

Reality Sector – Accounting Issues

Organized by

Northern India Regional Council (ICAI)

January 9 2010



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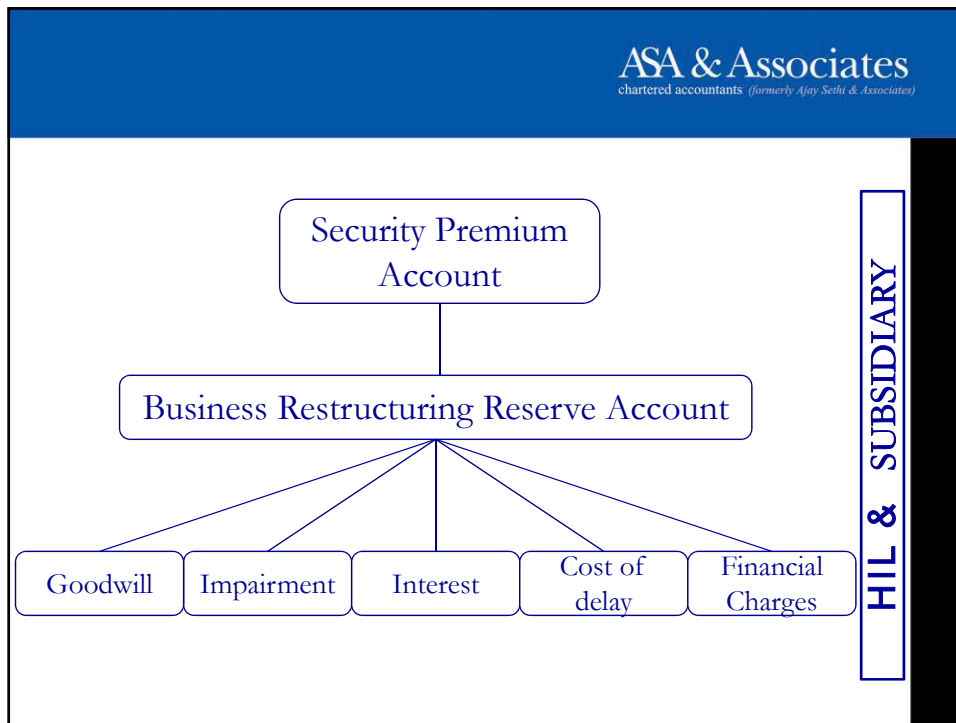
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Deviation from Accounting Standard not a ground for rejection of a scheme of Arrangement

Hindalco Industries Ltd. (Petition No. 293 of 2009)

Dated 22 June, 2009

- Mumbai High Court



Section 211 (3A) of the Companies Act 1956

“Every profit and loss account and balance sheet of the company shall comply with the accounting standards.”

The slide features the ASA & Associates logo in the top right corner. The main content is centered on the slide, consisting of the section title and a quoted statement.

Section 211 (3B) of the Companies Act 1956

“Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely :-

- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.”

- (a) Announcement on Disclosure (ICAI – July 2004)
- (b) Parrys Confectionery Ltd (2004) 122 comp CAS 900 (Mad)
- (c) Hyderabad Industries Limited (2004) 55 SCL 1 (AP)
- (d) Zee Telefilms Ltd (2004) 124 comp CAS 102 (Bom)

Issues in Real Estate Transactions

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Revenue Recognition

- AS-9- Revenue Recognition
- AS-7- Construction Contracts
- Guidance Note on Recognition of Revenue by Real Estate Developers

IFRS

- IAS-18- Revenue Recognition
- IAS-11- Construction Contracts

Indian GAAP

- All significant risks and rewards are transferred to buyers
- No uncertainty in amount of consideration
- Not Unreasonable to expect ultimate collection

Recognition of Revenue - AS -9

If seller is obliged to perform substantial acts after transfer of all risks...

Percentage Completion Method- AS-7

Accounting for Investment Properties

Once Construction is complete:

- **IAS -40** – Lesser of Cost / Fair Value
- **AS- 13** – Cost of Investment (after providing for Depreciation)

Infrastructure for Public Use

IFRIC 12

Service Concession Agreement

- Guidance on accounting by public to private service concession agreement.
- Operator can not recognise as its assets.
- In India it is recognised as Fixed Asset.

