IMPACT OF IFRS ON INDIAN INFRASTRUCTURE AND REAL ESTATE INDUSTRY

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ABSTRACT

Indian Infrastructure and Real Estate companies are booking revenues even before they start the construction. This is possible under the currently used percentage of completion method of accounting, which allows companies to book revenues provided an agreement of sale has been signed with the buyer and a specified percentage of the project cost has been incurred. As a result, Indian Infrastructure and Real Estate companies’ revenues are higher by as much as 30% as compared to the work done by them. The adoption of International Financial Reporting Standards (IFRS) will reflect more appropriately the revenues of Indian real estate developers and their ability to deliver projects. We also believe that IFRS deals with market risks that are related to real estate projects more effectively than the percentage completion method.

Keywords: IFRS, PPE, Fair-value, Cost model, Revaluation model, EBITDA
CLASSIFICATION OF REAL ESTATE PROPERTIES

The first determination to be made by real estate entities adopting IFRS is the classification of their real estate. The classification of real property will determine the available accounting options for their subsequent measurement. Typically, real estate entities will have one or more of the following classes of real property.

Investment Property are defined as real estate held to earn passive rental income or capital appreciation and generating cash flows largely independently of the other assets held by the entity. IFRS has a distinct standard addressing investment property and it allows a choice of using either the fair-value model or the cost model to account for such properties. Property, Plant, and Equipment (PPE) comprises property held by the owner for use in the production or supply of goods or services or for administrative purposes. Depending on the exact nature of other services provided, other owners of real estate such as hotels and seniors’ residences may be required to classify their investments as PPE. IFRS requires entities to account for PPE using the cost model, unless fair value can be measured reliably, in which case the revaluation model may be used. Inventory would comprise property held by a real estate entity for sale in the ordinary course of business or in the process of development for sale (e.g., condo units or houses). Inventories are required to be recorded at the lower of cost and net realizable value. Investment Property and PPE held for sale represents property that management intends to sell, but, unlike inventory, the sale of such property is not in the ordinary course of business. While adopting IFRS, real estate entities will have the option to record their investment property using the fair-value model. Under this model, the carrying value of the property is adjusted each reporting period to its fair value and all the changes in fair value reflected immediately in profit or loss. With the fair-value model, investment property is not depreciated and impairments are not assessed as essentially the property is “marked to market” each period. As it may have business implications beyond financial statement reports and once an entity chooses the fair-value model, it is unable to revert back to the cost model. Each situation should be carefully analyzed with professional advice, if necessary, before making the important decision between the fair-value model and the cost model.

FAIR-VALUE MODEL

The adoption of the fair-value model for investment property will require the support of the entire organization. The cost-benefit analysis should be considered while making the decision. Considerations include:

- Who will perform the fair-value calculation?
- Are the in-house resources and knowledge to determine fair value each reporting period and/or processes to support external appraisers available?
- If external appraisers are used, what will be the cost?

In addition to logistical and cost issues, the decision to adopt the fair-value model could have other business implications. For example, using the fair-value model will result in significant fluctuations in net income arising from the unrealized appreciation/depreciation in fair value of investment property being recognized each period. This may create challenges in maintaining certain key performance indicators and ultimately require modification of external debt covenant requirements, internal bonus arrangements or trust indentures among others.

COST MODEL

The cost model may appear to be the status quo of current Indian GAAP (Generally Accepted Accounting Principles) however, committing to this model on adoption of IFRS also presents unique
challenges. First, IFRS requires a more stringent approach to componentization than the current practice. Componentizing assets may result in significant GAAP difference, depending on Canadian current practice and it may present some practical challenges with reconstructing cost information. Second, IFRS provides additional choices in the first year of its adoption. On adoption of IFRS, real estate entities may make a one time election to record individual items of PPE and investment property at fair value thereby avoiding the requirement to determine the historical cost of each component. However, in making the election, the adjustment to the carrying value of the assets is increased with a corresponding adjustment to opening retained earnings. Increased carrying values will reduce post changeover earnings by increasing depreciation charges, reducing future gains on disposal and leaving more assets value exposed to future impairments. Foregoing this elective option may result in additional conversion efforts to identify and determine the historical cost of each material component. Regardless of the methodology used in year first, it is likely that additional general ledger accounts and amortization policies will be required on a go-forward basis. Since IFRS is to be adopted on a retroactive basis, this should be kept in mind for current capital projects to avoid losing information that may be difficult to reconstruct when IFRS is adopted. Third, entities with investment property recorded under the cost model are still required to disclose the fair value of their real estate in the notes to the financial statements. As a result, significant efforts will still be required to calculate the fair value of the property for each reporting period.

