IMPACT OF THE NEW REVENUE RECOGNITION STANDARD (IND AS 115) ON REAL ESTATE COMPANIES

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Abstract: *To attract more Indian and Global investors to invest in real estate sector, Ind-AS 115 had been introduced. Ind-AS 115 has also enhanced transparency to the users of financial statements. This is possible when we have an accounting standard which is close to the global standard and it provides useful information about timings, certainty of revenue and cash flows arising from customers contracts. In this study, we are going to analyse the impact of Ind-AS 115 on real estate sector. The true impact of the implementation of the new revenue recognition standard can be analysed by the comparison of theses parameters of various real estate companies pre and post implementation of Ind-AS 115.*

Key words: *Global Investors, Real Estate Sector, Ind-AS 115, Revenue, Cash flows*

1. Introduction:

Growth of a nation depends upon the various sectors like agriculture, real estate, Information technology etc. In India, real estate sector is one of the globally recognised and the second largest employed sector after agriculture and is slated to grow at 30 percentage over the next decade. The real estate sector comprises of four sub sectors namely housing, retail, hospitality and commercial. The commercial real estate sector has induced the economy directly and indirectly to a larger extent and real estate sector contributes 6.3 percentage to Gross domestic product (GDP). Revenue is an entity's most important financial performance indicator which is keenly scrutinized by analysts and investors. Ministry of Corporate Affairs (MCA) has notified a new Indian accounting standard, Revenue from Contracts with Customers (Ind AS 115) and is effective from April 01, 2018. The implementation of the new revenue recognition standard will have a significant impact on the financials of an entity and the standard focuses on recognizing revenues when obligations of the Company have essentially been completed, risks have been nearly eliminated for the Company and control over the property is deemed to be passed over to the buyer. Hence, revenue recognition for the quarter under review is driven by this standard and figures for previous periods are not comparable. Following the Five step model approach, the standard replaces the previous accounting standard (Ind-AS 18 and Ind-AS 11) that is moving from period-based recognition to completion based. The standard also provides more clarity by providing disaggregated revenue information statements. This change has impacted the profitability of Real Estate companies like DLF, Kolte-Patil Developers and Omaxe Limited both in standalone financials and in Consolidated Financials in Q1-19.

2. **Review of Literature**:

- **(Shumaxer & Reza, 2018)-** Ind AS 115 comes with its own set of challenges (a drastic change from recognising revenue from POCM to completion basis) unlike IFRS 15 which had a smooth transition of replacing the other set of standards. Such as ICDS (applicable from financial year 2016-17) even though there is no ICDS for real estate but the one the taxpayers follow is based on guidelines issued by ICAI which was withdrawn as on 1.06.2018. Tax payment are based on POCM but the books are maintained as per completion bases, hence confusing the investors and shareholders. There is also a mismatch on computation of MAT, as it would be determined on POCM book profits but rebooked revenue and margins as per Ind-AS 115 will lead to repayment of MAT, a clarification to be given by CBDT. The other problems faced is when to issue and recognize GST transaction and so forth.
- **(Deloitte, 2015)-** On February16th, 2015 MCA had notified companies to adopt Ind-AS for preparation of financial statements. It is divided in two phases based on the Net worth of the companies. **Phase 1** (effective date of adoption on or after 1-4-2016) ---Listed or Unlisted companies having Net worth of more than Rs 500 crores. **Phase 2** Listed companies having Net worth of less than Rs 500 crores, unlisted Companies having Net worth of Rs 250 crores or more but less than Rs 500 crores. Comparatives of the financial statements for previous year of adoption has to be disclosed. Companies may also voluntarily adopt Ind AS for financial statements for accounting year beginning on or after 1st April, 2015. Insurance companies, banking companies and non-banking finance companies will not be required to adopt Ind AS for the preparation of financial statements, either voluntarily or mandatorily. Companies may face issues relating to financial performance management, management reporting and budgeting due to this change. In the roadmap companies should consider the potential impacts on these areas during the implementation phase.
- (**KPMG, 2018)**- The core principle of the new standard is that the revenue from contacts should be recognized only when an entity transfers the control of goods or services to the customers at an amount which the entity expects to realize from such contracts. A five-step model to recognize revenue was formulated as follows. Identify contracts with customers. Identify performance obligation in the contract. Determine the transaction price. Allocate the transaction price to the performance obligation. Recognize revenue when the entity satisfies its performance obligation. The sectors which will be impacted by the new standard are real estate and construction, software and technology, aerospace and defences. Ind AS also contains extensive disclosure requirements compared to those of current Ind AS.
- **(ICAI, 2018)-** The new accounting standard for revenue recognition will help in "improved disclosures" as well as reduce the scope for interpretation on various areas. Information about revenue is important and it is used to assess a company's financial performance and position which facilitates comparison of data. This standard prescribes one key underlying principle for revenue recognition, that is transfer of control over goods or services. It also replaces the fair value concept with transfer price.
- **(ET BUREAU, 2018)-** Due to implementation IND AS 115, which is in accordance with global standards listed real estate companies should write back about Rs 20,000 crore from their Net worth in the current financial itself. As the profits are written down there will be a great impact in the balance sheet of the company many of which are

