Ind AS Case Study

When Real Estate is sold before completion

Standard required:

115 **Revenue from Contracts with Customers**

CASE STUDY

Recognition of Revenue when Real Estate is Sold before Completion under Ind AS 115

Learning outcome

This Case Study aims to determine when to recognise revenue, and at what amount when a property (real-estate) is sold to a customer before completion. Prior to Ind AS 115 *Revenue from Contracts with Customers,* there was a lack of clear and comprehensive guidance and, in effect, the timing and the amount of revenue to be recognised has been a cause for criticism. Therefore, entities involved in property development have had the difficulty with determining whether revenue should be recognised *over time*, ie, in a manner that depicts an entity's performance in transferring control of goods or services promised to a customer; or *at a point in time*, ie, when a customer obtains control of a promised asset and the entity satisfies a performance obligation. Ind AS 115 specified a clear and objective basis for assessing whether revenue should be recognised over time or at a point in time – depending on whether certain conditions are met. This Case Study discusses how an entity shall apply the principles of Ind AS 115 to report about the nature, amount and timing of those revenue arising from a contract with a customer.

Introduction

Real estate is defined as property in the form of land and building. Many a time, real-estate companies sell properties (eg, houses or units of apartments) when they are under construction or development. The core principle of Ind AS 115 is that entities should recognise revenue to depict the transfer of promised goods or services to customers and the amount of revenue should reflect the consideration to which they expect to be entitled in exchange for those goods or services. The following is the 5-step model –

Step 1	**Identify the contract (including combination of contracts)**
Step 2	**Identify performance obligation(s)**
Step 3	**Determine the transaction price (considering the time value of money)**
Step 4	**Allocate the transaction price to performance obligations**
Step 5	**Recognise revenue when a performance obligation is satisfied at a point in time or over time**

Definitions (Refer Appendix A: *Defined terms* of Ind AS 115)

Transaction price (for a contract with a customer)

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (eg, some sales taxes).

Performance obligation

A promise in a contract with a customer to transfer to the customer either a –

- *good or service (or a bundle of goods or services) that is distinct; or*
- *series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.*

Stand-alone selling price (of a good or service)

The price at which an entity would sell a promised good or service separately to a customer.

Incremental borrowing rate

The rate of interest that an entity would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar asset.

Contract liability

It is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Case Study

On 1 October 20x2, REP Ltd entered into a contract with a customer to sell a building and to subsequently provide servicing facilities relating to the building. Control of the building would transfer to the customer in two years (ie, 30 September 20x4). The servicing facilities were for a 2-year period from 1 October 20x4. Since REP Ltd combined the two separate performance obligations (ie, delivery of the building and the provision of servicing facilities), a single transaction price was charged to the customer for both the performance obligations. The contract included two alternative payment options: Payment of CU 18,150 in two years when the customer obtained control of the building (ie, 30 September 20x4) or payment of CU 15,000 when the contract was signed (ie, 1 October 20x2). The customer elected to pay CU 15,000 when the contract was signed.

The following costs were incurred for construction of the building –

• Direct materials	CU 3,200;
• Direct labour	CU 800;
• Allocations of costs that related directly to the contract	CU 1,000;
• Costs that were explicitly chargeable to the customer	CU 1,000;
• Payment to subcontractors	CU 2,000.

On 30 September 20x4, the building was delivered to the customer. In the 6-month period from 1 October 20x4 to 31 March 20x5, REP Ltd incurred costs of CU 400 relating to the servicing facilities. REP Ltd estimated that this rate of expenditure would continue over the remainder of the 2-year period. REP Ltd would normally expect to earn a mark-up of 25% on the provision of servicing facilities of this nature. REP Ltd's reporting period used to end on 31 March each year and the applicable income tax rate was 40%.

To ascertain the amount of revenue to be recognised in financial statements, REP Ltd has to consider the following factors:

- **Combination of Contracts**

As per Ind AS 115 *Revenue from Contracts with Customers*, an entity shall combine two or more contracts entered into at or near the same time with the same customer and account for the contracts as a single contract if the contracts are negotiated as a package with a single commercial objective. Here, REP Ltd has combined the two separate performance obligations, ie, delivery of the building and the provision of servicing facilities.

- **Satisfaction of performance obligations**

In accordance with Ind AS 115, an entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

REP Ltd had two separate performance obligations as under:

1. **Control of the building would transfer to the customer in two years.**

   Since REP Ltd considered the following indicators of the transfer of control, it was a performance obligation that was satisfied *at a point in time* –

   - ***The customer has legal title to the asset*** The legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of the asset.

- ***REP Ltd has transferred physical possession of the asset*** The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to the benefits.
- ***The customer has the significant risks and rewards of ownership of the asset*** The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset.
- ***The customer has accepted the asset*** The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

In this example, on 30 September 20x4, REP Ltd transferred control of the building to the customer, but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

2. The provision of the servicing facilities to the customer is a performance obligation satisfied over time since the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

REP Ltd provided recurring servicing facilities in which the receipt and simultaneous consumption by the customer of the benefits of REP Ltd's performance could be readily identified. In fact, revenue could be recognised over time (ie, over the 2-year period).