REVALUATION MODEL

IFRS provides entities holding PPE the option to annually “revalue” PPE’s carrying value to fair value. Under this model, unlike the fair value model for investment property, increases in fair value are reflected in equity (not in profit or loss) and the amounts are never recycled through profit or loss. Under this method, entities continue to depreciate their assets. If entities choose to revalue their real estate, increases in fair value are recorded through equity with decreases to be first used to eliminate any unrealized gains previously recorded within equity and then included in the income statement for any excess.

REAL ESTATE INVENTORY

Accounting for real estate inventory under IFRS is similar to Indian GAAP with one major exception i.e. the ability to capitalize interest is based on a more prescriptive standard. Interest costs may only be capitalized to a property when an entity incurs expenditures for the asset, incurs borrowing costs and begins development to prepare the asset for its intended use or sale. As a result, borrowing costs on land held for development may not qualify. Further, borrowing costs must cease being capitalized to a project in cases of extended delays in development or once the property is substantially complete for its intended use regardless the level of occupancy.

INVESTMENT PROPERTY AND PPE HELD FOR SALE

Under IFRS, similar to Indian GAAP, real estate held for sale is measured at the lower of the carrying amount and fair value less costs to sell and is no longer amortized from the date of transfer. The primary difference between IFRS and Indian GAAP relates to the definition of discontinued operations. Under IFRS, discontinued operations are currently limited to those operations that represent a separate major line of business or geographical area. It is generally assumed that individual properties held for sale would not meet the definition and, therefore, not require separate presentation on the income statement and balance sheet. An exposure draft was recently issued to change the definition of discontinued operations to an operating segment. The proposed standard would more closely align with current Indian GAAP, if adopted.
PROVISIONS

Under IFRS, a provision is recognized for a legal or constructive obligation when it arises from a past event, the outflow of resources is probable and the amount can be estimated reliably. In this context, “probable” means “more likely than not” and represents a lower recognition threshold than “likely” as used under Indian GAAP. More items may therefore need to be provided for under IFRS.

Under IFRS, provisions are measured based on management’s best estimate of the amount required to settle the obligation. When a range of estimates exists and no single estimate within the range is better than another, the obligation is measured at the midpoint of the range. A range of estimates is often encountered with legal claims. Discounting is also required on all provisions where the effect of the time value of money is material. The discount rate should reflect current market assessments of the time value of money and the risks specific to the liability. Provisions must be re-measured when discount rates change.

IMPAIRMENT OF ASSETS

IFRS has one impairment model covering PPE, investment property, goodwill, and intangible assets. Assets are evaluated either individually or grouped in a Cash-Generating Unit (CGU) for impairment-testing purposes. A CGU is the smallest group of assets that generates independent cash inflows. It may be smaller than an asset group or a reporting unit under current Indian GAAP. For real estate entities, a CGU could be as low as an individual property. Assets are tested and any resulting impairment charges are measured using a one-step test that compares an asset’s or CGU’s carrying value to its recoverable amount. Recoverable amount is the higher of the fair value less cost to sell (a market-based model) and its value in use (an entity specific model). Since IFRS requires that discounting be factored when assessing impairment and impairment is often evaluated in smaller “asset groups,” entities are more likely to have impairments under IFRS. Further, impairment losses associated with PPE, investment property and intangible assets are reversed in subsequent periods if the circumstances that led to the impairment have changed. When an entity adopts IFRS, it may therefore need to reverse prior-year impairment losses and review for further impairment.