recovering from debt-fuelled spending from their binge of the past decade. This IND AS 115 will also lead to higher tax outflow considering the tax provisions.

- **(MCA, 2018)-** The objective of this Standard is to set up the rules that an entity will apply to report helpful data to the users of financial statements about the nature, sum, timing and uncertainty of income and money streams emerging from an agreement with a client. An entity will consider the terms of the agreement and every important actuality and conditions while applying this Standard. An entity shall apply this Standard, including the utilization of any viable catalysts, reliably to contracts with similar attributes and in similar conditions.

From the above review of literature, the researchers have found that, there is a practical impact on Real estate company's profitability, tax impact, business and credit risks which has not been analysed and quantified. Since, the standard is new and there are few referral articles and journals corresponding to the reviewed articles, but no one has explored further studies on this particular topic.

3. Statement of Problem:

There is a paradigm shift in the revenue recognition of real estate companies from percentage completion method to project completion method and so it may impact the profitability of the company. The issue addressed in the research is how banks will now evaluate financing of the real estate companies since its credit rating will be impacted as well due to negative impact of profitability and cash flows. The stock prices of these real estate companies and sector as a whole may show underperformance due to negative growth and volatility of quarterly performances There is also a possibility of tax controversy on income recognition of real estate companies.

- What is the impact of revenue and profitability on financial statements of real estate companies?
- What is the tax impact due to implementation of Ind AS 115 on real estate companies?
- What are the fluctuations in the stock market of real estate companies due to the change in the revenue recognition standard?

4. Objectives:

- To elucidate the effects of revenue and profitability on Financial statements of Real estate companies
- To analyse the tax impact due to implementation of Ind AS 115
- To analyse the effects of fluctuation in the stock market of Real estate companies

5. Research Design:

Ind AS 115 for Real Estate requires a radical shift where it tells how revenue is to be recognized for Real estate companies. Based on the analysis and understanding of this new standard in detail which has come into effect from 1st April, 2018 assumption has been made that this change will possibly impact the profitability, Net worth and stock prices of the selected sample companies. Once the research question has been defined, the impact of Ind AS 115 has been analysed by sector with special attention to Real Estate. The analysis has been reinforced by considering the Management Discussions and Analysis (MD&A) of the selected companies on the anticipated impact. The research further took eight sample companies and analysed the financial data comparing the result Q1-19 with historical data year over year and quarter over quarter (Table no: 6.4 and 6.5). This is important to understand the financial impact on pre and post implementation of the new revenue recognition standard (First quarter of 2018-2019). Since this standard has only come into effect from 1st April, 2018 this research has also referenced company analyst reports for the sample companies.

