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Revenue Recognition - Construction Contract & Real Estate Developers

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Prelude:

Now with more thrust on Make in India, the happening of which primarily depends on various financials, statutory and physical infrastructure development. India being one of the fastest growing economy where in infrastructure and housing sector are key sectors which simultaneously brings in accounting and taxation issues. This article is aimed at bringing in the concepts and issues in recognition of revenue for construction contract and closely associated industry of real estate development. Taxation aspects are not dealt with in this article. However this has been touched upon in the light of Income Computation and Disclosure Standards (ICDS) which became effective from 01.04.2015. Further the distinction between the present accounting standard the IND AS has also been touched upon at appropriate places.

As the Technical terms are defined in the accounting literatures referred to in this article the same is not reproduced. Readers are requested to refer the accounting literatures referred to herein.

A. Construction Contracts – Concepts & Issues:

Concepts enumerated in AS 7 for Construction Contract are relatively simple as compared to the Real Estate Developments. There is no issue with respect to recognition of revenue and cost for a construction work when the construction activity is started and completed within the same financial year. However in practice this is not the case. Normally the construction activities are carried on for more than one financial year which need for more clarity in the allocation of contract revenue and cost to the various accounting period during which the economic activity takes place. ICAI has come up with an accounting standard AS 7 Construction Contract which was revised in 2002.

Concepts enumerated in AS 7:

- Timing of recognition of contract revenue and contract cost in Statement of Profit & Loss
- Extent and method of recognition of Contract Revenue and contract cost
- Treatment for progress payments/ advances received
- Provision for foreseeable losses

I. Timing of recognition of contract revenue and Cost in Statement of Profit & Loss:

- ✓ Contract revenue and cost shall be recognized only when the ***"outcome of the contract is reliably estimated"***.

- ✓ There are various criteria given to ***"confirm"*** whether the outcome of the contract is reliably estimated. The most important criteria are: i. Economic benefits will flow to the enterprise and ii. Contract cost & Revenue is measured reliably.

In most of the cases the criteria stated above can very well be confirmed based on the contract terms entered into with the Customers. These criteria assume greater importance especially with respect to revenue when the price escalation /claims are lodged with the customer the outcome of which primarily depends on the negotiations. Till the certainty is established as to flow of economic benefits to the enterprise no income is recognized viz., the cost incurred is recognized in the statement of Profit and Loss as per the basic accounting principle of "prudence". It may also be noted that the confirmed contract claims be included in the contract revenue.

When uncertainty is involved as to outcome of the contract viz.,, the recognition criteria could not be confirmed, revenue can be recognized only to the extent the recovery of cost incurred is probable and all other costs shall be charged off to Statement of Profit and Loss.

Accounting policies adopted by the some of the listed entities with respect to claims produced for the readers understanding:

Hindustan Construction Company – March'15:

iii) Accounting for claims

Claims are accounted as income in the period of receipt of arbitration award or acceptance by client or evidence of acceptance received. Interest awarded, being in the nature of additional compensation under the terms of the contract, is accounted as contract revenue on receipt of favorable award.

IL and FS Engineering and Construction Company – March'14:

Price Escalation and other claims/or variations in the contract works are included in contract revenue only when:

a. Negotiations have reached to an advanced stage such that it is probable that customer will accept the claim; and

b. The amount that is probable will be accepted by the customer and can be measured reliably.

II. Extent and method of recognition of Contract Revenue and contract cost:

The next issue that arises is extent of recognition of contract revenue and cost once the recognition criteria stated above are satisfied. AS 7 allows only percentage of completion method in determining the extent of recognition of revenue against the cost in the Statement of Profit and Loss. AS7 allows an enterprise to follow any method which reliably measures the work performed in determining the percentage of Completion. These methods include:

i. Contract cost incurred to Total estimated contract cost

ii. Survey of work performed

iii. Completion of Physical proportion of contract work.

In general, the percentage of completing is determined as the ratio of Contract Cost Incurred up to reporting date to Total Estimated Contract Cost. In determining such percentage the following costs are specifically be excluded in arriving at the realistic percentage of Completion:

a. Contract cost incurred towards future activities viz., material on hand which is not used in the construction activities and
b. Progress payments / advance payments made to sub-contractors.
c. All cost which are not pertaining to Contract activities viz., indirect admin cost, borrowing cost etc.