CURRENT REVENUE RECOGNITION POLICIES ALLOW REVENUE BOOKING AHEAD OF CONSTRUCTION –

According to the percentage of completion method, developers can recognize revenues in proportion to the construction cost incurred in a year provided the ownership of the apartment has been transferred to the buyer. Furthermore, land cost is allowed to be the part of construction cost and the agreement of sale between buyer and seller is supposed to transfer the ownership to the buyer.

Let us consider the following example to understand the percentage of completion accounting method. For a project, which has total cost of $100 (of which $30 is the land cost) and revenue of $120, if a developer has incurred 30% of the total cost ($30), he/she can recognize 30% of revenue (i.e., $36). Since the land costs are usually a part of the construction cost, developers can recognize this revenue even prior to starting any construction. Hence, it is not surprising that developers have started using this provision to their advantage and have started booking revenues for projects even before any construction commenced. Table 1 shows that in 2008 revenues recognized by leading Indian Infrastructure and Real Estate companies were significantly higher than the cash received from customers. Ideally, revenues should be close to the cash received from customers especially because most customer payments are construction-linked but they can exceed the cash received from customers when-
• Revenues have been booked but no invoice has been raised to the customer because the company has not reached any construction milestone.

• The customer has been invoiced but the builder has yet to receive payments. Such instances were rare because during Financial Year 2008, real estate investments were appreciating and customers did not have any reason to delay payments.

Table 1: Revenues Booked versus Actual Cash from Customers

<table>
<thead>
<tr>
<th>COMPANIES</th>
<th>REVENUES (A) (INR IN MILLION)</th>
<th>CASH FROM CUSTOMERS (B) (INR IN MILLION)</th>
<th>DIFFERENCE (A-B)/A (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DLF</td>
<td>144,374.96</td>
<td>73,797.50</td>
<td>48.88%</td>
</tr>
<tr>
<td>Unitech*</td>
<td>41,152.41</td>
<td>30,710.00</td>
<td>25.37%</td>
</tr>
<tr>
<td>Sobha</td>
<td>14,310.73</td>
<td>9,180.06</td>
<td>35.85%</td>
</tr>
<tr>
<td>Akruti</td>
<td>4,397.54</td>
<td>4,592.39</td>
<td>-4.43%</td>
</tr>
<tr>
<td>Omaxe</td>
<td>22,816.18</td>
<td>21,844.88</td>
<td>4.26%</td>
</tr>
<tr>
<td>Parsvnath</td>
<td>17,713.25</td>
<td>9,543.06</td>
<td>46.12%</td>
</tr>
<tr>
<td>Total</td>
<td>244,765.07</td>
<td>149,667.89</td>
<td>38.85%</td>
</tr>
</tbody>
</table>

(Sources: Annual reports of companies and Evalueserve analysis)

• Cash from customers has been calculated in the following manner:

• Revenues (FY 08)-( Receivable (FY 08)-Receivable (FY 07))+ (customer advances (FY 08)-customer advances (FY 07))

For Unitech cash from customers – Gross customer advances FY 08-Gross customer advances FY 07

IFRS IMPACT ON INDIAN INFRASTRUCTURE AND REAL ESTATE COMPANIES

Such overstatement of revenues has also favourably impacted the earnings and interest cover indicators (as depicted in Table 2). Again, we have restated FY 08 revenues to match these to the payments received from customers, after which we have applied the overall EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization) margins to the restated revenues. Table 2 shows that the revised earnings and interest coverage indicators are significantly lower than the reported earnings.

