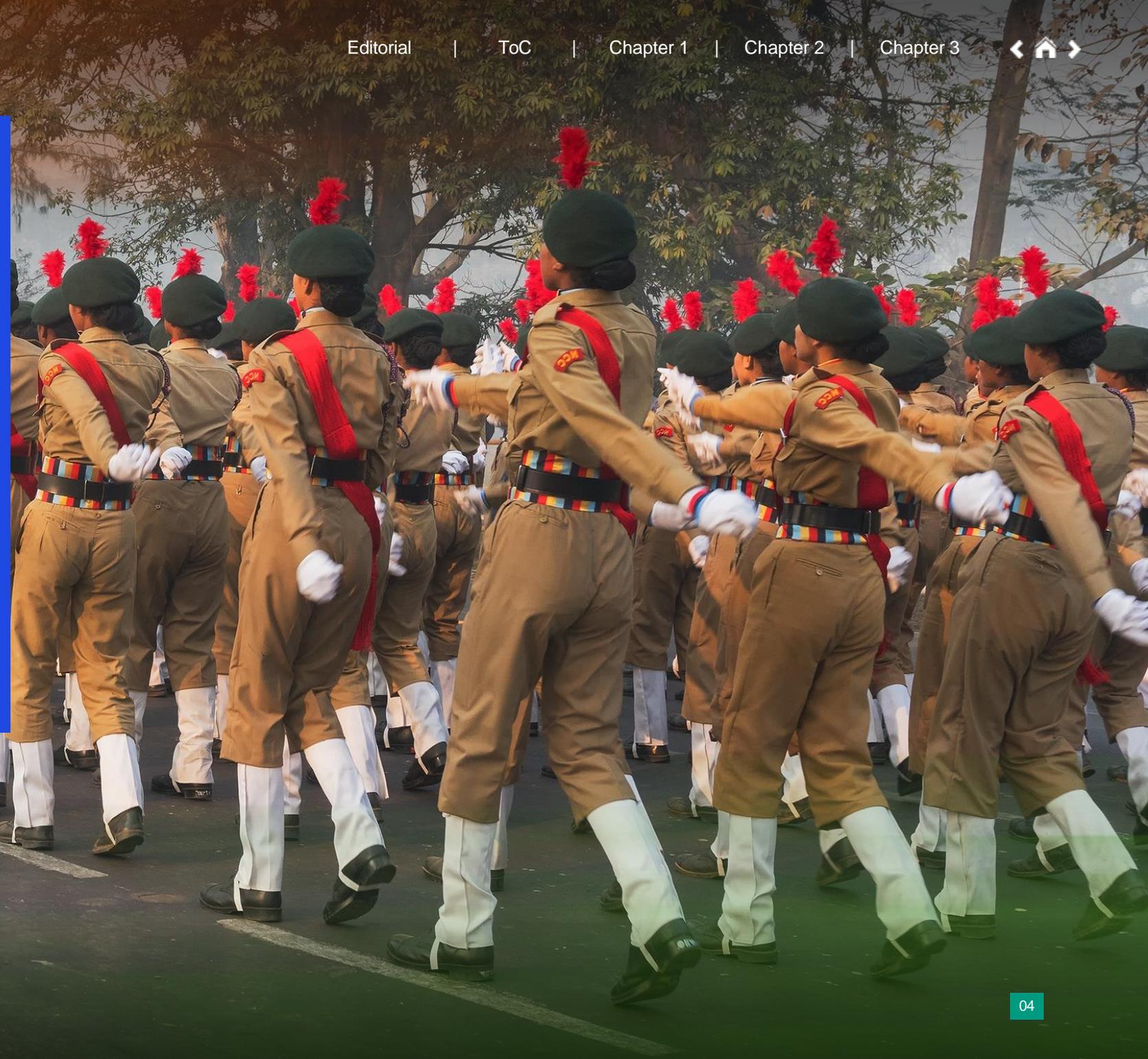


CHAPTER 1

Revenue recognition in real estate companies: key principles and application challenges

This article aims to discuss key aspects of revenue recognition for real estate companies under Ind AS and separation of significant financing component in such arrangements.



Background

With real estate contributing significantly to India's GDP and urban expansion, accurate financial reporting has never been more critical. Yet, applying Indian Accounting Standards (Ind AS) to real estate transactions presents unique challenges that go beyond conventional accounting practices. As a key driver of economic activity, employment, and infrastructure development, accounting for real estate transactions involves unique considerations that set it apart from revenue recognition practices in other industries. The complexity and diversity of real estate arrangements - ranging from long-term construction contracts to multiple-element sale agreements - require tailored approaches for recognition, measurement, and disclosure, making real estate accounting particularly nuanced under Ind AS. This article explores the key aspects of accounting for real estate companies in India under Ind AS, focusing on two crucial areas:

- Practical challenges in assessment of the point of transfer of control for revenue recognition at a point in time.
- Assessment and quantification of significant financing component in the transaction price.

