

**GN(A) 23 (Issued 2006)**

## **Guidance Note on Recognition of Revenue by Real Estate Developers**

### **Foreword**

The real estate sector is one of the key sectors in achieving an overall socio-economic growth in a country. It helps in fulfilling one of the basic necessities for human existence, viz., the housing. It also provides basic infrastructure for anchoring the economic growth in a country. A developing nation like India, with rapidly growing population and having tremendous potential for economic growth, is required to pay special attention to this sector. Keeping this in view, the Government of India has provided several incentives for the growth of the sector through fiscal, monetary and other policies. Recently, the Government has decided to allow 100% foreign direct investment (FDI) in this sector through 'automatic route'. The incentives provided by the government in tandem with the conducive economic environment are yielding positive results for the growth of this sector and this sector is expected to become one of the fastest growing sectors in the Indian economy.

With the growth of this sector, the issue regarding recognition of revenue arising from real estate sales has assumed greater importance. Although Accounting Standard (AS) 9, *Revenue Recognition*, is now applicable for recognition of revenue arising from real estate sales, yet a need was being felt to amplify the application of the principles of AS 9 to real estate sales, particularly in cases where the seller has entered into an agreement for sale with the buyer at initial stages of construction. I am glad to note that with a view to address such issues, the Accounting Standards Board of the Institute has formulated this technical document on 'Recognition of Revenue by Real Estate Developers' which is issued as a Guidance Note under the authority of the Central Council of the Institute.

I am confident that this Guidance Note would go a long way in establishing sound accounting principles for recognition of revenue by real estate developers and would be extremely helpful not only to the members but also to the others concerned.

New Delhi  
May 5, 2006

CA. T.N. Manoharan  
*President*

## **Preface**

In recent years, there has been a major spur in the demand for the residential and commercial properties, due to the factors such as the fast-growing population, lower interest rates and greater need for commercial space to anchor economic growth. This together with the favourable government policies has resulted in a growth at a rapid pace in the real estate sector and this trend is likely to be continued in the years to come. With the growth of this sector, there is a need for prescribing robust accounting principles for recognition of revenue arising from the real estate sales. The distinguishing features of the real estate sales from other sales are the agreement to sell entered by the seller with the buyer at the initial stages of construction and the transfer of risks and rewards related to the real estate sales in such cases. Keeping this in view, the pre-revised AS 7 (1983), *inter alia*, provided that “The Statement also applies to enterprises undertaking construction activities of the type dealt with in this Statement not as contractors but on their own account as a venture of a commercial nature where the enterprise has entered into agreements for sale”. However, in line with the corresponding International Accounting Standard (IAS), the revised AS 7 does not contain this provision. As a result of this, the revised AS 7 is not applicable to certain enterprises, e.g., real estate developers. To such enterprises, AS 9, *Revenue Recognition*, is applicable. A need was being felt for guidance as to how the principles of AS 9 should be applied in case of such enterprises. Keeping this in view, the Accounting Standards Board of the Institute has formulated a technical pronouncement on ‘Recognition of Revenue by Real Estate Developers’ which is issued as a Guidance Note on the subject.

The Guidance Note provides guidance on application of principles of AS 9 to the real estate sales, particularly the transfer of risks and rewards of ownership to the buyer in a case where the seller has entered into an agreement to sell. The Guidance Note also provides specific guidance on recognition of revenue in a situation where the seller is obliged to perform any substantial acts after the transfer of all significant risks and rewards of ownership.

I would like to take this opportunity to thank all my colleagues on the Accounting Standards Board of the Institute for the current year as well as the last year and my colleagues on the Central Council of the Institute for their comments/ suggestions in the formulation of this

document. I would also like to thank the various regulators and other bodies, our members and other individuals for providing invaluable comments and suggestions in the formulation of this document.

I firmly believe that this Guidance Note would be extremely useful to the members of the Institute and others interested in the subject.

New Delhi  
May 9, 2006

CA. S.C. Vasudeva  
*Chairman*  
*Accounting Standards Board*

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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.