Table 2: Restated Earnings and Debt Coverage Indicators

<table>
<thead>
<tr>
<th>COMPANIES</th>
<th>EBITDA (INR IN MILLION)</th>
<th>RESTATED EBITDA (INR IN MILLION)</th>
<th>REPORTED INTEREST COVERAGE</th>
<th>NEW INTEREST COVERAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>DLF</td>
<td>99,614.8</td>
<td>50,918.3</td>
<td>32.1</td>
<td>16.4</td>
</tr>
<tr>
<td>Unitech</td>
<td>23,687.2</td>
<td>17,676.6</td>
<td>8.4</td>
<td>6.3</td>
</tr>
<tr>
<td>Sobha</td>
<td>3,756.4</td>
<td>2,409.6</td>
<td>6.1</td>
<td>3.9</td>
</tr>
<tr>
<td>Akruti</td>
<td>4,098.0</td>
<td>4,279.6</td>
<td>6.7</td>
<td>7.0</td>
</tr>
<tr>
<td>Omaxe</td>
<td>6,804.3</td>
<td>6,514.7</td>
<td>11.6</td>
<td>11.1</td>
</tr>
<tr>
<td>Parsvnath</td>
<td>6,802.5</td>
<td>3,664.9</td>
<td>17.4</td>
<td>9.4</td>
</tr>
<tr>
<td>Total</td>
<td>144,763.3</td>
<td>85,463.7</td>
<td>17.8</td>
<td>10.5</td>
</tr>
</tbody>
</table>

(Sources: Annual reports of companies and Evalueserve analysis)
Revenue growth is not in line with the growth in projects (area) delivered

For Indian Infrastructure and Real Estate companies, revenues and project (area) delivered are not growing at the same pace. For example, Table 3 depicts that while revenues of DLF increased by 447% in the FY 2008, projects completed decreased by 3.3%. Similarly for Unitech, in 2007 the growth in area delivered was much lower than its revenue growth.

**TABLE 3: REVENUE GROWTH VERSUS THE GROWTH IN PROJECTS (AREA) DELIVERED**

<table>
<thead>
<tr>
<th></th>
<th>DLF FY 06</th>
<th>DLF FY 07</th>
<th>DLF FY 08</th>
<th>UNITECH FY 06</th>
<th>UNITECH FY 07</th>
<th>UNITECH FY 08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from real estate operations (INR billion) *</td>
<td>11.54</td>
<td>26.37</td>
<td>144.37</td>
<td>6.96</td>
<td>30.46</td>
<td>37.75</td>
</tr>
<tr>
<td>Growth (%)</td>
<td>128.6</td>
<td>447.4</td>
<td>337.64</td>
<td>23.93</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area delivered (million sq. ft.)</td>
<td>2.60</td>
<td>9.14</td>
<td>8.83</td>
<td>3.30</td>
<td>7.15</td>
<td>8.70</td>
</tr>
<tr>
<td>Growth (%)</td>
<td>251.5</td>
<td>-3.39</td>
<td></td>
<td>116.7</td>
<td></td>
<td>21.7</td>
</tr>
</tbody>
</table>

(Source: Annual Reports of DLF Ltd. and Unitech Ltd.)

- For Unitech—Revenue from Real estate operations have been calculated by subtracting construction, consultancy and other income from total income.

**IFRS LINK REVENUE RECOGNITION TO PROJECT DELIVERY**

According to IFRS guidelines on real estate that will be adopted in India in 2011 IFRIC (International Financial Reporting Interpretations Committee) 15), revenues can be recognized only when the risk and rewards of ownership have been transferred. IFRS allows the use of the percentage completion method only if one of following conditions is met:

- If the contract is a construction contract, i.e., the contract is such that buyer has complete control over the design and specification of the property until its completion.

- If the contract is for rendering services, i.e., if the buyer provides the materials and the contracting entity only provides services.

- If the control, risks, and rewards of ownership of the work-in-progress passes on a regular basis to the buyer (as the construction progresses). EvaluateServe has reviewed sales contracts of various residential properties that are in various phases of construction and the key terms of these contracts are listed in Table 4.
Table 4: Terms and condition of sales contracts of residential properties (in construction)