Key application challenges in revenue recognition

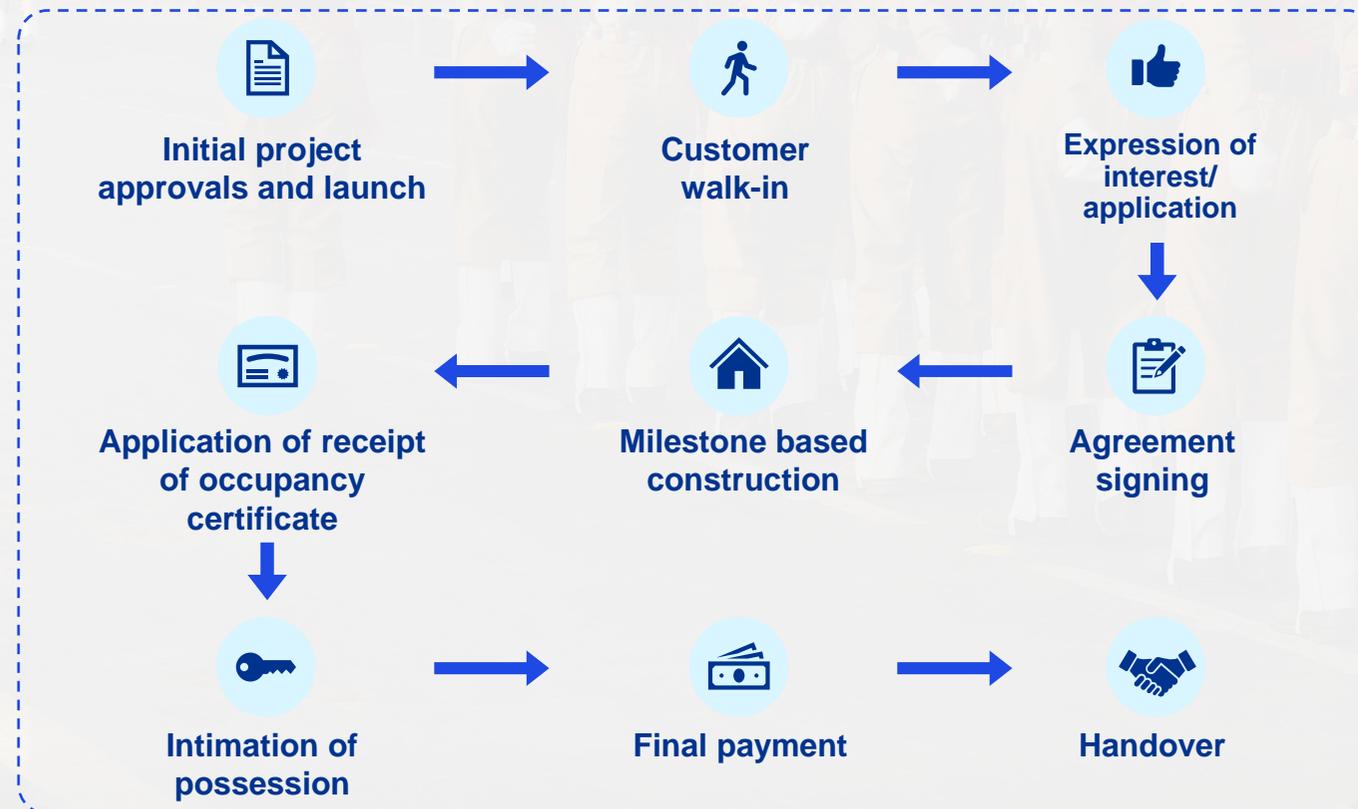
As per Ind AS 115, *Revenue from Contracts with Customers*, an entity is required to evaluate whether control of a promised good or service transfers to the customer at a point in time or over time. Control is considered to have transferred when the customer obtains the ability to direct the use of and obtain substantially all the remaining benefits from the asset. While in case of sale of goods, it may be easy to define the point of transfer of control based on the terms of the underlying arrangement, in the case of real estate sector, judgement is required to determine the point of transfer of control. Accordingly, such evaluation requires consideration of the facts and circumstances of each case.

While it may seem that the only performance obligation in a real estate contract is to develop and deliver the real estate unit, there are many factors to be considered, given that transfer of a real estate unit is not necessarily straightforward as delivery of manufactured goods. This has also a lot to do with the statutory regulations of the state in which the project is being developed and Real Estate Regulation Act (RERA) related requirements.



