Accounting Treatment of Profit on Sale/lease of Houses

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1 A company is one of the leading steel producers with a turnover of over Rs. 16,000 crore. The company's manpower strength in the nineties was about 2 lakh which has reduced to the prevailing level of 1.5 lakh. As part of its business restructuring, the company plans to further reduce its manpower strength to 1 lakh by the year 2005. The plants having been located at green sites with no facilities available, in order to attract manpower from across the country, the company developed large and comprehensive residential townships around its units. The company had targeted a satisfaction level of about 55% in providing housing facilities to its employees. Thus, there are about 1.3 lakh houses/flats at its townships. However, by the year 2005, with manpower strength almost halving, the steel plants would have houses and flats in excess of their requirements. Therefore, the company has launched a scheme offering specified number of constructed houses/flats, i.e., quarters built for employees to its employees/ex-employees and spouses of deceased employees on long term lease for residential purposes at a value based on the recommendations of a valuer on 'as is where is' basis. The objectives of the scheme are to gainfully utilise assets created by the company while enabling welfare of employees and ex-employees and to mobilise additional resources.

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.

2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 21 volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

2 Other salient features of the scheme are as under:

(a) The houses/flats in each category shall be leased to eligible persons within the number specified. The order of preference for the leasing of the houses/flats will be as under:
- Employees (including those released under VRS-2001), in occupation of the company's houses/flats offered under the scheme.
- Employees of the concerned steel plant not in occupation of the company's houses/flats.
- Employees of other plants/units/corporate office.
- Spouses of deceased employees in authorised occupation of the houses/flats.
- Ex-employees in authorised occupation of company's houses/flats.
- Ex-employees not in occupation of company's houses/flats.

(b) The houses/flats have been offered on long term lease on payment of one time lumpsum premium/consideration, initially for 33 years, renewable for two like periods. The successful allottee is required to enter into lease agreement with the lessor in the prescribed format on requisite stamp paper. The costs of documentation/registration will be borne by the allottee.

(c) On allotment, the allottee called 'lessee' is required to make all payments as specified in the offer letter within the stipulated time-frame of one month from the date of issue of the allotment order. Within three months of his making full payment, lease deed/agreement to lease will be executed between the company and the lessee in prescribed format on requisite stamp paper at lessee's own expenses and costs.

(d) The company is not to entertain any complaints

whatsoever regarding the cost of the flat, its design, the quality of material used, workmanship, etc. The premises will be leased on 'as is where is basis'. The company is not responsible for any maintenance or repairs of the demised premises and of the fittings and fixtures thereto, prior to and after allotment.

(e) The annual lease rent, service charges, etc., as prescribed by the lessor are payable during the pendency of the lease on annual basis in advance as prescribed in the lease deed to be executed between the lessee and the lessor and may be revised from time to time by the lessor. The annual lease rent shall be as indicated below:

Plinth Area (Sq. Ft)	Lease Rent/Annum (Rs.)
Upto 400	Rs. 85.00
401-600	Rs. 130.00
601-900	Rs. 200.00
901-1400	Rs. 300.00
Above 1400	Rs. 400.00

(f) The lessee shall pay all duties, taxes and charges, as existing or as may be levied by the State Government, any statutory body and the lessor in future in respect of demised premises during the tenure of the lease including the duties/taxes being paid by the lessor in respect thereof.

(g) The lessee shall pay proportionate amount as his share in respect of demised premises, as decided by the lessor, any tax/duty being paid or payable by the lessor for the entire property of the steel plant.

(h) The lessor has the right to terminate the lease giving three months notice to the lessee in case of violation/breach of any of the terms and conditions of the lease and upon such termination, the lessor shall have the right to evict the lessee from the demised premises.

(i) The leasehold interest in whole or in part cannot be transferred or sub-leased for a period of five years from the date of lease except under exceptional circumstances such as death of the lessee or on the lessee becoming insane and/or invalid, with the prior permission of the lessor in writing. In such cases, transfer could be considered, if it is in favour of spouse/legal heir/next of kin of the lessee.