Example:

Ultimately the profit reported (Gross Profit) is equivalent to % of completion to estimated profit of the Contract. To put it simply, if the Profit estimated out of Contract A is Rs.50 lakh and Percentage of Completion is 45% for year I 75% for year II and 100% for year III the Cumulative Gross Profit Reported will be Rs.22.50 lakh, Rs.37.50 lakh and Rs.50 lakh in year I,II and III respectively. This may be noted that if any loss is estimated out of the said contract the same shall be provided for 100% in the year I itself. In the same example, if the contractor estimates a loss of Rs.50 lakh at the end of III year, the same shall be provided for in year I itself. In practice the loss may be ascertained only when the contract has reached certain stage of completion and in those cases the entire estimated loss shall be provided for in the year in which the loss is estimated.

In the early stage of the contract work, no profit is recognized in the Statement of profit and Loss. Accordingly contract revenue is restricted to contract cost incurred up to the date of reporting. Accounting Standard does not define what the early stage of completion is. However, Guidance Note on Accounting for Real Estate Transaction (Revised 2012) specifies that "stage of completion of the project is said to have reached reasonable level of development only when it has incurred 25% of construction and development cost". Taking inference from the above, recognition of profit may be deferred till the contract cost incurred reaches 25% of estimated total contract cost for a construction contracts.

It may be noted that IND AS 11 Construction Contract, principles of which is extended to real estate developers is also silent on the term of early stage of completion.

Accounting policies adopted by the some of the listed entities with respect to Revenue recognition claims produced for the readers understanding:

Hindustan Construction Company – March'15:

1.13 Revenue Recognition

i) Accounting of construction contracts

The Company follows the percentage completion method, based on the stage of completion at the Balance Sheet date, taking into account the contractual price and revision thereto by estimating total revenue including claims/variations as per Accounting Standard 7 and estimated total cost till completion of the contract and the profit so determined has been accounted for proportionate to the percentage of the actual work done.

IL and FS Engineering and Construction Company – March'14:

(b) Revenue recognition:

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Company and revenue can be reliably measured. Revenue recognized is net of taxes.

Revenue from construction contracts

Revenue from construction contracts is recognized on the percentage of completion method as mentioned in Accounting Standard (AS 7) Construction Contracts- notified by the Companies Accounting Standards Rules, 2006 (as amended). The percentage of completion is determined by the proportion that contract costs incurred for work performed up to the balance sheet date bear to the estimated total contract costs. However, profit is not recognized unless there is reasonable progress on the contract. If total cost of a contract, based on technical and other estimates, is estimated to exceed the total contract revenue, the foreseeable loss is provided for. The effect of any adjustment arising from revision to estimates is included in the income statement of the year in which revisions are made. Contract revenue earned in excess of billing has been reflected under Inventories and billing in excess of contract revenue has been reflected under other current liabilities in the balance sheet. Revenue recognized is net of taxes.

III. Treatment for progress payments/ advances received:

As already discussed earlier in this article, advance payments / progress payments received are not relevant in determining the contract revenue that should be recognized in the Statement of Profit / Loss. Commissioning advances, material advances etc., are only economics worked out between the contractor and customer for the undisturbed execution of the work. Though the progress billing largely reflects the work executed and considered in determining the percentage of work completed, the progress payment received has no relevance.

IV. Provision for foreseeable Losses:

Under AS 7 all foreseeable losses which may arise on account of the contract shall be recognized in full immediately in the books of account which goes well with the basic accounting principle of prudence. Recognition of foreseeable losses immediately means recognition of loss in the same year in which the management has estimated losses irrespective of stage of completion and whether or not the work commenced on the contract work.

A. Real Estate Developers:

As of now there is no separate standard for Revenue Recognition of Real Estate Development. Considering the growth and importance of Real Estate business, ICAI had come with a Guidance Note on Recognition of Revenue by Real Estate Developers in 2006 which was revised in 2012. This Guidance Note (GN) provides basis for recognition of income for real estate a developer

which is the blend of AS 7 Construction Contract and AS 9 Revenue Recognition.