- **Sources of data- "**Secondary data"
  "Quarterly financial statements of the respective companies. ICAI website for Ind AS rules & regulations. Income tax website for Tax provisions. Money control website for share prices and"
- **Period of study-** From April to January-(2018-2019)

6. Data Analysis and Interpretation:

Implementation of Ind AS 115 has led the change in revenue recognition has impacted the profitability of Real Estate companies like DLF, Kolte-Patil Developers, Omaxe Limited etc., both in standalone financials and in Consolidated Financials in Q1-19 when the standards have been adopted for the first time, the impact of this change on past profitability from the date of adoption has been adjusted in the opening Reserves. We can draw reference from ICRA article which states that the adoption of Ind AS 115 have pulled down the Net worth of top nine listed real estate companies (including DLF, Godrej) by 18% from their March 2018 reported numbers due to the adjustment of the revenue due to incomplete contract on the adoption date.We have analysed at random few listed top real estate companies and have found that revenue from these companies have reduce in Q1-19 (first quarter) by around 20 per cent plus from last quarter.

Table No: 6.1

Extract of Income statement of DLF Limited

(Rs. in crores)

CONSOLIDATED	Q1-19	Q1-18
Revenue from Ops	1507.35	2047.70
PBT	-95.03	139.12
Tax	-25.97	17.90
PAT	172.44	109.01
EPS	0.97	0.62

STANDALONE	Q1-19	Q1-18
Revenue from Ops	356.27	1017.74
PBT	-46.52	276.49
Tax	-24.48	91.80
PAT		184.69
EPS	-22.04	1.04

(Source: Website of DLF limited)

DLF's primary business is development of residential, commercial and retail properties. It is the largest Real estate company in India. The company has a unique business model with earnings arising from development and rentals. Its exposure across businesses, segments and geographies, mitigates any down-cycles in the market. From developing 22 major colonies in Delhi, DLF is now present across 15 states and 24 cities in India. The adoption of the accounting standard Ind AS 115 on a consolidated basis has necessitated reversal of revenues and margins recognized on open contracts (where control is deemed to have not passed over to the customers till March 31, 2018). The margins reversed from the opening reserves in the Balance sheet due to Ind AS 115 as on April 1, 2018 stood at Rs 5,383 crore (net of taxes Gross Impact Rs 8040 crores, Tax on the same 2656 crores) This adjustment in the retained earnings is done only in the first year of adoption of standards with retrospective effect. On a Standalone entity basis, the impact in DLF has been significant, the Company has applied the modified retrospective approach to contracts that were not completed as of April 1, 2018 and has given impact of Ind AS 115 application by debit to retained earnings as at the said date by ₹ 3,944.45 crores (net of tax) pertaining to recognition of revenue based on satisfaction of performance obligation at a point in time. Accordingly, the numbers for the comparative previous periods have not been restated and hence the current period figures are not comparable with previous period figures. Due to the application of Ind AS 115 for the period ended June 30, 2018, revenue from operations is lower by ₹ 421.40 crores and net profit after tax is lower by ₹. 37.08 crores, then what it would have been if replaced standards were applicable. Similarly, the basic EPS for the current period is lower by ₹ 0.20 per share and diluted EPS for the period is lower by ₹. 0.19 per share. The cash flow of the company is also impacted due to this change in accounting method, which has been negatively impacted. The impact of cash flows from operations in Q1-18 is -27 crores (Rs). Total cash flow after investment in CAPAX is Rs -750 crores in Q1-18. A dramatic change in the PBT of the standalone DLF entity signifies a huge revenue dip and hence profitability for Q1-18 under IND AS 115.

