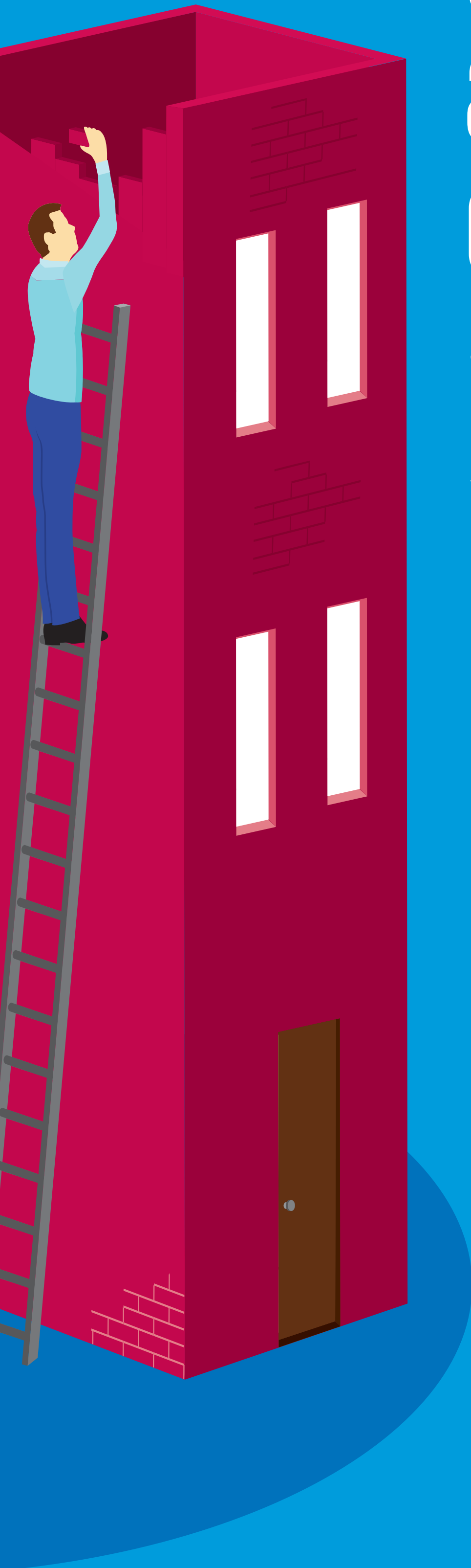
Ind AS 115 - Impact on the real estate sector and construction companies



This article aims to:

- Highlight key areas of impact of Ind AS 115 on the real estate sector and construction companies.

Summary

Assessment of collectability is important as entities cannot recognise revenue from a contract until collection is probable.

When applying 'distinct test', think about land, building, common areas, car parks, management services, golf memberships.

When recognising revenue over-time, assessment is required whether sales contracts meet one of the three criterias.

Significant financing element could lead to complex calculations for contracts recognised over-time.

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Background

Globally IFRS 15, *Revenue from Contracts with Customers* is applicable for accounting periods beginning on or after 1 January 2018. Ind AS 115 being the equivalent standard to IFRS 15, R*evenue from Contracts with Customers* is effective in India for accounting periods beginning on or after 1 April 2018.

