Resolving the complex revenue recognition issues in the development companies and construction of real estate

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Background

A real estate development company is the company which facilitates by providing a platform and basic infrastructure facilities to other companies in construction.

The basic problem arises whether the developer is selling a product e.g. sale of factory or building or is selling a service i.e. a construction service as a contractor engaged by the buyer. Revenue from selling products is normally recognized at delivery. Revenue from selling services is normally recognized on a percentage of completion basis as construction progresses.

IFRIC 15 'Agreements for the Construction of Real Estate' is an Interpretation defined for guidance on the accounting for the construction of real estate, and specifically where the contractor generates revenue from the construction project prior to the completion date.

Accounting treatment for the construction of real estate depends upon the substance of the agreement. IFRIC 15 defines the accounting for revenue for development companies that undertake construction of real estate directly or through subcontractors, IFRIC 15 requires components accounting.

IFRIC 15 mainly distinguishes two areas which have given rise to divergence in practice:

(i) whether, the transaction is a sale of goods or a provision of a service, and

(ii) timing of the revenue recognition where the transaction is considered to be a sale of goods.

Construction contracts are under the scope of IAS 11 'Construction Contracts'. Construction contract can be defined as the work done on a specifically negotiated contract for the construction of an asset or combination of assets. In accordance with IAS 11, revenue arising from construction is recognized based on the percentage of completion method.

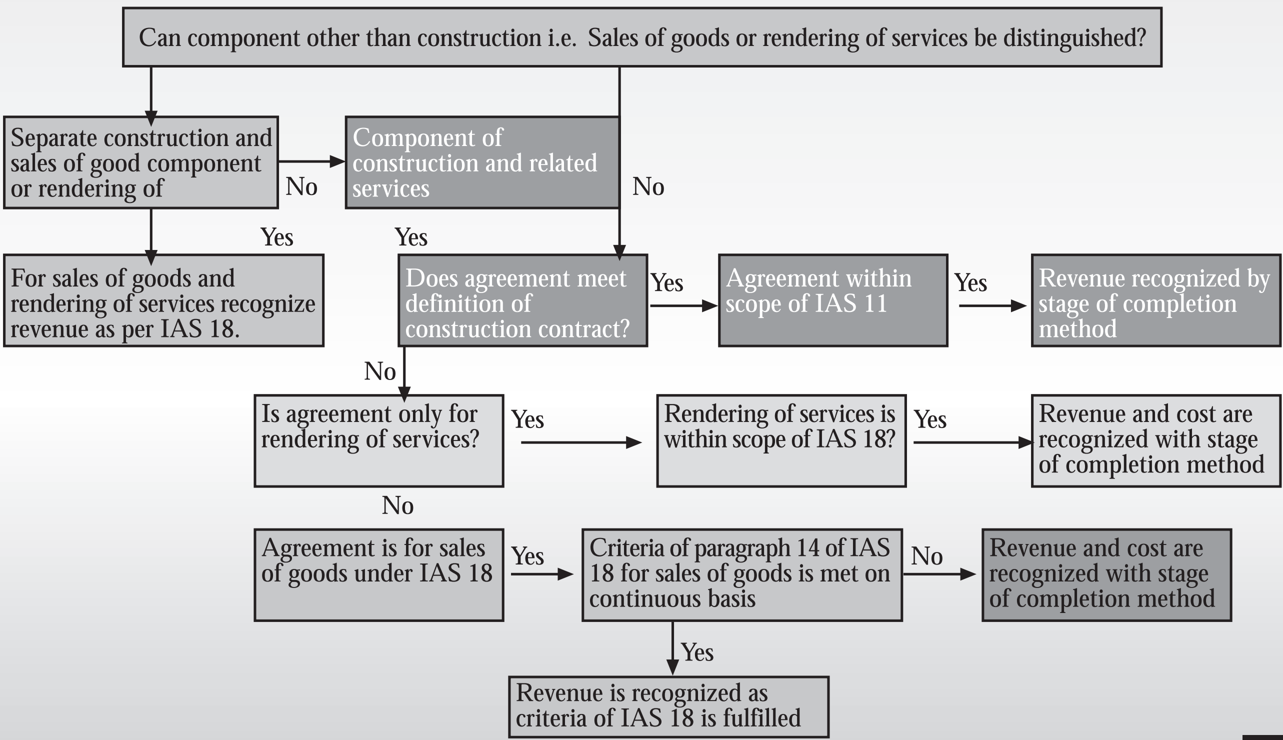
On contrary the sale of a good or the rendering of a service do not within the scope of IAS 11 and are accounted within the scope of IAS 18 'Revenue'. Sale of goods may be treated as the converse to a construction service, i.e. the sale of non-tailored asset; but ultimately is all contracts that do not fall within the scope of IAS 11.

Accounting treatment of revenue recognition is dependent upon the nature of the sale agreement:

- If the development company provides construction materials along with services in order to perform its contractual obligation, the said agreement is an agreement for the sale of goods and revenue is recognized in accordance with paragraph 14 of IAS 18 which elaborates five criteria for the revenue recognition for sales of goods. In simple words, revenue is recognized when risk and rewards are transferred to the buyer without any further involvement of seller.
- If developing company does not supply construction materials, i.e. the agreement for the rendering of services. Revenue would be recognized in accordance with IAS 18 paragraph 20, using the stage of completion method.