Table No: 6.2

Extract of Income statement of Omaxe limited

(Rs in crores)

CONSOLIDATED	Q1-19	Q1-18
Revenue from Ops	173.53	482.48
PBT	13.36	31.88
Tax/(Credit)	4.71	11.17
PAT	8.65	24.97
EPS	0.48	1.27

STANDALONE	Q1-19	Q1-18
Revenue from Operations	85.87	311.23
PBT	4.32	23.26
Tax/(Credit)	1.51	8.05
PAT	2.81	15.21
EPS	0.15	0.83

(Source: Website of Omaxe limited)

Omaxe Limited is a listed real estate company situated in New Delhi, India. The organization has delivered more than 100 million sq. ft. of created space including apartments, plots and business units. The organization has a land bank of approximately 3,700 acres of land containing 125 million sq. ft. of territory, which is to be produced later on.

As per AS-115, Revenue shall be recognized when the entity transfers the control of goods or services to the customer. In other words, the entity shall "satisfy its performance obligation" to the customer to recognize the revenue. "Satisfying the performance obligation" in the context of the real estate industry means, completion of all obligations by a developer and intimating the customer's readiness for handing over the unit. The Company has applied the modified retrospective approach to contracts that were not completed as of April 1, 2018 and has given impact of IND AS 115 application by reducing to retained earnings as at the said date by Rs. 353.75 Crores (net of tax of Rs. 190.01 Crore) and Rs. 501.30 Crores (net of tax of Rs. 257.48 Crore) on standalone and consolidated basis respectively. Accordingly, the comparatives have not been restated and hence not comparable with previous period figures. Due to the application of IND AS 115 for the period ended June 30, 2018, revenue from operations, is lower by Rs. 150.51 Crores and Rs. 167.29 Crore and Net profit after tax is lower by Rs. 10.45 Crores and Rs. 10.99 Crores on standalone and consolidated basis respectively, vis—a-vis the amounts if replaced standards were applicable. The basic and diluted EPS for the period is Rs, 0.15, and Rs. 0.48 as against of Rs. 0.72 and Rs. 1.07 per share on standalone and consolidate basis respectively.

Table No: 6.3

Extract of Income statement of Kolte-Patil developers

(Rs. in lakhs)

CONSOLIDATED	Q1-19	Q1-18
Revenue from Ops	39056	24616
PBT	11348	3439
Tax/(Credit)	3723	901
PAT	7625	2538
EPS	5	3.06

STANDALONE	Q1-19	Q1-18
Revenue from Ops	8046	15357
PBT	1986	3640
Tax/(Credit)	275	1123
PAT	1711	2517
EPS	2.26	3.32

(Source: Website of Kolte-Patil Developers)

Kolte-Patil are Pune- based real estate developer. With regard to the above standalone Financial statement, the company has provided an exit to a Joint Venture, holding 49% equity shares in one of its subsidiaries, Kolte Patil Real Estate Private limited for a total purchase consideration of ₹5750 lakhs, payable over 6 months. Along with the above transmission, the adjustments in accordance to Ind AS-115, the amount of ₹21,660 lakhs (net deferred tax) has been adjusted against the opening balance of retained earnings. As per the requirements of AS, the revenue from operations, cost of services construction and land, profit before tax and profit after tax have significantly increased by ₹11,134, ₹3,134, ₹8,000 and ₹5,777(figures in lakhs) compared to if the previous revenue recognition standard was applicable. The consolidated statements also state the acquisition of Bellflower properties private limited. The transactional amount (net of deferred tax) of retained earnings of ₹15221 lakhs to the opening balance of retained earnings. As Ind AS115, the revenue from operations, cost of services construction and land, profit before tax and profit after tax have decreased by ₹5,205, ₹4,496, ₹708 and ₹463 (figures in lakhs) compared to if the previous revenue recognition standard was applicable.