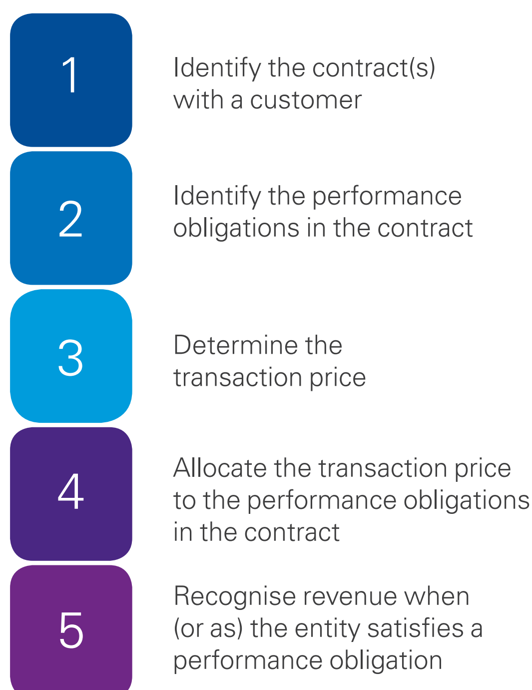
Currently, companies in the real estate sector in India applying the Indian Accounting Standards (Ind AS) recognise revenue using the principles of the Guidance Note on Accounting for Real Estate Transactions issued by the Council of the Institute of Chartered Accountants of India (ICAI) (GN on Real Estate).

This new standard will supersede all the existing guidance available under Ind AS with respect to revenue recognition i.e. Ind AS 18, *Revenue*, Ind AS 11, *Construction Contracts* and GN on Real Estate.

The GN on Real Estate provides guidance on:

- Application of the principles of Ind AS 18 in respect of sale of goods to a real estate project when the revenue recognition process is completed
- Application of the percentage of completion method based on the methodology as per Ind AS 11, where the economic substance of the transaction is similar to construction contracts.

The core principle of Ind AS 115 is based on the five-step model prescribed in the standard:



(Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016)

Ind AS 115 will change the way in which many real estate developers account for their sales contracts.

For the purpose of this article, real estate sector includes entities that i) own, operate and sell real estate ii) provide property management services, and iii) construct and sell residential property.

The key impact areas for real estate sector on transition to Ind AS 115 are discussed below:

1. Assessing collectability

Generally, when relevant, one of the most difficult criteria to assess for real estate developers is whether the consideration is collectible. This is due to the fact that there could be certain conditions that would be outside an entity's control, both during the construction phase and subsequently e.g. economic conditions that result in increases or decreases in property prices.

In making the collectability assessment, an entity would consider the customer's ability and intention (which includes assessment of its credit worthiness) to pay the consideration when it falls due. All other relevant facts and circumstances are considered – for example:

- The buyer's rights to cancel the contract for no penalty
- Any prior experience with the buyer
- Historical data on buyers with similar characteristics
- The importance of the property to the buyer's operations
- Contractual terms (e.g. small down payment without sufficient collateral)
- Whether the seller is providing non-recourse finance (i.e. seller only has a right to the property in the event of default) to the buyer.

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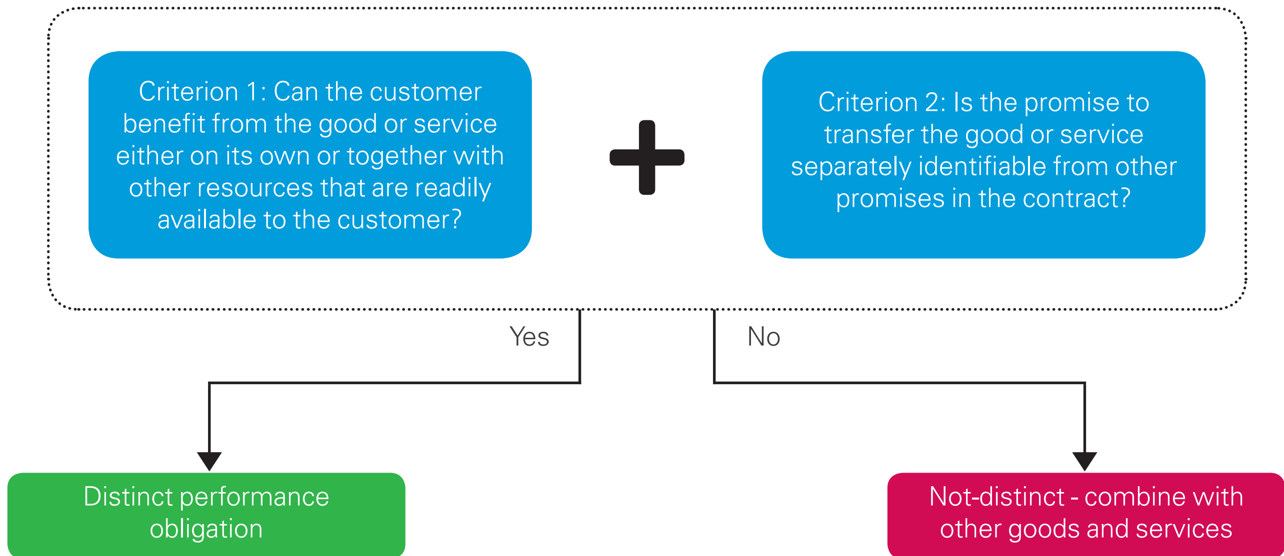
2. Identification of performance obligations