(j) Any transfer of the leasehold interest can only be effected with prior permission of the lessor on payment of the requisite transfer fee as may be prescribed by the lessor. In case of such transfer, the sub-lease shall be governed by the same terms and conditions as the original lease. In addition to the transfer fee, the lessee would also be required to pay the lessor, 15% of the capital gain or 10% of the initial premium, whichever is higher, at the time of such transfer of leasehold interest in the property for executing the transfer. This will however, not be applicable to a transfer made to the spouse/legal heir/next of kin of the lessee.

(k) The company is to maintain the common basic infrastructural facilities (wherever municipal services are not available) on payment of annual service charges by the lessee in advance for the full financial year, which shall be notified from time to time.

(l) The company is to, subject to availability, supply water and electricity wherever municipal services/alternate arrangements are not available. The electricity charges shall be recovered from the lessee based on actual consumption. The charges towards water, electricity, service charges and lease rent, etc., shall be levied from the date of the lease agreement and will be reviewed by the company, as and when required.

3 The houses are being leased based on the fair market value determined by the valuer by taking representative samples for various types of houses at each of the townships. For valuation of building, the cost of replacement of dwelling units has been considered on the basis of per square foot as per the present market rates of materials and labour in the neighbourhood. The cost per square foot for different types of dwelling units has been arrived at after considering the plan, type of structure and other features, which are relevant.

4 As per the querist, Accounting Standard (AS) 19, 'Leases', may not be applicable in the scheme in question as the buildings are being transferred alongwith the land thereof, and the referred Standard does not apply to lease agreements for use of land. Further, the querist has made the following observations:

(a) Finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. The ownership of houses is being immediately transferred to the lessee on receipt of consider-

ation, whereas as per the Standard in respect of the finance lease the ownership of assets is transferred by the end of lease term.

(b) As per the company's scheme, the lessee has to purchase the house at a price based on fair value (present value) fixed by the valuer considering numerous factors and does not take into consideration any implicit interest rate to determine the discount rate for arriving at the aggregate present value of the dwelling unit.

(c) Under the scheme, there is no consideration with regard to the economic life of asset which may vary from house to house.

5 According to the querist, though legally, the house is given on lease basis, the period of lease is fairly long and, for all practical purposes, the transaction amounts to passing of the property to the lessee and the significant rights of ownership in the houses are passed on to the purchaser immediately on payment of the consideration and allotting the house to the employee/ex-employee. Thus, the company's scheme may not fall under the category of operating lease also.

6 The querist has further argued that the transactions and other events are required to be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, the substance and financial reality are that the lessee acquires the economic benefits of the leased house for the major part of its economic life in return for payment of lumpsum consideration. Thus, it is substantially and effectively transfer of property (land and building) for all practical purposes.

7 On the basis of the above, according to the querist, the transfer/leasing of houses is being considered by the company as outright sale and the treatment of profit arising thereon is as per the policy followed for normal sales. On the basis of issue of allotment letters to the applicants and premium/consideration received, the difference between the fair value and book value of the dwelling unit is being recognised as 'Profit on sale/lease of houses' in the accounts and the book value of the houses is removed from the fixed assets.

B. *Queries*

8 The querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issues:

(a) Whether AS 19 is applicable to transactions relating to sale/lease of houses, alongwith the land, entered into by the company.

(b) Whether the accounting practice followed by the company with regard to recognition of difference between the lumpsum consideration on sale of house and book value as income is proper.

(c) What disclosure (including any specific accounting policy) should be made in the accounts of the company with regard to transactions relating to sale/lease of houses.