Other Accounting Issues

- Consolidation – Eliminations
- Business Combinations – Fair Value
- Collaboration Agreements
- Internal Controls - De centralized Payments
- Due Date Billing

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Overview - Exposure Draft of AS-1

Presentation of Financial Statements

Current Position

- Presentation of Financial Statements as per Law
- Schedule VI to The Companies Act 1956
- AS – 1 Disclosure of Accounting Policies

ED - From April 1, 2011 – Moving Towards IFRS

Objective

Financial Statements to Disclose

- Financial Position
- Financial Performance
- Cash Flows

To Help User Making Decision

Components

- ▲ Statement of Financial Position (Balance Sheet)
- ▲ Statement of Comprehensive Income (P&L A/c)
- ▲ **Statement of Changes in Equity (SOCIE)**
- ▲ Statement of Cash Flows
- ▲ Accounting Policies And Explanatory Notes

Financial Statements

- ▲ Should Show
 - Economic substance not Merely Legal Form
- ▲ The Off-setting of Assets and Liabilities is not Allowed

Format as per Schedule VI.....

Deviation from complying with the Accounting Standard is allowed if:-

- The management concludes that such a compliance will be misleading and,
- The regulatory framework requires or does not prohibit such a departure.

Real Estate Transactions

- Issues
 - How to Differentiate ?
 - How to Classify the Assets/Liabilities into Current and Non Current ?

May Need to Change ERP Systems

Current Ratios may Change

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No Extra Ordinary Item

Disclosure Requirements

- Management Judgment and Critical Estimates
 - In Applying Accounting Policies
 - Key Source of Estimation

**At Present No Such Requirement – Will be
A Challenge**

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Requirement of Third Balance Sheet

- If -
 - An Accounting Policy is Retrospectively Applied!!
 - Reclassified Items in Financial Statements !!
 - Retrospective Restatement !!

Related Notes to Accounts

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Financing Construction Projects

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THE REALTY SECTOR

- ▶ Sectoral Perspective
- ▶ Regulatory Evolution
- ▶ Growth in Financing Prospects
- ▶ Some Major Players
- ▶ Key considerations in financing
- ▶ Modes of Financing
- ▶ Some Evolving Vehicles
- ▶ Peculiar Issues

Sectoral Perspective

- ▶ Sustainable economic growth – a key driver
- ▶ Real estate sector to grow ~30% CAGR thru' 2005-2010
- ▶ Current housing shortage ~ 19.8 mio housing units
- ▶ Increase in office space ~ 5x over next 3 – 5 years
- ▶ Market size ~ USD 50 billion in 2010
- ▶ Expected to grow to ~ USD 90 billion by 2015

Sectoral Perspective

Demographics favouring this sector are :

- ▶ Affordability – growth in per capita disposable income
- ▶ Burgeoning middle class
- ▶ Growing urban population
- ▶ Supported by growth in other sectors
Organized retail, Power, Infrastructure projects, IT / ITES, hotels and tourism
- ▶ Land – a scarce resource, high population density

India is 11x that of the US, with country area of 3.3 mio km²

Some Major Players

FOREIGN

Blackstone Group
 Goldman Sachs
 Citigroup Property Investors
 Morgan Stanley

NATIONAL

HDFC Property Fund
 Kotak Mahindra Realty Fund
 ICICI Real Estate Fund
 DHFL Venture Capital Fund

Key considerations in financing

- ▶ Management
- ▶ Track record
- ▶ Transparency in operations
- ▶ Sectoral & geographical spread
- ▶ Financial health

Modes of Financing

- ▶ Debt
 - Rupee Debt
 - External Commercial Borrowings (ECB)
- ▶ Equity participation
 - Initial Public Offer (IPO)
 - Qualified Institutional Placement (QIP)
 - Foreign Direct Investment (FDI)

Rupee Debt

- ▶ Regulated by RBI
- ▶ Bank credit USD 19.7 billion in FY 09 (USD 13.6 billion in FY 08)
- ▶ Real estate credit < 4% of total bank credit
- ▶ Risk weight - commercial real estate 100%, housing loans 50%
- ▶ Generally takes the form of syndication

Rupee Debt

- ▶ Lease Rental Discounting
 - Concept introduced in 2000
 - Securitisation of future rent receivables
 - Unlocks future revenue streams
 - Real estate has to be self owned
 - Against commercial or residential properties
 - Lease rents flow directly to the lender

External Commercial Borrowings

- ▶ Regulated by ECB guidelines of RBI
- ▶ Under automatic or approval route
- ▶ Covers FCCBs, non/partly convertible instruments
- ▶ Only projects into purely integrated townships eligible upto Dec 2010 (minimum area 100 acres)
- ▶ To promote infrastructure development
- ▶ Proposal to permit for other types of projects in the offing

Qualified Institutional Placement (QIP)