Another important aspect to note is that while the developer may have satisfied the performance obligations as per the contract, the rights of the customer to cancel the contract are equally important to consider. If a customer has the right to cancel the contract at any time before the acceptance of possession of the real estate unit without any significant penalty, the developer may be able to recognise revenue only when the final possession is handed over to the customer.

A typical real estate contract comprises of multiple milestones from booking to handover. The below illustration shows the journey:



The most straightforward situation for revenue recognition is where the real estate unit is sold to the customer after receipt of the Occupancy Certificate (OC) for such unit. The developer may recognise revenue at the point in time when the real estate unit is handed over to the customer. This typically takes place once the customer has accepted possession and has made full and final payment in accordance with the terms of the real estate contract.

However, there are other complexities in determining the timing of transfer of control which are considered in the following situations where revenue recognition may vary depending on contractual terms, regulatory requirements, and practical considerations.

Unit of account for revenue recognition – individual real estate unit vs combined tower-based approach

In high-rise developments, construction and regulatory approvals often occur at the tower level, even though contracts are signed per unit. This creates a unique challenge in aligning revenue recognition with the actual transfer of control. While real estate developers in India typically enter into separate contracts for each real estate unit with customers, construction and OC often occur at tower level. The OCs are also received either for an entire tower or partially, based on combination of certain flats.

Despite issuing a common possession notice for all units in a tower, revenue recognition must be assessed individually for each unit based on its specific contract. For example, if a tower with 100 flats receives an OC, and the developer issues a common communication to all the customers of the flats in that tower, the developer cannot recognise revenue solely based on this one communication. Instead, the developer must assess the revenue recognition criteria based on whether the performance obligations under each customer's agreement has been satisfied.



General criteria for transfer of control based on intimation of possession

Under RERA, developers are required to mandatorily obtain an OC from the municipal corporation, confirming the unit is fit for occupation. Post this the developer is formally required to intimate the customer that the residential unit is ready for possession and invite the customer to come and accept the possession of the property, subject to final payment.

In this situation, the developer's performance obligation could be considered fulfilled once the OC has been received and the customer has been formally notified that the real estate unit is ready for possession. It is pertinent to note that often, residential unit sales are bundled with amenities such as recreational facilities, roads, lobbies, etc.

In such cases, the developer must assess whether the contract treats these amenities as separate performance obligations. If so, and a distinct portion of the transaction price is allocated, revenue should be recognised only when access is provided. The value these amenities provide to the customer also plays a role in this assessment. Recreational amenities may be viewed as separate obligations, whereas common infrastructure elements like roads, lobbies, and pavements are generally considered integral to the residential unit. These are typically not treated as separate obligations.

Impact of delays in payment/possession

Generally, if the terms of the contract prohibit the customer from cancelling the agreement after possession intimation, then the developer may consider recognising revenue. However, in case the customer is delayed in making final payment/taking possession, it is also important for the developer to assess the reasons behind such delay. In some instances, there may be genuine challenges such as the customer being abroad or facing administrative hurdles like sale deed registration. However, there may also be strategic reasons, such as negotiating a price reduction or expressing dissatisfaction with the unit's quality, seeking discounts, etc.

In such situations, the developer should exercise judgement and evaluate whether there is a reasonable certainty that the customer will accept possession at the agreed transaction price before recognising revenue. Administrative delays or absence from the country may suggest a likely acceptance and support recognition. Conversely, intentional delays driven by dissatisfaction or negotiations for costs may warrant caution in revenue recognition.



Nature of agreement

In certain Indian states, a real estate transaction involves two agreements - an initial agreement, entered into at the start of the transaction and second - sale deed, which is signed at the end when the real estate unit is handed over and legally registered in the name of the customer. The statutory transfer of title and payment of stamp duty is generally established at the time of registration of sale deed.

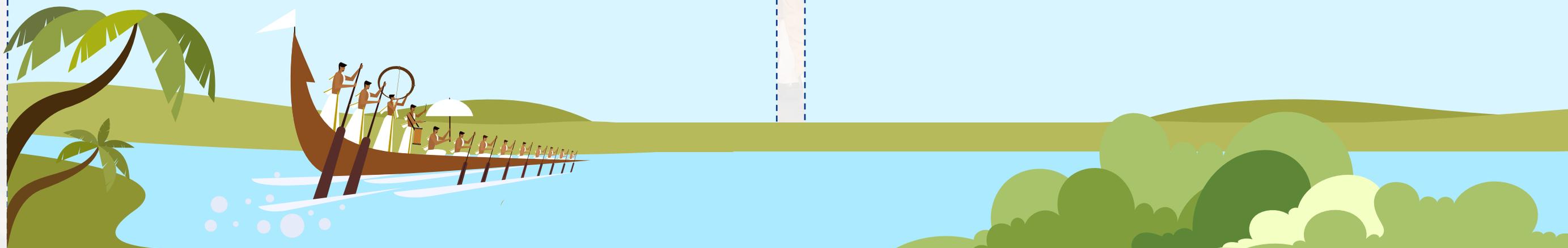
Developers may face a scenario where the OC is received and full payment is made by the customer, but sale deed registration is delayed due to administrative formalities. In certain situations, the developers may grant access to the property (referred to as a soft possession) allowing the customer to occupy the unit.