- ***Allocation methodology***

  As per Ind AS 115, the objective when allocating the *transaction price* is for an entity to allocate the transaction price to each *performance obligation* in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. To allocate the transaction price to each performance obligation on a relative *stand-alone selling price* basis, an entity shall determine the *stand-alone selling price* at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those stand-alone selling prices. The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. If a stand-alone selling price is not directly observable, an entity shall estimate the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective, as stated above. One of the suitable methods for estimating the stand-alone selling price of a good or service is the "expected cost *plus* a margin approach". Under this method, an entity would forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

The total revenue arising on the contract was split into the following –

- Revenue from sale of building; and
- Revenue from servicing facilities.

The expected total costs of providing servicing facilities were CU 1,600 (CU 400 x 12/6 x 2). Therefore, if a normal gross mark-up on servicing contracts was 25%, the revenue that was allocated to the servicing facilities was CU 2,000 (CU 1,600 + 25% of CU 1,600). Since REP Ltd estimated that this rate of expenditure would continue over the remainder of the 2-year period, the revenue of CU 2,000 was recognised evenly over the 2-year servicing period.

Therefore, on 30 September 20x4, the contract liability of CU 15,000 was allocated as follows –

CU 13,000 (CU 15,000 – CU 2,000) for the building; and

CU 2,000 for servicing facilities.

Again, CU 500 (CU 2,000 x 6/24) of the contract liability from servicing facilities was recognised as revenue in the 6-months period to 31 March 20x5 (since the reporting period ended on 31 March). Of the remaining contract liability of CU 1,500 (CU 2,000 – CU 500), CU 1,000 (CU 2,000 x 12/24) was shown as current liabilities and CU 500 (CU 1,500 – CU 1,000) as non-current liabilities.

- ***Existence of a significant financing component***

  As per Ind AS 115, in determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the *time value of money* if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

  The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services when (or as) they transfer to the customer (ie, the cash selling price). In other words, cash selling price represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

  a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
  b) the combined effect of both of the following –
     - the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
     - the prevailing interest rates in the relevant market.

REP Ltd concluded that the contract contained a significant financing component because the length of the time between when the customer paid for the building and servicing facilities and when REP Ltd transferred the building and provided servicing facilities to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction was 10%, which was the interest rate necessary to make the two alternative payments economically equivalent. However, REP Ltd determined that the rate that should be used in adjusting the promised consideration was 8%, which was REP Ltd's incremental borrowing rate.

REP Ltd was to recognise a *contract liability* for CU 15,000 payment received at contract inception. Depending on the facts and circumstances relating to the contract, the contract liability recognised represents the REP Ltd's obligation to either transfer the building and providing servicing facilities or refund the consideration received.

Journal			
Cash		CU 15,000	
	Contract liability		CU 15,000

During the two years from contract inception until the transfer of the building, REP Ltd adjusts the promised amount of consideration and accretes the contract liability by recognising interest on CU 15,000 at 8% for 2 years, ie, CU 2,400.

Journal			
Interest expense *		CU 2,400	
	Contract liability		CU 2,400

The revenue is recognised when the building is transferred.

Journal			
Contract liability		CU 15,900	
	Revenue		CU 13,500
	Interest revenue*		CU 2,400

*As per **paragraph 65 of Ind AS 115**, "*an entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the Statement of Profit and Loss. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer.*"

Regarding the provision of servicing facilities, the contract with the customer did not have a significant financing component because of the following –

The difference between the promised consideration and the cash selling price of the good or service arose for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts was proportional to the reason for the difference.

Moreover, to determine whether there was a significant financing component in the contract, REP Ltd considered the nature of the service being offered and the purpose of the payment terms. Here, REP Ltd allocated a single upfront amount for the servicing facilities, not with the primary purpose of obtaining financing from the customer but, instead, to maximise profitability, taking into consideration the risks associated with providing the service.

REP Ltd

Balance Sheet (Extract)

	CU
Non-current liabilities	
Contract liability	500
Current liabilities	
Contract liability	1,000

Statement of Profit and Loss (Extract)

	CU	**CU**
Revenue (sale of building)	13,000	
Less: Cost of sales (cost of construction)	8,000	5,000
Revenue(servicing facilities)	500	
Less: Cost of sales (cost of servicing facilities)	400	100
Gross profit		**5,100**
Interest expense		(2,400)
Interest revenue		2,400
Accounting profit		**5,100**
Tax expense (40% of 5,100)		2,040
Profit for the period		**3,060**

Conclusion

To apply Ind AS 115, an entity, involved in real-estate development, will need to evaluate the nature of its performance obligation(s) and review its contract terms, to assess whether to recognise performance obligation *over time* or *at a point in time*. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. Secondly, an entity applies Ind AS 115 on consideration received before the control of the property is transferred to the customer and has to initially account for any cash collected as a contract liability. In effect, an entity will be considering for the first time whether advance payments represent a significant financing component. Thirdly, entities will generally allocate the transaction price to each performance obligation in proportion to its stand-alone selling price. However, if the stand-alone selling price is not directly observable, one of the methods to estimate it is by forecasting expected costs *plus* an appropriate margin. Lastly, an entity recognises revenue when (or as) it satisfies a performance obligation by transferring control of a good or service to a customer. As stated earlier, control may be transferred at a point in time or over-time.