As per the new standard, once a contract has been identified, an entity has to evaluate the contractual terms and the general business practice to identify whether the entity has promised one or several distinct goods or services to its customer. These distinct goods or services are identified as performance obligation(s).

The standard provides the following criteria to identify performance obligations:



(Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016)

If these criteria are not met, the entity would need to combine promised good or service with other promised goods or services until a distinct bundled goods or services has been identified. While assessing distinct goods and services, it is important to analyse these from the customer's perspective.

In the case of a real estate developer, a key consideration would be whether land and building elements are separate performance obligations. This assessment is critical as different performance obligations may have different patterns over which the control is transferred and as a consequence the timing of revenue recognition would have a significant impact. In the case of residential apartments, the customers also receive the undivided share (commonly referred to as UDS) of the land on which the apartment blocks are constructed. In such a case, since the title to the UDS of land is transferred to the customer separately, it would need to be evaluated if the land would be considered as highly inter-related with the apartment constructed and hence, both together would constitute a single performance obligation, or, will the UDS of land and the apartment constructed cost be considered as separate performance obligations.

Issues on identification of separate performance obligations would also arise with respect to common areas/amenities that are provided by the developers to its customers such as car parks, recreational centers, etc.

In certain other cases, identification of separate performance obligations would be straight forward such as property management services, golf memberships, etc. since these services are not significantly customised, integrated with, or dependent on the underlying property.

To summarise, the identification of performance obligations would require an in-depth understanding and analysis of the terms of the contract and the property laws which are different across the different states in India.

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3. Variable consideration

For entities in the real estate sector, variable consideration includes price concessions, incentives, performance bonuses, claims, variations, discounts, refunds, right of return, credits, or other similar items. However, the variable consideration would be included in the transaction price only to the extent that it is highly probable that significant revenue reversal will not subsequently occur (the constraint).

Under Ind AS 115, an entity is required to determine the transaction price and reassess the same at each reporting date. The transaction price may vary depending upon the variable consideration included in the contract. The approach and accounting of the variable consideration is significantly different from the existing requirements.

For example, assume that in addition to the fixed transaction price of INR100 lakh, the real estate developer will also be eligible for a bonus of INR5 lakh for each month of early completion of the project. Under the existing standard, an entity would either include the bonus as part of total contract revenue or exclude it in entirety. Under Ind AS 115, an entity would estimate the variable consideration using the most likely amount and include the same in the transaction price to the extent that significant reversal will not subsequently occur.

It is important for the entity to consider all facts and circumstances while applying the constraint as it might result in understatement or overstatement of revenue. And, the assessment of the estimate has to be updated at each reporting date.

For any claims or variations to be accounted by an entity as part of transaction price, they need to give rise to enforceable rights and obligations. This threshold could be different from what was applied earlier by entities resulting in acceleration or deferment of revenue recognition from these claims and variations.

4. Timing and measurement of revenue

Timing of revenue recognition

For the purpose of revenue recognition, an entity must determine whether the performance obligation is satisfied over time or at a point in time.