Table showing the revenue from operations, other incomes, tax and share prices of listed companies

Table No:6.4

Extract of Financials

	Omaxe			Godrej Properties			Puravankara			Brigade Enterprises		
	Jun '18	Mar'18	Jun '17	Jun '18	Mar'18	Jun '17	Jun '18	Mar'18	Jun '17	Jun '18	Mar'18	Jun '17
			(Rs. Crs.)			(Rs. Crs.)			(Rs. Crs.)			(Rs. Crs.)
Net Sales/Income from operations	86	328	311	88	105	167	269	176	215	526	294	367
Other Income	7	12	11	90	217	124	8	31	12	26	26	23
Total Income	**93**	**341**	**322**	**177**	**322**	**291**	**278**	**207**	**227**	**552**	**319**	**389**
Tax	2	6	8	1	20	20	5	-	4	34	13	10
PAT	3	17	15	-11	34	59	22	23	7	67	43	35
Net worth Adjustment in Jun'18	-354			-498			-390			-227		
Share price - 2 Apr 2018			222			728			146			264
Share price after Jun 2018 results	06-Aug-18		223	06-Aug-18		713	10-Aug-18		101	14-Jul-18		194

(**Source:** Website of Omaxe, Godrej property, Puravankara, Brigade enterprise)

Table No: 6.5
Extract of Financials

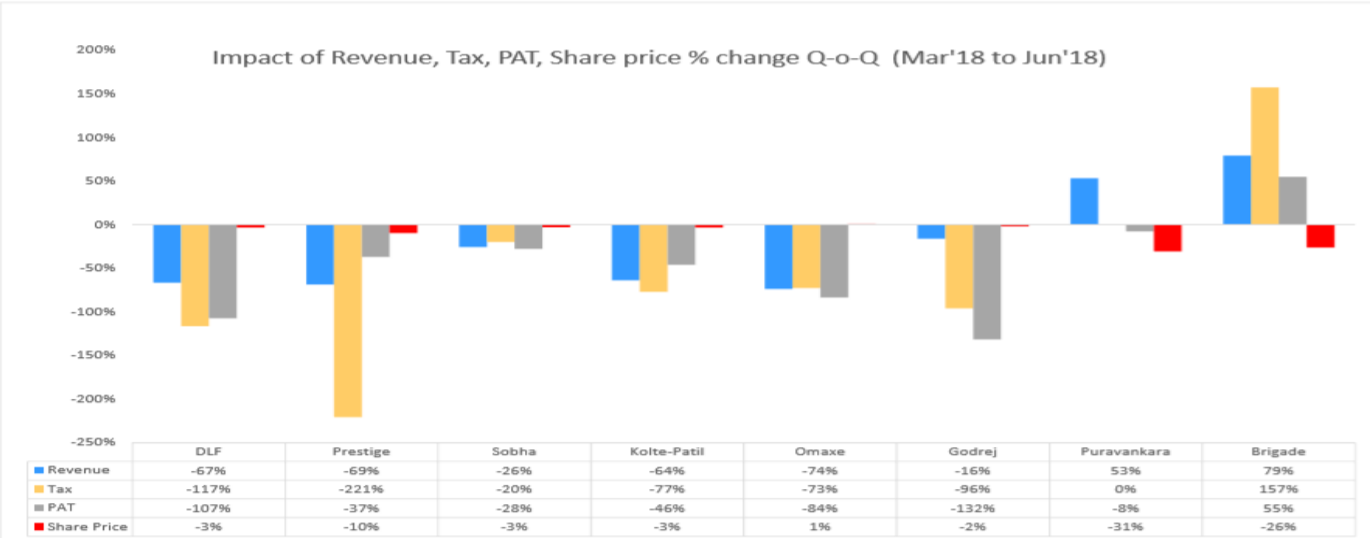
(**Source:** Website of DLF, Prestige estates projects, Sobha, Kolte-Patil developers)