C. *Points considered by the Committee*

9 The Committee notes that the query relates to offering specified number of constructed houses/flats, i.e., quarters built for employees to its 'employees/ex-employees' and spouses of deceased employees on long term lease for residential purposes. The Committee also notes from the 'Scheme for leasing of houses to employees 2001', submitted by the querist separately, that the contract of lease also comprises land appurtenant to the flats/houses, and that separate valuation is done for land and buildings, viz., houses/flats. Accordingly, it may be concluded that the contract of lease of flats/houses is a composite contract of lease of land and buildings.

10 The Committee notes that the observation made by the querist in paragraph 4(a) above that as per AS 19 under finance leases, the ownership of assets is transferred by the end of lease term, is not correct. The Committee notes that AS 19 states in paragraph 6 that under a finance lease, title may or may not eventually be transferred. The Committee also notes that the observation made by the querist in the above stated paragraph that the ownership of houses is being immediately transferred to the lessee on receipt of consideration by the company, is not supported by other facts supplied by the querist.

11 The Committee notes that AS 19 on 'Leases' clearly specifies that the Standard should be applied in account-

ing for all leases other than lease agreements to use lands (paragraph 1(c)). The Committee notes that the lease is given by the company on long term basis, i.e., initially for a period of 33 years renewable for two like periods. The Committee is of the view that taking into account the long period of lease and prevalent commercial practices in India of lease being generally renewed at the end of the lease period, in substance, the lease of land in this case amounts to passing of the significant rights of ownership to the parties concerned. In this regard, the Committee also takes note of the requirement of Schedule VI to the Companies Act, 1956, of showing leaseholds as an asset of the lessee.

12 The Committee notes that buildings, viz., houses/flats given on lease are within the scope of AS 19. The Committee further notes that as per AS 19, for accounting purposes, there are two types of leases, viz., finance leases and operating leases. AS 19 defines a 'finance lease' as "a lease that transfers substantially all the risks and rewards incident to ownership of an asset". The Committee notes that one of the examples of situations which would normally lead to a lease being classified as a finance lease is a situation where at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset (paragraph 8). In the present case, the amount of the leasehold premium which is determined by valuer by taking representative samples for various types of houses at each of the township represents their fair value. Thus, the fair value at the inception of the lease is equal to the present value of minimum lease payments, viz., the amount of premium paid at the inception of the lease. The annual lease rent, service charges, ground rent, duties, taxes, etc., to be paid by the lessee are not material amounts.

13 The Committee notes that as per paragraph 26 of AS 19, "the lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease". Further, as per paragraph 28, "the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease". The Committee is of the view that in the present case, since substantially the entire amount of minimum lease rental is received at the inception of lease, there is no net investment outstanding and the need for recognition of asset as a receivable and finance income as contemplated in paragraphs 26 and 28, would not arise. Thus, the entire amount of lease premium received should be considered as a sale consideration in respect of the buildings, viz., houses/flats. The Committee is also of the view that as explained in paragraph 11 of the facts of the case, land given on lease should also be treated as sale.

14 The Committee notes that paragraph 37 of AS 19 prescribes the disclosure requirements for finance leases. The Committee is of the view that the following disclosures would be relevant in the present case:

(i) a general description of the leasing arrangements of the lessor, and
(ii) the accounting policy adopted in respect of initial direct costs, if any.

D. *Opinion*

15 On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 8:

(a) The composite contract of land and building, viz., houses/flats should be bifurcated between the two components. AS 19 is applicable to transactions relating to lease of buildings, viz., houses/flats, on long term lease for residential purposes. However, AS 19 clearly provides that it does not apply to lease agreements to use lands.

(b) The accounting practice followed by the company with regard to recognition of income on lease of houses is proper.

(c) The following disclosures should be made in the accounts of the company with regard to transactions relating to sale/lease of houses:
   (i) a general description of the leasing arrangements of the lessor, and
   (ii) the accounting policy adopted in respect of initial direct costs, if any.

I am an idealist. I don't know where I am going, but I am on my way.

-Carl Sandburg