The new standard requires an entity to recognise revenue progressively over time if any of the following criteria are met:

1. Customer simultaneously receives and consumes the benefits as the entity performs.
2. The customer controls the asset as the entity creates or enhances it.
3. The entity's performance does not create an asset for which the entity has an alternate use and there is a right to payment for performance to date.

The most relevant indicator to analyse for real estate developers would be criterion no. 3. This includes assessment of two parts (i). No alternative use of asset and (ii) Right to payment.

When applying the first part of the test – 'no alternative use' – is generally met when a real estate developer enters into a contract with a customer that includes a clause that the property cannot be sold to another party. These types of clauses are sufficient for the asset to be considered as having no alternative use to the entity.

However, one of the most challenging areas would be assessing the right to payment criteria in cases where the contract is terminated for reasons other than non-performance by the developer. As per Ind AS 115, the right to payment needs to be enforceable and should approximate the selling price of goods or services transferred i.e. should at least cover performance to date including a reasonable profit margin. A mere reimbursement of cost would not qualify for over-time satisfaction of performance obligation. Hence, this is likely to be an area of significant debate and would require careful evaluation of whether the developer is entitled as per the contract to recover his/her costs of performance plus margin from the customer and would also need an assessment of the local property laws to check on the legal precedent on enforceability of rights and the past practice with respect to enforcing these rights. The general practice of repossessing the property in case of default in payment will not again meet this criteria since a right to repossess a property will not qualify as a right to payment for performance.

As per the new standard, if the above criteria for recognising revenue over time are not met, then the revenue has to be recognised at a point in time i.e. when the customer obtains the control of the asset.

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This guidance under Ind AS 115 will be in contrast to the current GN on Real Estate that permits real estate developers to recognise revenue using the percentage of completion method.

Measuring progress

Under the current requirements, some entities recognise work in progress balances that may include both amounts related to uninstalled materials and amounts that may be deferred until the next milestone is reached. Under Ind AS 115, these practices are no longer appropriate because when control of the property is transferred over time, it is assumed that the transfer is continuous such that no material amounts of work in progress are recorded. As a result, the recognition of work in progress as a balance sheet 'true up' to ensure a smooth margin is no longer permitted. Ind AS 115 provides specific guidance on the treatment of uninstalled materials which requires revenue recognition at a zero margin when control of these materials is passed to the customer. Under the current guidance, materials that have not yet been installed are excluded from contract costs when determining the stage of completion of a contract and are recognised as part of work in progress.

Thereby under the new standard an entity can capitalise only the following costs:

- Cost of inventory for which the control has not been passed on to the customer
- Cost of obtaining a contract (discussed subsequently)
- Cost of fulfilling a contract i.e. set up costs.

5. Significant financing element

Currently Ind AS 18 requires revenue to be recognised at fair value for arrangements with deferred credit that provide a financing arrangement for a customer. Under Ind AS 115, the concept of significant financing element needs to be looked at from both deferred credit and receipt of advance basis and would result in recognition of interest income and interest expense respectively over the period of the contract with a corresponding adjustment to revenue (reduction in case of deferred credit and gross up in case of advance). While the computations of these can be straight-forward in cases where revenue is recognised at a point in time, in case of real estate where the revenue recognition would be over-time, the computations could get complex and would require exercise of judgement.

6. Costs of obtaining a contract

There is no specific guidance under current Ind AS on accounting for the costs to obtain a contract. Ind AS 11 states that costs that relate directly to a contract and are incurred in securing the contract are included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

Ind AS 115 provides specific guidance on accounting for costs incurred for obtaining the contract. An entity can capitalise costs that are directly attributable and incremental in nature for obtaining a contract and are expected to be recovered. Costs are considered as incremental in nature if they are incurred only as a result of obtaining the contract.

The asset recognised based on the above guidance shall be amortised on a systematic basis over the contract period in a pattern matching the transfer of promised goods or services. The standard provides a practical expedient by allowing to recognise such costs as expenses when they are incurred if the amortisation period would be less than 12 months.

