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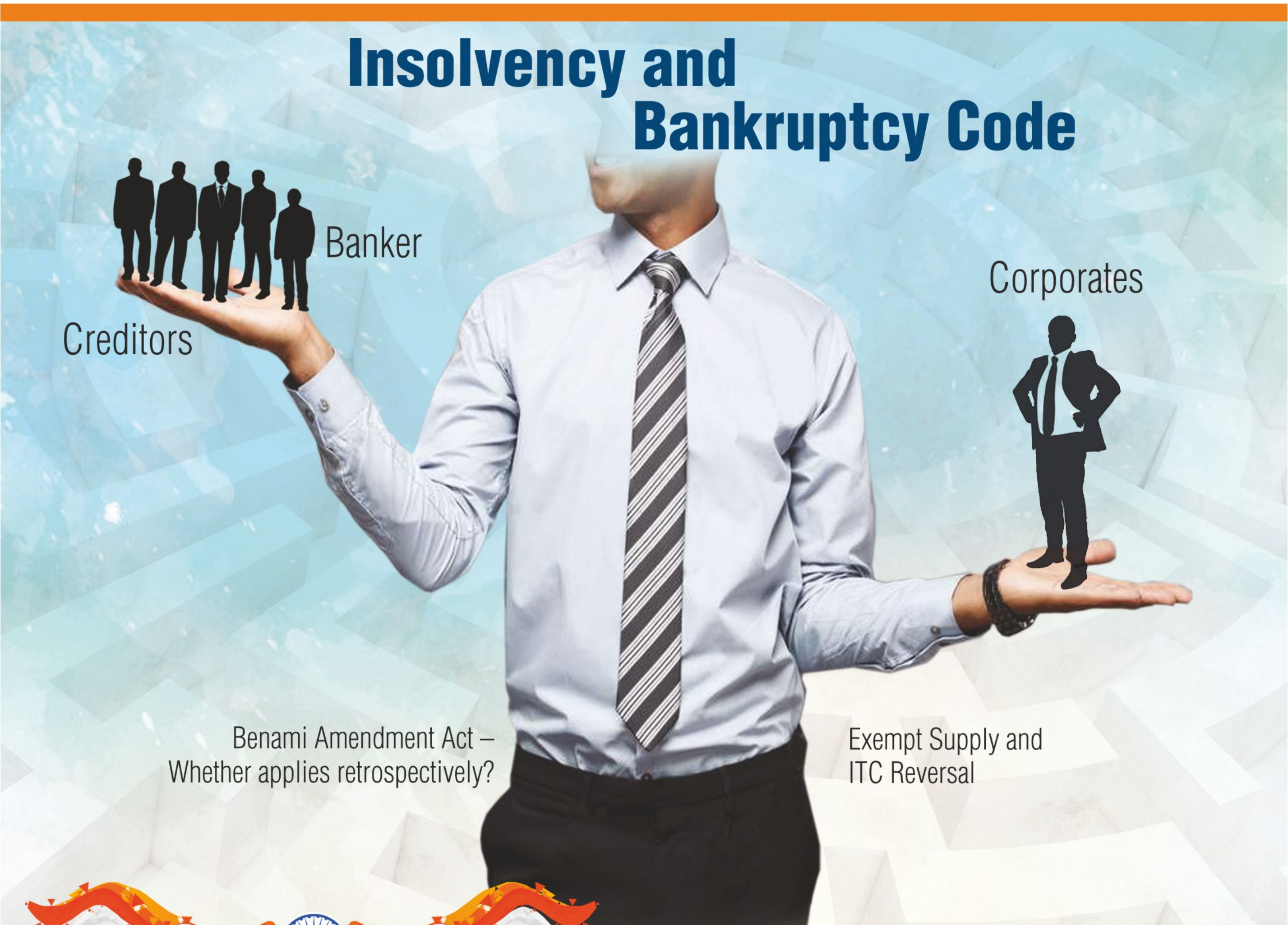

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Reality check for Real Estate Companies: Revenue recognition under Ind AS 115

CA Prashant Daftary & CA Rakesh Jain

Background

Real estate industry has been in a constant state of turmoil since last few years and has been severely impacted by demonetization, RERA, GST and other factors like liquidity issues, low demand etc. In addition to these factors, the real estate companies (especially the large companies and listed companies) have also been impacted by transition to Ind AS (which are in line with IFRS). This transition involved changing from earlier accounting standards to Ind AS. One of the change that had the most significant impact was with respect to the revenue recognition. Revenue recognition in real estate is more peculiar as compared to many other industries on account of following factors:

- Project duration ranging from 3-5 years
- Significant reliance on management judgment and assumptions as regards to cost and expected project profitability
- Practices and peculiarities in different states
- External factors like approvals from government authorities, local bodies etc.

