Revenue Recognition of Construction of Houses

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Introduction

XYZ (Private) Limited is a medium scale construction entity, which construct houses for low income earning community. The shares of the entity are held by Mr. A and Mr. B who are also members of the board not-for -Profit entity of AB Sri Lanka.
The entity does not deploy and execute construction contracts by itself; rather constructions are fully subcontracted for material and labor. Accounting policies and presentation of financial statements of the entity comply and adhere with Sri Lanka Accounting Standards (LKASs and SLFRSs).

Discussion of the Issue

At the initial phase, the entity purchases bare lands in rural sub-urban areas and divide them into plots for that purpose of reselling to low income earners. Where buyers expect to purchase the lands with houses constructed or solely purchase the bare land.

On the second phase, housing contraction are undertaken by the entity. Where, the clients are provided with **four pre-designed housing models**, with similar low budget construction cost and opted to select one out of them. At this phase, an agreement of contract bounds the client and the entity for land acquisition and house construction. On the date of agreement, one third of the contract value is paid the client to the entity.

The period of construction is set to complete in six months, and upon the date of completion the deed are transferred to the client, subject to receipt of payments in full as per the agreement.

According to the agreement payments are made by the client as follows.
1). Mobilization - 1/3 of the contract price upon signing of agreement.
2). Progressive receipts

However, revenue is recognized by the Company on cash basis.

Implication of the Issue

According LKAS 11 this can be defined as construction contract since there were legally binding agreement between two parties to construction of assets. However, paragraph 22 of LKAS 11, construction revenue should be recognized when the outcome of a construction contract can be estimated reliably; contract revenue and contract costs associated with the construction contract shall be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period.

However, IFRIC Interpretation 15 applies, where entities undertake the construction of real estate, directly or through subcontractors, may enter into agreements with one or more buyers before construction is complete. As per paragraph 08 of IFRIC 15, within a single contract, an entity may agree to deliver goods or services in addition to the construction of real estate (e.g. Sale of land).

In accordance with paragraph 13 of LKAS 18, such an agreement may need to be split into separately identifiable components including one for the construction of real estate. Accordingly two components are identified as below:
1. Sale of land.
2. Construction of house and sale of land.

On the other hand, paragraph 11 of the IFRIC 15 discusses the scope of arrangement to determine, whether an arrangement fall in either LKAS 11 or LKAS 18. Accordingly, an agreement for the construction of real estate meets the definition of a construction contract when 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".**

In contrast, paragraph 12 states **"an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, e.g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of LKAS 18."**

According to above circumstances, whereas, the buyer have limited ability to influence over the design and structure of the construction **(as he/she is opted to select from four pre-designed plans)** and also very minimal amendments are allowed to the designs due to the nature of social houses.

Therefore, in XYZ (Pvt) Ltd arrangement, it is **not categorized within the scope of LKAS 11**; and **LKAS 18 is applicable** over recognition of revenue from construction contracts.

Therefore, the entity shall determine whether the agreement is for the rendering of services or for the sale of goods. As per paragraph 15 of the IFRIC 15, if the entity is not required to acquire and supply construction materials, the agreement may be only an agreement for the rendering of services in accordance with LKAS 18. In this case, if the criteria in paragraph 20 of LKAS 18 are met, LKAS 18 requires revenue to be recognized by reference to the stage of completion of the transaction using the percentage of completion method.

And also as per the paragraph 16 if the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver the real estate to the buyer, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue set out in paragraph 14 of LKAS 18 apply. Which means, the revenue shall be recognized, upon the **transfer of risk and rewards** to the buyer.
In the above scenario, XYZ (Pvt) Ltd provides construction materials and labor costs to its subcontractors in order to perform the construction to deliver the houses to the clients. Therefore, revenue shall be recognized only when transfer of control and the significant risks and rewards of ownership of the houses in its **entirety at a single time** which mean XYZ (Pvt) Ltd **should recognize revenue for selling lands and houses when the deed is signed**.

Accordingly, treatment adopted by XYZ (Pvt) Ltd for revenue recognition does not provide the appropriate information in the financial statements. An estimated LKR 3.6 million of revenue of the entity has been early recognized thus derives a significant misstatement over audit materiality. Hence, the accounting policies used by the Company are not in accordance with applicable accounting standards.

Conclusion and Recommendation

XYZ (Private) Limited has more contractual power than the clients, over the contract, whereas, construction materials and labor costs are borne by the entity by paying to its subcontractors in order to fulfill the contractual obligation to deliver the houses to the clients.

Hence revenue should be recognized for both the components of sale of land and construction of house and sale of land as mentioned above **on the deed signed date.**

Therefore XYZ (Private) Limited should recognize revenue as below:

Nature of transaction	**Applied accounting treatment**	**Recommended accounting treatment**
Sale of land (Upon signing of deed)	Dr Cash Cr Revenue	Dr Cash Cr Revenue
Sale of land together with houses (⅓ Advance amount)	Dr Cash Cr Revenue	Dr Cash Cr Receipts in Advance
Sale of land together with house	Dr Cash Cr Revenue	Dr Cash Cr Receipt in Advance

(Progressive payment until 6 month/ Time to time cash receipt from the client)		
Upon signing of deed	No Accounting entry	Dr Receipt in Advance Cr Revenue

Finally we can conclude that as per the above course of business, revenue from the construction contract should be recognized at point of transformation of risk and reward from contractor and the contractee despite the stage of completion.