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IFRS Developments for Real Estate

Revised revenue recognition proposals – implications for the real estate and construction industries

What you need to know

- The IASB and FASB issued a second exposure draft on their converged revenue recognition model on 14 November 2011.
- The proposed standard would replace or modify standards and interpretations of significance to real estate and construction entities, including IAS 18 *Revenue,* IAS 11 *Construction Contracts,* IFRIC 12 *Service Concession Arrangements* IFRIC 15 *Agreements for Construction of Real Estate*, IAS 40 *Investment Property* and IAS 16 *Property, Plant and Equipment*.
- The effective date is not expected to be earlier than 1 January 2015. The revised ED proposes retrospective application, with limited transitional relief.
- The Boards are asking for feedback on the exposure draft to be provided by 13 March 2012.

Highlights

The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, the Boards) jointly released a second exposure draft (ED) on the accounting for revenue from contracts with customers in November 2011. At a high level, their proposed five-step model is consistent with the original proposals in the June 2010 ED, as is the core principle to recognise revenue when 'control' (as opposed to 'risks and rewards' under IAS 18) transfers to the customer. However, the Boards have made certain changes from the original ED, which are relevant to the real estate and construction industries.

Under the revised ED:

- Entities would be permitted to combine two or more contracts if certain criteria are met
- Entities would be allowed to treat multiple goods and services as one performance obligation provided certain conditions are met
- The possibility of bundling goods and services as one performance obligation would reduce the instances when a loss is recognised at contract inception
- The accounting for pre-contract costs would change
- Only certain warranties would be treated as separate performance obligations

The Boards set out criteria for assessing when control of a good or service transfers and when a performance obligation is satisfied over time.

This publication considers the key implications for entities in the real estate and construction industries, including real estate investment trusts ("REITs"), funds and homebuilders. For a more complete overview of the revised revenue recognition ED, please read our *IFRS Developments Issue 18: IASB and FASB issue revised revenue recognition proposals* (November 2011), which is available at www.ey.com/IFRS.

How we see it

The revised ED has addressed many of the concerns raised by constituents of the real estate and construction industries on the proposals in the original ED, although many uncertainties remain.

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Quality In Everything We Do

Construction and development contracts — satisfying the performance obligation

The terms of real estate construction contracts vary significantly for different types of construction projects; the contracts in different countries also vary. Since the proposed accounting for a contract under the revised ED depends on the specific terms of the contract, different accounting may apply to different contracts.

Development contracts

The proposed model takes a control-based approach. Revenue can only be recognised when an identified performance obligation is satisfied, by transferring control of a promised good or service to the customer. A performance obligation can either be satisfied over time or at a point in time. The revised ED provides several indicators to help entities determine whether a customer has obtained control at a point in time. These include physical possession, present right to payment for the asset, transfer of title, transfer of risks and rewards, the right to rescind the contract and evidence of customer acceptance.

A performance obligation is satisfied over time if the entity's performance either:

a. Creates or enhances an asset that the customer controls as the asset is being created or enhanced

Or

b. Does not create an asset with alternative use

And

(i) The customer receives and consumes the benefits as the entity performs

Or

(ii) Another entity would not need to re-perform work completed to date

Or

(iii) The entity has a right to payment for work completed to date and is expected to fulfill the contract as promised

Under the revised ED, a promised asset would not have an alternative use when an entity is "unable, either contractually or practically, to readily direct the asset to another customer". This means that if a real estate entity enters into a contract to sell a specific apartment to a specific customer, that apartment does not have an alternative use to the real estate entity. This is because the entity cannot use that apartment to fulfill a contract with another customer without breaching its contract with the first customer.

Below we describe how to consider the requirements of the proposed standard in three arrangements that are common in the home-building industry:

- Type A: a developer waits until a significant proportion of units are sold off-plan and finance is guaranteed before work begins. The buyer of a unit typically makes a non-refundable payment for a specific unit and has no right to rescind the contract unless the developer fails to perform. Future instalments are billed by the developer as construction progresses.

  As the customer has contracted for a specific unit, which the developer cannot redirect or substitute for another unit, the unit does not have an alternative use. This arrangement may meet criterion b.(iii) because the developer has a right to payment for work performed. However, for criterion b. (iii) to be applicable, there needs to be a relationship between the right to receive payment and the performance to date.

  The revised ED does not address how to determine whether the progress payments represent financing or transfer of control of the asset to the customer. Futhermore, the revised ED does not address the accounting for the work-in-progress (WIP), i.e., whether the developer would remove inventory from its balance sheet and the customer would be expected to record property as the work progresses. Since these are not addressed in the ED, an entity would need to look to other IFRS in this regard.

- Type B: a developer builds property using its own financing resources and sells the units off-plan over the construction period. The buyer pays a deposit for a specific unit and pays the balance payment on completion of that unit when legal title is transferred to the buyer. The contract terms allow the buyer to terminate the contract without penalty, other than forfeiture of the deposit initially paid.

  Again it can be concluded that the unit does not have an alternative use to the developer as the contract with the customer would be specific to a particular unit. This arrangement may meet criteria b. (ii) above if another developer would not be required to re-build in-progress construction. Criteria b. (ii) presumes that another developer would not have the benefit of any asset (e.g., WIP) presently controlled by the current developer. The transfer of control of WIP in a build-then-sell arrangement depends largely on the contractual terms of the arrangement and the legal framework of the applicable jurisdiction. Therefore, this arrangement may also be one in which control transfers at a point in time, such as completion.