In this write-up, we have analysed how this transition has affected the financial statements, various position taken up by different companies and how an investor/lender should read the financial statements of the real estate companies.

Implementation of Ind AS 115

Upon transition to Ind AS, the specified class of real estate companies were required to comply with Ind AS 18 – 'Revenue' and Guidance Note on Accounting For Real Estate Transactions issued by the ICAI up to FY 2017-18. With effect from 1st April 2018, the companies are required to adopt Ind AS 115 – 'Revenue from Contracts with Customers'. This effectively meant two levels of transition and thus making the entire process very complex.

Prior to Ind AS, the real estate companies were following the requirements of Accounting Standard - 9 on "Revenue Recognition" and the Guidance Note on Real Estate issued by the ICAI. Based on the same, revenue was generally being recognized on percentage of completion method. The guidance note provided guidelines as regards computation of percentage of work completion and how revenue should be recognized. This guidance note broadly ensured consistency in the method of accounting and was also being generally accepted by the tax authorities.

Post Ind AS 115, 5 step model needs to be followed for revenue recognition as given below:

Step 1 : Identify the contract(s) with the customer

Step 2 : Identify the separate performance obligations in the contract

Step 3 : Determine the transaction price

Step 4 : Allocate the transaction price to the performance obligations

Step 5 : Recognise revenue when (or as) each performance obligation is satisfied

The key factor in the above conditions is 'satisfaction of performance obligation', as this determines whether revenue can be recognised 'at a point of time' or 'over a period of time'. In case of real estate, customer enters into an agreement with the developer (generally at construction stage) whereby the customer agrees to make payments based on specified milestones or other terms and in return developer promises to handover the property (flat, apartment etc.) along with the agreed amenities as per the agreed time-line. Here a judgement is required to be made whether performance obligation is satisfied over a period of time or at a point of time.

If we conclude that the performance obligation is satisfied over a period of time then revenue recognition on percentage of work completed ('POCM') is possible and in other cases, revenue can be recognized only upon completion of work ('Completed Contract').

POCM vs. Completed Contract

Revenue recognition by real estate sector under Ind AS 115 was a subject matter of major controversy. There were multiple articles and newspaper reports which expressed a view that it would no longer be possible for real estate companies to take up a position that obligations are satisfied 'over a period of time' and all companies would have to change from POCM to Completed Contract which would have significant impact on the financial statements.

The ICAI cleared this misconception by issuing a clarification. This clarification stated that the Ind AS 115 does allow recognition of revenue using POCM and has explicit and specific requirements to recognise revenue, where performance obligation is satisfied over a period of time. It may be noted that paragraphs 35-37 of Ind AS 115 explicitly permit recognition of revenue using POCM, where the performance obligation is satisfied over time. The clarification further stated that the recognition of revenue on POCM is possible based on prevalent long established legal system/jurisprudence in India, and facts and circumstances of individual case/contract.

Based on above, it is clear that both methods of revenue recognition are possible depending upon the terms of the contract and compliance with specific requirements of the standard. Some of the key points that needs to be considered while making the above judgement are as under:

- **Cancellation clause**: Ability of customer to cancel the contract without a default by the developer
- **Restrictive clauses:** Whether the agreement restricts the customer from selling or transferring the property which is under construction or whether the selling price in such a situation is controlled by the developer
- **Historical trend:** History of cancellation/ actual trade practice followed by the developer
- **Actionable claim over dues:** Whether the developer has an enforceable right to payment
- **Nature of arrangement**: Whether the arrangement is in substance a financing arrangement

Other areas with divergent views affecting revenue recognition

- *Minimum threshold of revenue recognition*

  In case of companies which recognize revenue based on POCM, there is no bright line test (as compared to guidance note on real estate under Ind AS-18) for minimum threshold of construction, area sold and collection. Consequently, different companies would apply different principles & judgements.