Application:

Application of principles of AS 7 and AS9 to Real Estate Development contracts depends on the nature of arrangement / agreements viz.,

- For Real estate transactions having "as such economic substance of construction contracts", AS 7 applies
- For Real estate transactions which are in substance Delivery of goods, AS 9 applies

In practice the real estate transactions for construction of residential units primarily consist of two components viz., Sale of Undivided share (UDS) of Land and Contract for Construction of the unit. Generally two agreements are entered into with the customer viz., one for sale of UDS of Land and another for construction of residential unit. Registration of UDS takes place at very early stage which will facilitate the customer to raise bank finance for the construction of the house / unit. Though the UDS registration happens immediately, the final product is Residential Unit (construction and delivery of residential units to the customers). As the economic substance of the contract is similar to Construction Contract the principles laid down in AS 7 shall be applied in recognizing the revenue.

Same principles as laid down in AS 7 shall be applied in determining the Percentage completion and in recognition of Project revenue over the period during with the Project Continues. GN list out various conditions which has to be considered to "start recognizing" the Revenue for the Real Estate Projects which is substance construction contract viz.,

a. All critical approvals for commencement of the Project is obtained;
b. 25% of construction and development cost is incurred;
c. Minimum 25% of the saleable project area is secured by contract or agreement with buyers and
d. Minimum 10% of total revenue is realized with respect to contract entered into with the customers. (For Example, if there are 100 units is sold of which 10% of consideration is realized only for 40 units, Income shall be recognized only for the 40 units)

It is also normal practice that a part of the constructed property is retained by the developer for the purpose of earning income thereon by way of rental in which case proportionate cost be capitalized in line with AS 10 Fixed Assets.

Accounting policies adopted by the some of the listed entities with respect to Revenue Recognition for Real Estate Development produced below:

DLF Limited- March 31, 2014:

g) Revenue recognition

i) Revenue from constructed properties for all projects commenced on or before March 31, 2012 and where revenue recognition commenced on or before the above date, is recognized in accordance with the provisions of Accounting Standard (AS) 9 on Revenue Recognition, read with Guidance Note on Recognition of Revenue by Real Estate Developers. Revenue is computed based on the percentage of completion method and on the percentage of actual project costs incurred thereon to total estimated project cost, subject to such actual cost incurred being 30 percent or more of the total estimated project cost. Revenue from constructed properties for all projects commenced on or after April 1, 2012 or project where the revenue is recognized for the first time on or after the above date, is recognized in accordance with the Revised Guidance Note issued by the Institute of Chartered Accountants of India (ICAI) on Accounting for Real Estate Transactions (Revised 2012).

As per this Guidance Note, the revenue have been recognized on percentage of completion method provided all of the following conditions are met at the reporting date.

- required critical approvals for commencement of the project have been obtained,
- atleast 25% of estimated construction and development costs (excluding land cost) has been incurred,
- atleast 25% of the saleable project area is secured by the Agreements to sell/application forms (containing salient terms of the agreement to sell); and
- atleast 10% of the total revenue as per agreement to sell are realized in respect of these agreements.

RDB Realty and Infrastructure Limited– March 31, 2014

C. Revenue Recognition

a) Revenue from own construction projects are recognised on Percentage of completion method. Units for which agreement for sale is executed till reporting date are considered for it. Revenue recognition starts when 20% of estimated project cost excluding land and marketing cost is incurred and 30% of consideration is received from party. Further, units for which Deed of Conveyance is executed or possession is given, revenue is recognised to full extent.

b) Revenue from Joint Venture Development Agreement under work sharing arrangements are recognised on the same basis as similar to own construction projects independently executed by the company to the extent of the company's share in joint venture.

B. IMPACT OF ICDS ON CONTRACT ACCOUNTING AND REAL ESTATE DEVELOPEMT:

a. Though ICDS also recognize percentage of completion method in reckoning Income, unlike AS 7 it does not permit recognition of expected loss on construction contract on immediate basis. Accordingly even if loss is expected out of an ongoing contract, realized losses shall be recognized over the period of the contract for the purpose of determining taxable Income under the Income Tax Act. This is because ICDS 1, Accounting Policies does not recognized "Prudence" as one of the basic accounting principle.

b. Unlike AS 7 where the early state of completion is not defined, ICDS allows for not recognizing income up to 25% of the stage of Completion. It may be noted that different entities may have different percentage for the early stage of completion not exceeding 25% of the stage of completion under the Income Tax Act. Accordingly, percentage of completion adopted for revenue recognition may be different under Companies Act and under ICDS for Income Tax purpose which may trigger litigation.

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