- ▶ Introduced in 2006 by SEBI
- ▶ Listed companies issue equity / convertible securities for private placement
- ▶ Reduced time span for raising funds locally
- ▶ Lesser procedural requirements – no pre-issue filing of placement document with SEBI
- ▶ Preferred tool in PIPE (private investment in public equity) deals during slowdown to restructure debt
- ▶ Easy exit to Qualified Institutional Buyer(QIB)

Foreign Direct Investment (FDI)

- ▶ Regulated by RBI
- ▶ USD 2.8 billion in FY 09, compared to USD 38 mio in FY 06
- ▶ Liberalised in 2005 to promote real estate sector
- ▶ Proposed to be further liberalised in 2010 removing the 3 year lock-in period – ADRs / GDRs may be a possibility

Some Evolving Vehicles

- ▶ Real Estate Investment Trust (REIT)
- ▶ Real Estate Mutual Fund (REMF)

Peculiar Issues

- ▶ Regulations favour large institutions
- ▶ ECB cost ceiling restricts liquidity
- ▶ Measly floor area ratio (FAR)
- ▶ Governmental support – conversion of land use (CLU)
- ▶ Vanishing agricultural land

Thank You

Reality Sector – FDI Restrictions

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Outline

- ❑ Foreign Exchange Management Act
- ❑ Foreign Investment in India
- ❑ Monitoring Authorities in India
- ❑ FDI Guidelines – Reality Sector
- ❑ Acquisition and Transfer of Immovable Property
- ❑ Guidelines - Calculation of Total Foreign Investment

Foreign Exchange Management Act

FEMA

Transactions Regulated by FEMA

- Capital Account Transactions
- Current Account Transactions

FEMA**Capital Account Transactions**

- ❑ Transfer of foreign or domestic securities
- ❑ Borrowing & Lending in foreign exchange
- ❑ Deposit between non-residents and residents
- ❑ **Acquisition & Transfer of Immoveable Property In India**
- ❑ Giving of guarantee or surety
- ❑ Foreign currency account

FEMA**Current Account Transactions**

- ❑ Payments due in connection of foreign trade, services, credit facilities
- ❑ Payment due as interest on loan and as net investment income
- ❑ Remittances of living expenses person residing abroad
- ❑ Expenses – Foreign Travel, Education, Medical Care

Monitoring Authorities

Government Ministries

- ❑ **Ministry of Finance**
 - ❑ Reserve Bank of India
 - ❑ Foreign Investment Promotion Board

- ❑ **Ministry of Commerce & Industry**
 - ❑ Department of Industrial Policy & Promotion ('DIPP')

Monitoring Authorities

DIPP

- ❑ Formulation and implementation of industrial policy and strategies for industrial development in conformity with the development needs and national objectives;

- ❑ Monitoring - Industrial growth - Advice on industrial & technical matters

- ❑ **Formulation of Foreign Direct Investment (FDI) Policy and promotion, approval and facilitation of FDI**

- ❑ Encouragement to foreign technology collaborations at enterprise level and formulating policy parameters for the same

Monitoring Authorities

RBI

- Foreign investment in India is governed by sub-section (3) of Section 6 of the Foreign Exchange Management Act, 1999 read with Notification No. FEMA 20/2000-RB dated May 3, 2000

- The regulatory framework and instructions are issued by the Reserve Bank of India through Circulars

FDI Guidelines – Reality Sector

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FDI Guidelines

RBI Master Circular

- **Permissible Activities**

A person resident outside India (other than a citizen of Pakistan) or an entity incorporated outside India, (other than an entity incorporated in Pakistan) can invest in India, subject to the FDI Policy of the Government of India. A person who is a citizen of Bangladesh or an entity incorporated in Bangladesh can invest in India under the FDI Scheme, with the prior approval of the FIPB.

- **Prohibited Activities**

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FDI Guidelines

Permissible Activities

1. **Construction Development projects, including** housing, commercial premises, resorts, educational institutions, recreational facilities, city and regional level infrastructure, townships.

Subject to conditions notified vide **Press Note 2 (2005 Series)**

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FDI Guidelines

Permissible Activities

2. Industrial Parks Setting up and in established Industrial Parks.

Press Note 2 (2005 Series) - Not applicable provided

- a) It comprises of a minimum of 10 units and no single unit shall occupy more than 50% of the allocable area; and
- b) Atleast 66% of the total allocable area - allocated for industrial activity

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FDI Guidelines

Permissible Activities

3. Investing companies in infrastructure sector

- Where there is a prescribed cap for foreign investment, only the direct investment will be considered for the prescribed cap and
- Foreign investment in an investing company will not be set off against this cap provided
 - FDI in such investing company does not exceed 49% and
 - Management of the investing company is with the Indian owners.