Separation point-construction, goods or services, and when to recognize income

IFRIC 15 states that where the buyer is able to specify the major structural elements of the design of the real estate before



construction begins and/or specify major structural changes once construction is in progress, then the contract would be considered to be specifically negotiated, and would hence fall within the scope of IAS 11. However, any minor improvements are not considered to be treated under IAS 11. For example: minor change in location of parking area.

A detailed example

ABC Ltd. is a development company. Total development price is Rs. 1 billion (Rs. 600 million for materials and Rs. 400 million for services) exclusive of land price which is Rs. 10 million for each unit. Maintenance service of Rs. 1 million each unit is provided.

Scenario 1:

ABC Ltd. sells land for the construction of industry comprising of many factories. Sale is simply sales of goods under paragraph 14 of IAS 18. Thus revenue of Rs. 10 million / unit is recognized for every unit sold.

Scenario 2:

If ABC Ltd not only sale the land but also provides maintenance services to the industry. In this case two different types of sales component are involved i.e. the sale of land and rendering of maintenance services.

- Sale of the land would be recognized under IAS 18, as the land would be transferred at one time. Hence, the revenue would be recognized at the time of transfer of the land. Revenue is recognized as in scenario 1.
- The rendering of maintenance services would be recognized under paragraph 20 of IAS 18. Thus recognition of Rs. 1 million/unit after fulfilling four conditions in paragraph 20.

Scenario 3:

ABC Ltd sells land along with the infrastructure development (road, electricity, water, gas etc.) to the industry as well as maintenance services. Here are three different sales components i.e. the sale of land, rendering of maintenance services and the sale of the infrastructure development.

- The sale of the land would be recognized under IAS 18, as the land would be transferred at time. Hence, the revenue would be recognized at the time of transfer of the land. Revenue is recognized as in scenario 1.
- Rendering of maintenance services would be recognized under paragraph 20 of IAS 18. Thus recognition of Rs. 1 million/unit after fulfilling four conditions in paragraph 20.
- The sale of the infrastructure development. Here IFRIC 15, clearly distinguish whether the agreement is under IAS 11 or under IAS 18 and if under IAS 18 whether it is sale of goods or rendering of services.

If the buyer is able (does not matter if buyer exercise or not the ability) to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress, then the contract would be considered to be specifically negotiated, and would hence fall within the scope of IAS 11. Here buyer usually engages the company for construction. For example, buyer asks for the separate wide-road facility along with power from alternative energy source for his factory, which is not readily included in the master plan for the construction of industry infrastructure for all the factories. Thus Revenue of Rs. 1 billion will be recognized as per stage of completion method under IAS 11 with progress of development.

In absence of such ability where buyer is not able to specify major structural changes at his own will the contract will fall under the scope of IAS 18.

Under IAS 18, there are again two options:

1. Whether this is falls under sale of goods, or
2. Under the sale of service.

If developing company provides infrastructure material along with the development services for developing industrial structure, the scope is under the sales of goods and revenue will be recognized as per paragraph 14 of IAS 18. For example, developing company provides concrete, steel, coal tar and all other materials necessary for construction of main road and access roads to all the factories spotted locations. Thus revenue of Rs. 1 billion should be recognized to the extent of each completed unit sold.

In any other case of selling of services, revenue is recognized as per paragraph 20 of IAS 18. Stage of completion method is used to record the service revenue over the period of time. For example 20 % of stage is completed thus revenue should be recognized to extent of Rs. 80 million (400 million X 20%).

However, for practical purpose, when services are performed by an indeterminate number of acts over as specified period of time, revenue is recognized on a straight line basis over the specified period unless there is evidence that some other method better represents stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until that significant act is executed. For example, terms of payment receipt from buyer are: 1st installment at signing of application, 2nd installment on transfer of land possession and provided with infrastructure facility to the buyer who can construct his factory and final installment at complete construction of factory buildings by respective buyer. Thus revenue can be postpone till the 2nd installment which is a significant act (when risk and rewards are transferred and seller does not have managerial involvement). Assuming stage completion is 50% thus revenue of Rs. 200 million (400 million X 50%) will be recognized starting at 2nd installment time and remaining over final payment time using stage of completion method.

Implications of IFRIC 15

IFRIC 15 was developed in order to facilitate the development companies as well as real estate companies that otherwise have recognized their income either in accordance with the wrong accounting standard, or have recognized too much in advance.

This Interpretation allows companies to review all active contracts to determine:

(a) Whether it meets the recognition criteria in IAS 11, or if the contract would now falls within the scope of IAS 18,

(b) at what point risks and rewards are transferred to the buyer, and

(c) if any of the components of the contract are delivered after the others, which may result in an element of revenue being deferred.

Conclusion

In order to resolve the complex environment of development companies and real estate companies for revenue recognition, IFIRC 15 is designed. IFRIC 15 allows not only to ensure that accrual concept of accounting is followed but also considers substance over form concept, this interpretation properly guides a user to recognize revenue at what stage and to what extent either under IAS 11 or IAS 18.