Revenue recognition for real estate developers – Indian GAAP vs ICDS

- *Published on August 2, 2016*

Authors –

- CA Vivek Newatia
- Email - vnewatia@sjaykishan.com
- Ph. No. - +91 98310 88818

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Real estate as a subject has always been of interest to all professionals considering the complex implications of the transactions – legal, accounting or taxation. One question which has perplexed everyone is whether revenue in the books of real estate developers should be recognised on percentage completion method (POCM) or project completion method/ completed contract method (CCM).

There are two reasons why a developer desires to follow project completion method of accounting. Firstly, it allows him to defer the taxes until the actual completion of the project. Secondly, there is no uncertainty in the determination of the income. The Revenue, however, has a desire to collect taxes at the earliest with income being determined based on estimates of the project completed. Though both the methods are revenue neutral and the dispute is only relating to timing of tax liability, this has been one of the major reasons for litigation in income-tax where the Department.

This paper attempts to analyse the accounting literature available in this area as well as the impact of the recently notified ICDS on real estate developers.

<u>Issue of Revised AS – 7 on Construction Contracts</u>

ICAI in the year 2002 issued Revised AS 7 – "Construction Contracts" applicable for construction projects undertaken during the accounting periods commencing on or after 1st April 2003. AS 7 (Revised) required that POCM must be followed for recognising revenue for construction contracts and removed the option of applying CCM. Further, the scope of AS 7 (Revised) was significantly different from its predecessor.

Scope of AS – 7 (1985)

"This Statement deals with accounting for construction contracts in the financial statements of enterprises undertaking such contracts (hereafter referred to as 'contractors'). <u>The Statement also applies to enterprises undertaking construction activities, of the type dealt with in this Statement not as contractors but on their own account as a venture of a commercial nature, where the enterprise has entered into agreements for sale."</u>

Scope of AS – 7 (2002)

"This Standard should be applied in accounting for construction contracts in the financial statements of contractors."

Due to the absence of the underlined phrase in the Revised Standard, there was a lot of confusion regarding applicability of AS 7 to real estate developers. EAC of ICAI in its opinion published in Vol XXIII Query 15 clarified that the Revised AS 7 was not applicable for real estate developers. The Committee further noted that the <u>principles laid down in para 10 and 11 of AS 9 (reproduced below) relating to sale of goods should be applied</u> for recognising revenue in the case of real estate developers.

"10.Revenue from sales or service transactions should be recognized when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have

been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."
Thus, even after the issuance of revised AS 7, real estate developers continued to recognise revenue on CCM based on the principles laid down in AS 9 relating to sale of goods as clarified in the EAC opinion.

Guidance note on "Recognition of Revenue by Real Estate Developers" in 2006 [GN (2006)]

Guidance Note (2006) was issued to address the timing of recognition of revenue by real estate developers. The GN (2006) recognised that than an agreement for sale (which is normally entered into during initial stages of construction) could be considered to have the effect of transferring all significant risks and rewards of ownership to the buyer, provided the agreement is legally enforceable and subject to satisfaction of all the following conditions which signify transferring of significant risks and rewards (even though the legal title is not transferred or the possession of the real estate is not given to the buyer):

- Significant risks relating to the real estate have been transferred; in case of real estate sales, price risk is one of the most significant risks.
- The buyer has a legal right to sell or transfer his interest in the property, without any condition or subject to only such conditions which do not materially affect his right to benefits in the property.

Even after the issuance of the GN (2006), considering the subjectivity involved and exercise of significant judgement on the part of the company to determine whether the risks and rewards have been transferred, majority of the developers continued to apply the CCM method.

Guidance note on "Accounting for real estate transactions" in 2012 [GN (2012)]

In an attempt to address the issues in GN (2006), ICAI issued a revised GN (2012) applicable to all projects in the real estate which commence on or after 1 April 2012 and also to projects which have already commenced but where revenue is being recognised for the first time on or after 1 April 2012. Earlier application was recommended. The GN (2012) provides for certain rule based criteria for recognition of revenue by applying POCM, subject to fulfilment of certain conditions.

The GN (2012) broadly classified the transactions into 2 categories – sale of completed real estate spaces and sale of property under construction/ development. Discussion here is limited to accounting for real estate developers only.

GN 2012 provides that the percentage completion method (POCM) should be applied in the accounting of all real estate transactions/activities where the economic substance is similar to construction contracts.

(a) Indicators for applicability of Percentage of completion method:
  (i) <u>The agreement for sale is entered into</u> between the buyer and seller, which has the <u>effect of transferring significant risks and rewards</u> of ownership to the buyer, provided the agreement is <u>legally enforceable</u> though the legal title is not transferred or the possession of the real estate is not given to the buyer. And any acts on the real estate, performed by the seller, are in substance, performed on behalf of the buyer in the manner similar to a contractor.
  (ii) The duration of such projects is beyond 12 months,
  (iii) Most features are common to construction contract, viz., land development, structural engineering, architectural design, construction, etc.
  (iv) When individual units in the project are dependent upon or interrelated to completion of common facilities / amenities,

(v) The construction activities form a significant proportion of the project activity.

(b) Conditions to be fulfilled before applying the Percentage of completion method:

(i) the outcome of the real estate project can be measured reliably,

(ii) the total project revenue can be estimated reliably,

(iii) the project costs to complete the project can be measured reliably,

(iv) the project costs incurred till reporting date can be clearly identified and measured reliably,

(v) it is probable that the economic benefits associated with the project will flow to the seller.