<table>
<thead>
<tr>
<th>TERMS</th>
<th>WHAT IT MEANS</th>
<th>ACCOUNTING IMPLICATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>The developer has the right to change the layout plan, including changes in location, the number of apartments the number of floors, and specifications.</td>
<td>Specifications are decided by the seller and not by the buyer.</td>
<td>Since buyers do not have any control over specifications, IFRS would not allow this revenue recognition.</td>
</tr>
<tr>
<td>In case of a delay, the developer will be liable to pay a penalty charge of INR 5–10 per sq. ft.</td>
<td>The buyer’s right is limited to receiving penalty; the buyer does not have the right to take the possession of an incomplete apartment.</td>
<td>Control/Risk and reward of the work in process is not being transferred; hence, IFRS will not allow this revenue recognition.</td>
</tr>
<tr>
<td>If the buyer is unable to pay Progress payments within the specified period, the developer has the right to forfeit the earnest money and cancel the sale.</td>
<td>The developer has more control over the apartment than the buyer.</td>
<td>Since there is no transfer of control, the percentage completion method will not be allowed to be used for revenue recognition.</td>
</tr>
<tr>
<td>If the developer is not able to deliver, the developer is liable to return the full amount along with some interest.</td>
<td>The contract does not mention the timeline that will be used to determine as to whether the developer will be able to deliver, signifying lack of Ownership of the buyer.</td>
<td>The percentage completion method will not be allowed.</td>
</tr>
</tbody>
</table>

Source: Evalueserve analysis

Our analysis of sales contracts of several properties (under construction) reveals that these contracts do not fulfill any of the conditions specified by IFRIC 15 and therefore would not qualify for revenue recognition by percentage completion method under IFRIC 15.

**IFRS ADDRESSES MARKET RISK AND EXECUTION RISKS MORE EFFECTIVELY**

IFRS addresses the following two key risks involved in revenue recognition with respect to the sale of real estate projects (under construction).

- **Market Risk** – A fall in real estate prices below the purchase prices would result in homebuyers asking for a refund of their payment amount. Most builders allow refund after deducting a penalty. Therefore, if sales are recognized at the time of signing of sale agreement, sales will have to be reversed at the time of cancellation. For some companies, cancellation and revenue restatements
can be material. For example, for the quarter ending December 31, 2008, Indian real estate developer Lok Housing and Construction Limited announced that it would have to restate revenues of almost 50% of the past three years’ sales because many buyers had cancelled the corresponding sale agreements.

- **Execution Risk** – Execution risk becomes critical, especially during an economic downturn when most projects get delayed because the builders have little or no cash. For partially completed projects, recognizing a portion of the total revenues may not properly reflect the execution risk inherent in these projects. Since IFRS allows revenue recognition only if the project has been delivered, an IFRS compliant company’s financial statement will provide a better perspective of its execution capabilities.

While IFRS would make it difficult for builders to evade the completed contract method of accounting, real estate developers may minimize the downside by restructuring their sale agreements so that they transfer the risk and reward continuously to the buyers (during the construction period). This also bodes well for homebuyers since it would make sale agreements more favourable for them than they currently are and since they will get more control and ownership of the apartment (while it is being constructed).

**SUGGESTIONS AND CONCLUSION**

IFRS in India will have far-reaching implications for real estate, construction and infrastructure companies. It will impact the basis for recognizing revenues, take cognizance of multiple-element contracts and barter transactions and allow the use of fair value for measurement of assets. Generally, companies must apply initial adoption rules retrospectively with some limited exceptions. Any differences resulting from the change in accounting policies upon the initial adoption date of IFRS are recorded directly through retained earnings. Key adoption differences or exceptions specific to real estate companies include:

- Fair value estimates of investment properties at initial adoption date need to be consistent with estimates made at the same date under U.S. GAAP (after adjustment to reflect any difference in accounting policies) unless there is objective evidence that those estimates were in error.

- Contracts (including leases) existing at the date of adoption will require review to determine if they contain a lease on the basis of facts and circumstances existing at either inception of the agreement or the adoption date and judgment will be required to determine the appropriate classification of leases under IFRS (i.e. no more bright line tests).

- PP&E that previously did not require impairment losses if the undiscounted cash flows exceeded carrying value may require write-down at adoption date if recoverable value is less than carrying value.

- At initial adoption, a company may elect to measure PP&E or investment property at the date of transition to IFRS at its fair value and use that fair value as its deemed cost at that date (if the historical cost model is used for investment property instead of fair value).

- Acquisitions and business combinations prior to the date of initial adoption do not require retrospective application of IFRS related to the assets and liabilities acquired.
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