Where the customer has physical access and enjoys substantially all benefits of the property, all performance obligations are completed, and the contract prohibits cancellation, the developer may exercise judgement to recognise revenue at the point of soft possession - despite the pending administrative title transfer.

Plotted developments

In certain rare scenarios, the time gap between receiving the OC and handing over the residential unit to the customer is minimal. In such cases, if it is evident that the developer has fulfilled all performance obligations under the contract, revenue may be recognised when the OC is received.

This approach is particularly relevant in real estate transactions involving plotted developments, where primary deliverable is the land parcel itself - often accompanied by basic infrastructure. Since these projects typically involve limited construction activities, the issuance of the OC generally indicates that the developer's responsibilities are substantially complete. In these cases, generally contract prohibits cancellation post receipt of OC. Therefore, when possession is imminent and there is no material uncertainty regarding the customer's acceptance, recognising revenue upon receipt of the OC can be considered appropriate and aligned with the principles of revenue recognition under applicable accounting standards.





Significant financing component

While the section above highlights the complexities in determining the point of revenue recognition based on control transfer and contractual obligations, another critical dimension in real estate accounting is the timing of payments - specifically, the impact of advance collections and deferred delivery, which brings into focus the concept of a significant financing component under Ind AS 115.

Real estate contracts typically span 1.5 to 4 years, with customer payments linked to construction milestones. Although developers receive payments throughout the construction period, the core performance obligation of handover of the unit is fulfilled only upon completion. This creates a time gap between the receipt of payments and the transfer of control.

In accordance with Ind AS 115, when a contract includes a significant financing component, the revenue must be adjusted to reflect the time value of money. However, this adjustment is not required when the practical expedient under Ind AS 115 is applied - specifically, when at the start of the contract, the developer anticipates that the time between transferring control of the unit and receiving payment will not exceed one year.

Since developers often receive payments well in advance of transferring control, this financing benefit must be considered in revenue recognition. According to paragraph 61 of Ind AS 115, the developer is required to adjust the transaction price for any significant financing component by comparing the promised consideration with the cash selling price of the goods or services.

Paragraph 61 of Ind AS 115 also requires developers to consider the combined effect of expected time gap between payment and transfer of control, and the prevailing market interest rate. In practice, developers often recover around 30 per cent of the consideration at the time of agreement registration, another 45 per cent upon laying foundation, and the remaining amount in phases as construction progresses. This results in a substantial time gap between payment and delivery, effectively providing the developer with a financing benefit. Even if not explicitly stated in the contract, this benefit should be accounted for using the developer's market borrowing rate as a reference.



Subvention schemes

Real estate developers frequently introduce subvention schemes as a strategic tool to reduce the financial burden on homebuyers during the construction phase of residential or commercial projects. These schemes are typically structured as tripartite agreements involving the buyer, the developer, and a financial institution (such as a bank or housing finance company).

Under these schemes, the developer bears the interest cost associated with the customers' borrowing for a specified period. In such situations developers are required to determine whether such subvention should be treated as a discount or incentive offered to the customer, or does it represent an interest expense to be borne by the developers.

Conclusion

Accounting for real estate transactions under Ind AS presents a unique set of challenges that require careful interpretation and professional judgement. The principles of revenue recognition under Ind AS 115, particularly around the assessment of transfer of control and the identification of significant financing components, demand a nuanced understanding of both contractual terms and practical realities of the real estate sector.

Given the complexity of real estate arrangements - ranging from milestone-based payments to bundled offerings of infrastructure and amenities - developers must adopt a contract-specific approach to revenue recognition. Factors such as customer rights, possession timelines, statutory requirements, and market interest rates play a critical role in determining the appropriate accounting treatment.

As the industry continues to evolve, it is imperative for real estate companies to stay aligned with the principles of Ind AS, ensuring transparency, consistency, and compliance in financial reporting. A robust accounting framework not only enhances stakeholders' confidence but also supports informed decision-making in a sector that remains central to India's economic development.