As there is now specific guidance under Ind AS 115, it could result in fewer or more costs being capitalised as compared to the current practice. In the real estate sector, many entities incur significant costs as sales commission, bonus paid to staff on targets, etc. Therefore, such entities would need to assess if such costs would qualify for capitalisation under Ind AS 115.

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Impact of Ind AS 115 on construction companies

The issues discussed above for real estate developers would also be relevant for construction contractors to a large extent. The determination of whether recognition of revenue should be at a point in time or over-time would be less of a challenge for construction companies since such contracts are likely to meet criteria 2 discussed above under the heading 'timing and measurement of revenue'.

A couple of topics more specific to the construction industry for which there could be an impact under Ind AS 115 are discussed below:

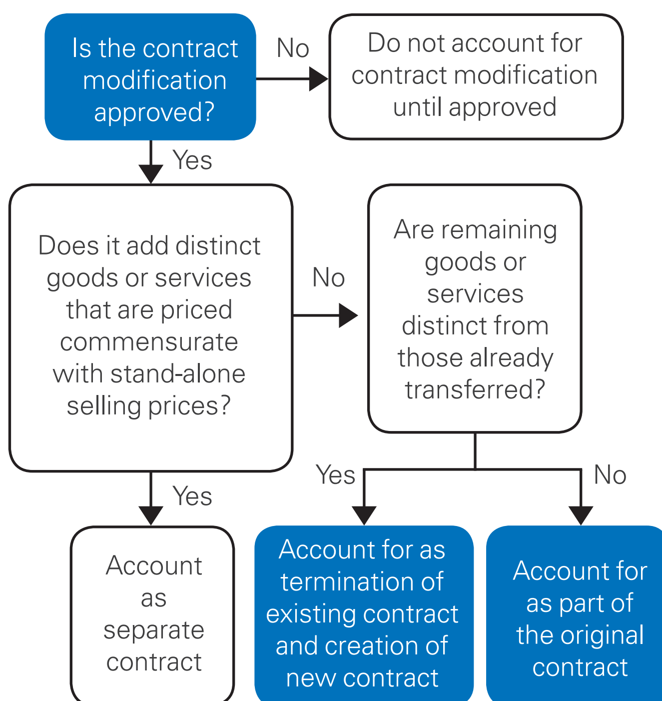
Contract modifications

A contract modification can happen either because of a change in price or scope and/or of both. Ind AS 115 would require a contract modification to be accounted only if the same has been approved i.e. when it creates legally enforceable rights and obligations on parties to the contract.

A contract modification could be accounted as:

1. A separate contract
2. A part of the original contract
3. As termination of existing contract and creation of a new contract.

These would require analysis to determine whether any distinct goods or services are being delivered to the customer and whether the same are priced at their stand-alone selling prices.



(Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016)

These contract modifications could get complex and involve significant administrative efforts, if these occur frequently. Further since the assessment focusses on enforceability, this would require significant judgement particularly in cases where the parties to the contract could dispute the scope or the price.

Loss making contracts

As per the new standard there is no specific guidance on loss making contracts. Therefore, the same has to be accounted based on the general guidance provided for onerous contracts under Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Transition approaches

Ind AS 115 provides the following transition options:

1. **Retrospective method:** Under this method, an entity would recognise the cumulative effect of the new standard at the start of the earlier comparative period. As part of this method, an entity could use certain practical expedients to ease the transition process.
2. **Cumulative effect method:** Under this method, an entity would recognise the impact of the new standard from the date of initial application with no requirement to restate the comparative period i.e. the comparative year would be presented under the current guidance (GN on Real Estate/Ind AS 18/Ind AS 11). An entity using this method would also need to disclose for the current period the quantitative effect of the new standard and an explanation of the significant changes between the results as per the new standard and those that would have been reported under the current guidance.

Both these approaches would have their pros and cons and hence, would require a careful evaluation before implementation.

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