  Further, as under Ind AS 115, a company can recognize revenue equal to the cost in case where minimum threshold limit is not achieved. This was not permitted under previous standard. However, this will have no impact on profit and loss for the period.

- *Joint development arrangements/barters*

  Real estate developers in India generally enter into various Joint Development agreements (JDA's) with land owners for developing land in return for free of cost constructed area or share of revenue. Developers also enter into redevelopment agreement with societies owners for demolition and reconstruction of the existing buildings. Developer gets development rights by way of built-up area.

  In such arrangements, identifying customer under Ind AS 115 would require judgment and based on the nature of arrangement, the accounting treatment could undergo a change. In case of an arrangement in the nature of revenue share, the landowner may not be considered a customer whereas in case of arrangement to share a specified built-up area, the landowner would be considered as a customer and accordingly accounting treatment would differ.

- *Slum rehabilitation*

  In case of slum rehabilitation project, where the company constructs free of cost area (rehab building) in return of specified Floor Space Index (FSI), whether the government or relevant authority would be considered as a customer or not would require a careful consideration.

Ind AS 115 vs. Income-tax vs. GST

Another aspect where special attention would be required is what method of revenue recognition is acceptable to the tax authorities. Following key factors needed to be considered:

- *Income Tax*

  – Income tax department is expected to come out with Income Computation and Disclosure Standard (ICDS) for Real Estate Sectors. As per draft ICDS, revenue recognition would be required as per POCM and hence for some companies this would mean virtually keeping two separate set of books of account and multiple reconciliations to satisfy the tax authorities and various stakeholders.

  Further, companies, which have shifted from POCM to completed contract on transition need to keep track of revenue/profit already offered for tax in earlier years and income taxes paid thereon.

  – Presently under minimum alternate tax there is no specific exemption/adjustment for transition adjustments under Ind AS 115 and hence it is possible that same revenue may be taxed twice (especially relevant for companies falling under MAT).

- ***GST***
  - Goods and Services Tax (GST) is collected and paid based on demand raised on customers on accrual basis and hence reconciliation of book of accounts with GST returns will be an enormous task.

Accounting policy adopted by leading Real Estate developers

Based on the analysis of method applied for revenue recognition by 20 large listed entities, majority of companies have shifted from POCM to Completed Contract except two companies. Transition to Ind AS 115 has had a significant impact on the net worth of these listed companies; however, this impact would be temporary and is more of a timing difference.

Investors/lenders perspective – Tips to analyse the financial statements

From investor/lenders perspective, the application of Ind AS 115 by real estate sector can be confusing (especially for retail investors) and would be difficult in understanding/projecting the revenue/profit numbers on account of the changes in accounting policies and varied practices followed. Some key points, which need to be considered by investor/lenders for reviewing financial statements of real estate entity:

- **Non-comparability with previous year:** Financial numbers for FY 2018-19 would not be fully comparable with the earlier year numbers on account of this change. Companies that have adopted completed contract method have reversed the revenue recognized in earlier years and would once again recognize the revenue when the project is completed. This would lead to recognition of revenue of same project twice (adjustment on transition has done through retained earnings, though option of revising previous year financials is available).

- **Benchmarking:** It would not be possible to benchmark real estate companies following different methods of revenue recognition based on declared revenue, profit numbers and inventory levels. Analysis based on Earnings Per Share/Price Earning ratio would also be misleading.

- **Security coverage:** Lenders while determining the inventory and receivables for the purpose of security/drawing power would need to have a better understanding of method of revenue recognition and stage of completion of work. As this would have a consequential impact on the inventory/work in progress.

In order to give a better understanding and comfort to the investors/lenders, the real estate companies would have to suitably explain how the transition has impacted them in terms of past and also how would this impact them going forward.

Conclusion – need for guidance (which is missing)

Considering the multiple practices followed by different real estate companies and different requirements under various tax laws, there is definitely a need for an overall/comprehensive review of various practices, to come out with a common methodology to facilitate ease of doing business, better benchmarking and consistency among the industry. Guidance Note for Real Estate Developer by the ICAI would be much appreciated to clarify on the above issues.