	DLF			Prestige Estates Projects			Sobha			Kolte-Patil		
	Jun '18	Mar'18	Jun '17	Jun '18	Mar'18	Jun '17	Jun '18	Mar'18	Jun '17	Jun '18	Mar'18	Jun '17
			(Rs. Crs.)			*(Rs. Crs.)*			*(Rs. Crs.)*			*(Rs. Crs.)*
Net Sales/Income from operations	356	1067	1018	312	997	627	535	720	641	80	223	154
Other Income	93	293	62	40	43	28	12	19	10	16	13	13
Total Income	**449**	**1360**	**1080**	**352**	**1040**	**655**	**547**	**739**	**651**	**97**	**236**	**167**
Tax	-24	148	92	-10	8	6	16	20	22	3	12	11
PAT	-22	300	185	36	57	63	43	60	45	17	32	25
Net worth Adjustment in Jun'18	-3944			-899			-745			-152		
Share price - 2 Apr 2018			201			297			512			306
Share price after Jun 2018 results	13-Aug-18		194	27-Jul-18		269	07-Aug-18		497	14-Aug-18		296

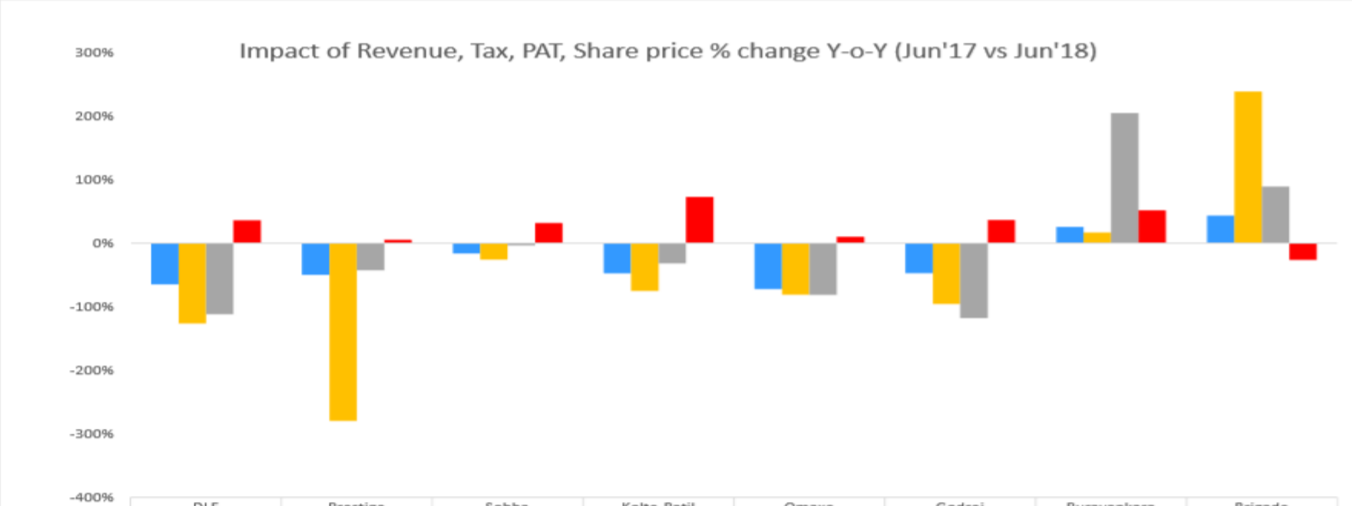
Graph showing the revenue from operations, PAT, tax and share prices of listed companies

Graph No:6.6

Impact of Revenue, Tax, PAT, Share price % change



Graph No:6.7
Impact of Revenue, Tax, PAT, Share price % change



	DLF	Prestige	Sobha	Kolte-Patil	Omaxe	Godrej	Puravankara	Brigade
Revenue	-65%	-50%	-17%	-48%	-72%	-47%	26%	43%
Tax	-127%	-280%	-26%	-76%	-81%	-96%	17%	238%
PAT	-112%	-43%	-4%	-32%	-82%	-118%	205%	89%
Share Price	36%	5%	31%	73%	10%	36%	51%	-27%

(**Source:** Website of DLF, Prestige estates projects, Sobha, Kolte-Patil developers, Omaxe, Godrej property, Puravankara and Brigade enterprise**)**

