rs 50)

Accounting for a toll project – Indian GAAP & IFRS

Indian GAAP	Rs	IFRS	Rs
Year 1		**Year 1**	
P& L		P& L	
Income	-	Construction income (50% of Rs 750; Rs 750 being construction cost of Rs 600 & profit thereon Rs 150)	375
Expense	-	Expense	300
	-	Profit	75
Balance Sheet		Balance Sheet	
Capital WIP	300	Intangible Asset	375
Creditors	(300)	Creditors	(300)
		Accumulated Profit	(75)
	-		-

Accounting for a toll project – Indian GAAP & IFRS

Indian GAAP	Rs	IFRS	Rs
Year 2		**Year 2**	
P& L		P& L	
Income	-	Construction income	375
Expense	-	Expense	300
	-	Profit	75
Balance Sheet		Balance Sheet	
Capital WIP	600	Intangible Asset	750
Creditors	(600)	Creditors	(600)
		Accumulated profit	
		Opening balance	(75)
		Profit for the year	(75)
	-		-

Accounting for a toll project – Indian GAAP & IFRS

Indian GAAP	Rs	IFRS	Rs
Year 3		**Year 3**	
P& L		P& L	
Income	97	Toll revenue	97
Expense (Dep – Rs 60; maintenance cost Rs 20)	80	Expense (Dep – Rs 75; maintenance cost Rs 20)	95
Profit	17	Profit	2
Balance Sheet		Balance Sheet	
Asset (Rs 600 – dep of Rs 60)	540	Intangible Asset (Rs 750 – dep)	675
Cash	97	Cash	97
Creditors (op bal + exp)	(620)	Creditors	(620)
Profit	(17)	*Accumulated profit*	
		Opening balance	(150)
		Profit for the year	(2)
	-		-

Example of a Service Concession Arrangement – Annuity project

Assumptions (same as earlier except as shown below)

- Company has obtained a service concession arrangement for 12 yrs (2 yrs construction + 10 yrs operation)
- Annuity revenues are Rs 100 each over 10 yrs, ie Rs 1,000
- Total cost is expected to be Rs 800 (Rs 600 for construction and Rs 200 in the operations phase)
- The total concession period profit of Rs 200 would need to be split into that construction profit, interest on the asset and that maintenance profit (assume that construction profit out of this is Rs 125, interest is Rs 25 and operation profit is Rs 50)

Accounting for a toll project – Indian GAAP & IFRS

Indian GAAP	Rs	IFRS	Rs
Year 1		**Year 1**	
P& L		P& L	
Income	-	Construction income*	362
Expense	-	Expense	300
	-	Profit	62
Balance Sheet		Balance Sheet	
Capital WIP	300	Financial asset	362
Creditors	(300)	Creditors	(300)
		Accumulated Profit	(62)
	-		-

* 50% of total construction revenue of Rs 725 (Rs 725 being construction cost of Rs 600 plus profit of Rs 125 thereon)

Accounting for a toll project – Indian GAAP & IFRS

Indian GAAP	Rs	IFRS	Rs
Year 2		**Year 2**	
P& L		P& L	
Income	-	Construction income	363
Expense	-	Interest income	5
		Expense	300
	-	Profit	68
Balance Sheet		Balance Sheet	
Capital WIP	600	Financial asset Rs (362+363+5)	730
Creditors	(600)	Creditors	(600)
		Accumulated profit	
		Opening balance	(62)
		Profit for the year	(68)
	-		-

Accounting for a toll project – Indian GAAP & IFRS

Indian GAAP	Rs	IFRS	Rs
Year 3		**Year 3**	
P& L		P& L	
Annuity income	100	Annuity revenue (Total Rs 100 relating to maintenance - Rs 25)	25
Expense (Dep – Rs 60; maintenance cost Rs 20)	80	Interest income Expense (maintenance cost)	7 20
Profit	20	Profit	12
Balance Sheet		Balance Sheet	
Asset	540	Financial asset Rs (730+ 7 – 75)	662
Cash	100	Cash	100
Creditors (op bal + exp)	(620)	Creditors	(620)
Profit	(20)	*Accumulated profit*	
		Opening balance	(130)
		Profit for the year	(12)
	-		-

Key Business Issues arising from application of IND-AS/IFRS

- Investor communication
  - Gap in cash flows and revenue recognition (IFRIC 15)
  - Significant volatility in profit or loss (Investment property – fair value model)
  - Changes in key performance indicators
- Impact on distributable profits and bonus shares
- Taxation
  - Impact on MAT
  - Taxability of unrealised gains/losses
- Debt Covenants
  - Impact on liquidity / gearing ratios
- Impact on revenue sharing arrangement
- Impact on systems / processes
- Involvement of valuation experts
- Executive compensation

Thank you.