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FDI Guidelines

Permissible Activities

4. Special Economic Zones and Free Trade Warehousing Zones covering setting up of these Zones and setting up units in the Zones

Subject to Special Economic Zones Act, 2005 and Foreign Trade Policy.

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FDI Guidelines

Permissible Activities

5. Hotels and Tourism related Industry

The terms hotel includes restaurants, beach resorts and other tourism complexes providing accommodation, Convention / seminar units and organizations

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FDI Guidelines

Prohibited Activities

- ❑ **Real estate business, or construction of farm houses**

It is clarified that “real estate business” does not include development of townships, construction of residential / commercial premises, roads or bridges educational institutions, recreational facilities, city and regional level infrastructure, townships

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Acquisition and Transfer of Immovable Property in India



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Immovable Property

Non Resident Indian & Person of Indian Origin

- **NRI & PIO** can
 - Acquire by way of purchase, any immovable property in India other than agricultural land / plantation property / farm house.
 - Transfer any immovable property other than agricultural or plantation property or farm house to a person resident outside India **who is a citizen of India**, or a **person of Indian origin** resident outside India, or a **person resident in India**
- **NRI & PIO** can transfer any agricultural land / plantation property / farm house acquired by way of inheritance, **only to Indian citizens resident in India.**

Immovable Property

Foreign Embassies / Diplomats / Consulate General

- Allowed to purchase/ sell immovable property in India other than agricultural land / plantation property / farm house provided
 - clearance from Government of India, Ministry of External Affairs is obtained for such purchase / sale, and
 - the consideration for acquisition of immovable property in India is paid out of funds remitted from abroad through normal banking channels

Immovable Property

Foreign Companies

- A branch, office or other place of business, (excluding a liaison office) in India of a foreign company established
 - Requisite approvals wherever necessary
 - Necessary for or incidental to carrying on such activity
 - Compliance with all applicable laws, rules, regulations or directions

Immovable Property

Repatriation of Sale Proceeds

- If the acquisition was in accordance with the FEMA Regulations;
- The amount to be repatriated does not exceed
 - Amount actual paid for acquisition of the immovable property in foreign exchange received through normal banking channels or out of funds held in Foreign Currency Non-Resident Account or
 - Foreign currency equivalent as on the date of payment, of the amount paid where such payment was made from the funds held in Non-Resident External account for acquisition of the property;
- Residential property – repatriation restricted to two such properties

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Due Diligence Issues In A Real Estate Transaction

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09 January , 2010

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CA Nitin Arora || *Associate Director* ||

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What Is Due Diligence?

- It is essentially an investigation to manage risks
- Due Diligence is an investigation or audit of a potential investment on information provided by a potential seller to a potential buyer
- It is the process of evaluating a prospective business decision by getting information about the financial, legal, and other material state of the other party.

Why Do One Need A Due Diligence?

- Transactions involve substantial financial obligations
- A characteristic of our business environment is to always present the best picture
- Essential to determine the undisclosed risks which are attached to the transaction
- Undisclosed risk may result in the transaction being aborted or affect the purchase price

Benefits of Real Estate Due Diligence

The principle benefits of a Real Estate due diligence are:

- Uncertainties regarding the true value of a piece of property can be reduced
- Hidden risks can be identified
- Potential obstacles to the sale or purchase can be dealt with strategically

Objective is to identify (i) Pricing issues; (ii) Negotiation matters; (iii) Protection and structuring matters; (iv) Next steps in the transactions

Classification Of Real Estate Businesses Based On Stage Of Activity

Only land bank entity

Land banks + Development activity commenced

Existing Real Estate developer

Target – Only Land Bank Entity

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- How the land banks are being valued
- Status of land acquisition - % acquired / % paid
- Computation of development potential and saleable area
- Approvals – land usage, commencement of construction, MoEF, etc.
- Review of project cost - cost per sq. feet / firm and non-firm costs
- Covenants in Co-development / Area sharing arrangements / Joint development agreements
- Identification of non real estate related asset and liability balances to be carved out / valued separately
- Understand funding status of the project

Target - Development Has Commenced

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Additional procedures include -

- Current status of physical progress
- Cost incurred, to be incurred and cost to complete
- Project margins & comparison with budgets
- Process of appointment of contractors - nomination / tender
- Key clauses in construction agreements - fixed price / escalation
- Timeline of completion of work per contracts and overall budgeted timelines
- Assess human resource band width to manage projects