(c) Conditions to be fulfilled before revenue to be recognized under Percentage of completion method:

(i) All critical approvals for commencement of the project have been obtained,

(ii) The expenditure incurred on construction and development costs, till reporting date, is at least 25% of total estimated construction and development cost

(iii) At least 25% of saleable area is secured by agreement to sale with buyers,

(iv) At least 10% of total revenue, of the contracts or agreements entered into with the buyers, is realized at the reporting date in respect of each of the contracts

On a reading of the above, it can be inferred that detailed application guidance has been given for recognising revenue on POCM in the hands of a real estate developer. The fundamental pre-requisite, however, is to ascertain **whether there is a transfer of risks and rewards on the basis of a legally enforceable agreement**. For this, the terms and conditions in the agreement to sell have to be carefully examined to assess if they have the effect of transferring risks and rewards of the property under construction. This assessment is fundamental to the entire process and the absence of transfer of risk and reward may result in no revenue being recognised till the legal title is transferred/ possession is given. The following clauses in the agreement to sell need to be particularly examined before coming to a conclusion:

- Right of buyer to transfer the interest in the property under development
- Provisional allotment and subsequent change in the area of flat
- Implications of cancellation of booking
- Ability of the developer/ buyer to raise finance on the property

The practice is varied and is based upon the manner in which agreement for sale is executed in different states.

<u>Impact of ICDS</u>

Before examining the impact of ICDS on real estate developers, let us examine Section 145 of the Income Tax Act.

Section 145 of the Income Tax Act provides for the computation of income the maintenance of books of accounts and regularity thereof. Therefore, any controversy arising in respect of the method of accounting should therefore originate from Section 145 of the Act. In circumstances where the Act intends that the method of accounting is not relevant, a specific provision is made. Reference may be made to Section 43B, 145A or presumptive taxation scheme (Section 44 onwards). Other than these, Section 145 is of paramount importance. A combined reading of Section 4, 5 and 145 will give us an answer as to <u>whether we have earned an income which is taxable for a period</u>. The primary purpose of Section 145 is to determine the year of taxation – the time when income shall be taxed.

Section 145 further provides that from the assessment year 2016-17, income determined as

per the method of accounting shall be subject to income computation and disclosure standards (ICDS) notified by the CBDT. The ICDS so notified have been made mandatory for assessees following mercantile basis of accounting.

Hon'ble Supreme Court in the case of Bilahari Investment made the following observations:

- Project completion method is a valid method for determining the revenue to be recognised.
- The same can be applied when the project is spread over a period of more than 12 months.
- The entire exercise of the CCM is revenue neutral. It does not result in leakage of revenue.
- CCM is allowed mainly for the reason it finds acceptance in the accounting standards issued by ICAI. In paragraph 21, it specifically stated that the court is conscious of the new accounting pronouncements and contracts prior to AY 2003-04. This pronouncement should not be held valid for all times to come.

Thus for projects commencing prior to AY 2003-04, there is a blessing in the form of SC decision and the CCM can be applied safely.

The most important question which arises now is whether ICDS III on Construction Contracts applies to real estate developers.

- The Scope of ICDS – III provides as follows:

  "This Income Computation and Disclosure Standard should be applied in determination of income for a construction contract of a contractor".

  It may be noted that the wording of scope of ICDS – III is similar to AS-7(Revised) as discussed above. It can therefore be argued that ICDS-III's application shall be confined only to construction contractors and not applicable to developers.
- It may be noted that the Committee Report on Tax Accounting Standards (TAS) recommended that TAS covering the following areas may also be considered for notification under the Act:
  (i) Share Based Payments
  (ii) Revenue recognition by Real Estate Developers
  (iii) Service concession arrangements (e.g. Build operate Transfer agreements)
  (iv) Exploration for and evaluation of mineral resources

  The Committee noted that there are certain areas on which the ICAI is yet to issue any accounting standards but where guidance on computation of income under the Act is required to reduce litigation and provide certainty. "Revenue recognition by Real Estate Developers" was one of such areas.

- Supreme Court in the case of **M/s Larsen and Toubro Limited (2014 (1) SCC 708)** has held a real estate transaction when flats are sold under construction as works contract for MVAT.

  After considering the aforesaid decision, Gujarat High Court in the case of **Mangala Properties (57 taxmann.com 35)** allowed deduction u/s 80-IB to the developer, who had entered in a JDA with a land owner and specifically stated:

  "While construing the provisions of the Income Tax Act, the ordinary meaning of the expression "works contract" is required to be taken into and resort cannot be had to the meaning of the said expression as envisaged under the relevant Sales Tax Act which are enacted in the context of the provisions of Article 366(29A)(b) of the Constitution."

Thus considering the above, it is possible to conclude that ICDS-III will not apply to real estate developers.

Although ICDS shall not have any impact on real estate developers, it remains to be seen how the revised Guidance Note (2012) is interpreted by the Courts for the purpose of method of accounting. The GN (2012) has made an attempt to define rule based criteria for determining when revenue should be recognised on POCM. A fundamental pre-requisite is however transfer of risks and rewards which is based on subjective assessment of the agreement for sale entered into by the buyer. The manner in which this subjective assessment will be done based on the clauses will determine the revenue recognition method in times to come for accounting as well as taxation purposes.

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