7. Findings and Suggestions:

- Financial statements will be impacted in a lot of ways, starting with their balance sheets as delay in revenue recognition will lead to bloated customer advances. P&L will be hit as developers will need to write back profits booked for on-going projects which are not 100% complete as per the standard. In some years, we will see huge profits and in some, huge losses. Significant change in the recognition method will lead to massive revenue and cost reversal in Q1 2018-19 and future results of listed real estate developer. Completed project completion method will result in volatility in revenue and growth. This may make year on year or quarter on quarter numbers meaningless till the impacts are fully understood by the investors. This has resulted in the underperformance of the stock prices of real estate sector in the last six months. We have seen the BSE Realty indices down by around 13-14% over the last six months (March 1 to Aug 30, 2018) time frame.
- The revenue and profits from all real estate companies has suffered set back in the first quarter due to the adoption of Ind AS 115. The analysis reflects DLF's revenue has gone down 27% YoY on a consolidated basis and PAT by 30% YoY. Similar trends in other listed organization where the range varies from 20% to 40%. In order to remove any uncertainty regarding costs & project timelines, the Company should sell

only completed product, once Occupancy Certificate is received and built inventory to normalize the fluctuation of revenue recognition under new accounting Standards.

- The Company has applied the modified retrospective approach to contracts that were not completed as of April 1, 2018 and has given impact of Ind AS 115 application by reducing to retained earnings as at the said date. The impacts are huge. DLF has adjusted downwards net worth to the extent Rs 5383 crores, Omaxe Rs 353 crores and Kolte Patil Rs 216 crores. This has skewed the debt equity ratio and other covenants and parameters of banks to extend credits. Improved capital structure is a must to provide flexibility in the business. This can be achieved through promoter infusion of capital or fund raising through QIP or refinancing loans at cheaper rates in global markets, aggressive collection of receivables and finally monetizing of finished inventories.
- The cash flows are impacted due to the change of revenue recognition under Ind AS 115. The Real Estate companies should strive to implement a business model where 50% of free cash is targeted to be reinvested in projects with returns in the range of 15-20 % and balance 50% of free cash to build up cash reserves for potential working capital and inorganic growth.
- It is expected that the transition to Ind AS 115 will raise certain questions and challenges while computing normal tax liability as also while determining book profit, not only in the year of first-time adoption of Ind-AS, but also on an ongoing basis. The tax impact is huge due to revenue reversals for the past period and in the current period. A company with MAT regime, company will have paid tax under Minimum alternate tax determined based on Percentage of completion method's (POCM) book profits that is before implementation of Ind AS 115. As clarified earlier revenue and margins get re-booked after execution of Ind AS 115 and on such rebooking MAT is paid once more. The tax analysis of the financials of selected sample Companies reflects huge deferred tax assets have been created which can be adjusted against future profits. But the tax authorities believe that POCM is the proper basis for purpose of taxation and standard-setters believe that completed contract basis gives true and fair view. This will impact immediate cash flows of the companies.

8. Conclusion:

Ind AS 115 in real estate hopes to bring about a greater transparency that was losing credibility. The system ensures that revenue on a project will be accounted for by the real estate companies only when full payment is realized from the customer and asset is transferred to the buyer. Profit and loss account will henceforth be reflection of deliveries concluded by customers. The first quarter numbers of the listed real estate have reflected significant drop of revenue, huge adjustments in reserves and reclassification of customer advances as current liabilities. This increase in liabilities and drop in Net worth may skew the debt equity profile of most companies which may impact the credit rating and borrowings of the companies. The real estate sector as a whole is under performing in BSE since volatility of the growth will continue till the companies crosses the hurdle of cleaning up their balance sheets and investors understands the numbers under the new standards. However, it is s welcome step to bring greater transparency. With time, we are confident that the stake holders will have the deeper understanding of the sector and will be able to analyse and appreciate the real estate company's financial performance contextually.

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