Target – Existing Real Estate Developer

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Additional procedures include:

- Past track record of executing projects within budgeted timelines
- Historical project profitability and cost of development
- Cash flows over project life for sample projects
- Movement in selling prices over project life
- Debt requirement and management plan for financing of these projects

Key Issues For Consideration Real Estate diligence

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- Land acquisition and usage related issues
- Project timelines – Actual vs. Budgeted
- Project funding related issues
- Sales / Lease trends – price and volume
- Revenue recognition
- Other matters

Land Acquisition And Usage Related Issues

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- **Land acquisition**
 - Land acquisition not completed - actual acquisition lower than projected
 - Commitments for future payment towards land cost
 - Verbal understanding and commitments with respect to Area/Revenue Sharing or Land Costs
- **End use restrictions attached to land usage**
 - State government can impose restrictions
 - Land conversion for intended use not carried out
 - Land bank and corresponding license conditions may embody end use restrictions e.g. sales to EWS / LIG

Model assumptions relating to costs, area availability and end use restrictions to be evaluated appropriately.

Project Timelines – Actual vs. Budgeted

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- **Delayed land acquisition and approvals**
 - Land acquisition not completed
 - Approvals commensurate with the construction level not obtained
 - Trends in obtaining approvals for past projects indicate greater time
- **Delayed construction**
 - Aggressive timelines budgeted in business model – Past trends and market condition
 - Comparison of budgeted and actual timelines by major activities may indicate delay in project
 - Mismatch in timelines as per agreements with construction contractors Vs. business model

Model assumptions for project timelines can be impacted by actual timelines for land acquisition, construction and project funding.

Project Funding Related Issues

- Money collected from pre sales to customers utilized towards construction of earlier projects due to:
 - Strapped Promoters facing funding problems and project equity not infused
 - Lower sales for ready properties and cancellations
 - Debt funding with banks / financial institutions not tied up
 - Delay in receipts from customers on sale

Funding is key to project timelines and shortage of funds increases costs and delays project timelines.

Sales / Lease Trends Price And Volume

- **Volume**
 - Monthly / Quarterly trend may show a decline in sales
 - Volume assumptions in business model not indicative of actual trend
 - High cancellation trends
- **Sales price / lease rental**
 - Sale price / lease rental assumptions not indicative of actual trend
 - Collection trend (down payment & slab wise payments) assumption in business model not indicative of actual collection
 - Assumption on security deposits (no. of months) in business model and deposit as per lease agreements / LOIs may vary
 - Variation in escalation clauses, rent free period etc. in business model and lease agreements

Model assumptions relating to price and volume trends to be evaluated appropriately.

Revenue Recognition

- Typical revenue recognition policy suggested for real estate entities in the Indian GAAP i.e. Percentage of completion method (POCM)
- Earlier pronouncements provided option between Percentage of Completion & Project Completion method
- Implementation of POCM requires, sophisticated systems as it is essential to
 - Estimate percentage completion of the project
 - Estimation of cost to complete and project margins
 - Revisit above variables at each reporting date and adjust revenue recognition

Correct recognition of revenues critical for financial modeling and evaluation of timing of exit

Revenue Recognition contd...

Guidance Note* recommends recognition of real estate sales when all the following conditions are satisfied:

- Transfer – the seller has transferred to the buyer all SiRRO (significant risks and rewards of ownership) and the seller retains no effective control of the real estate to a degree usually associated with ownership
- Certainty of consideration – no significant uncertainty exists regarding the amount of the consideration that will be derived from the real estate sales and
- Certainty of collection – it is not unreasonable to expect ultimate collection

* Guidance Note on Recognition of revenue by Real Estate Developers [GN(A) 23 (Issued 2006)]

Other Typical Matters In Real Estate Deals

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- Verbal understandings and commitments - not appropriately documented
- Carve out of non FDI compliant project in an entity level transaction
- Allocation of specific and common cost amongst projects
- Other balance sheet assets and net debt
- Related party transactions & commercial understanding
- Robustness of financial information and MIS systems

Due Diligence Limitations

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Dependency on Target :

- Information and explanations provided (verbal or written) are materially correct
- Financial information, details and other documents provided for analysis are materially correct and complete
- Various documents furnished are genuine

To Conclude...

- Due Diligence plays an important role in identifying, quantifying and reducing the risks related to an acquisition
- Although due diligence focuses on negative information, the aim is not to raise obstacles to transactions, but to facilitate transactions by identifying problems and manage the risks involved in acquisitions.

Thank You