- Type C: a developer transfers legal title of the land immediately to the buyer at the inception of the contract. As the building is constructed on the land, ownership of the property transfers to the buyer. The buyer pays the developer as work progresses.

  This arrangement may meet criterion a. above because the developer creates or enhances the property, which is controlled by the buyer, during the construction of the property.

How we see it

Different legal frameworks might result in, prima facie, different accounting outcomes under the revised ED. An entity needs to assess on a case-by-case basis whether transfer of control takes place at a point in time or over time.

The criteria for transfer over time (continuous transfer) in the revised ED are different from current accounting requirements under IFRIC 15. This difference may result in different outcomes from current accounting when determining whether a performance obligation is satisfied over time.

The revised ED does not address how to determine whether progress payments represent financing or a measure of the entity's satisfaction of the performance obligation. Consistent with current practice, judgement will be required, but the importance of the criteria for over time recognition makes careful assessment critical.

Construction contracts

Identification of the individual performance obligations is a critical component of the proposed revenue model in the revised ED, since an entity would recognise revenue as each performance obligation is satisfied. The revised ED proposes that entities account for multiple goods and services as one performance obligation, provided certain conditions are met. The revised ED explains that an entity would account for a bundle of goods and services as one performance obligation if both:

- The goods and services are highly interrelated and the entity provides a significant service to integrate them into the combined item(s) for which the customer has contracted

And

- The goods or services are modified or customised to fulfill the contract

For example, an entity enters into a contract to construct a bridge and provide the necessary services to design the bridge. To fulfill the contract, the entity will provide a significant service to integrate the design and the construction of the bridge, which are highly interrelated and customised services. Under the revised ED, these services are considered to be a bundle of goods and services that are accounted for as one performance obligation. If the criteria for satisfaction of the performance obligation over time are met, the revenue for the contract would be recognised progressively as the bridge is constructed. When the entity also provides ongoing maintenance services, this would generally be identified as a separate performance obligation, which is consistent with the original ED.

How we see it

The Boards recognised that many construction contracts provide integrated bundles of goods and services. As a consequence, many construction contracts may be accounted for as a single performance obligation under the revised ED. This would result in accounting that is similar to current IFRS.

Assessment of transaction price

The revised ED defines transaction price as the amount of consideration that an entity expects to be entitled to from a customer. The transaction price would include an estimate of any variable or uncertain consideration and the fair value of non-cash consideration. In addition, any consideration payable to the customer, such as discounts, would be accounted for as a reduction of the transaction price unless the payment is for a distinct good or service from the customer. The revenue that is recognised would be limited to the amount that the entity is reasonably assured to be entitled, taking into consideration any performance-based component.

In the revised ED, an entity would estimate variable consideration using either the expected value or the most likely amount, based on the method that best predicts the amount it is entitled. This is in contrast to the original ED in which variable consideration would have to be measured on the basis of a probability-weighted model.

The revised ED requires adjusting for the time value of money when the financing component is significant. However, as a practical expedient, entities can ignore the time value of money when the period between the customer's payment and the entity's satisfaction of the performance obligation is expected to be less than 12 months.

Contract modification

An entity would not account for contract modifications (e.g., subsequent change in floor plan, structural changes in the engineering construction design) as a separate contract unless a modification:

- Results in additional goods and services that are distinct

And

- Establishes a right for the entity to receive an amount of consideration that reflects the entity's stand alone prices

For all other modifications, the accounting treatment would differ depending on the nature of the modification and its relationship to the original contract.

Asset management fees/services charges

Asset management fees of REITs and funds would be subject to the same revenue recognition model as other real estate entities. Asset management fees that are based on performance (e.g., incentive fees based on a percentage of the property's net operating income) or the fair value of assets managed would be variable consideration. An entity could only recognise such variable consideration to the extent the performance obligation is satisfied and it is reasonably assured to be entitled to the consideration.

Onerous performance obligations

Entities need to assess whether an individual performance obligation is onerous only for performance obligations satisfied over time and over a period greater than one year. This may require an entity to apply the test to only some of the performance obligations in a multiple-element arrangement that includes goods and services. This onerous test is applied to individual performance obligations, and, therefore, could still result in the recognition of a loss for individual performance obligations (e.g., a low-margin service) in a contract with multiple performance obligations that is profitable as whole. However, as the revised ED proposes to bundle integrated goods and services together as a single performance obligation, many real estate companies might consider this to be less of an issue.

Rental income

Lessors' leases of property that is not investment property, and the related rental income, would be covered by the proposed new leases standard and are not within the scope of the revised revenue recognition ED.

Pre-contract costs

The revised ED would allow incremental costs of obtaining a contract to be capitalised only if the entity expects to recover those costs. Qualifying costs are those that an entity would not have incurred if the contract had not been obtained (e.g., sales commission paid on the basis of successful outcomes). Costs that would have been incurred irrespective of whether the contract was obtained would be expensed as incurred.

Product warranties

The revised ED would require only warranties that provide more than standard assurance that the product meets the agreed specifications to be treated as separate performance obligations. This is different from the original ED.

Entities would, therefore, continue to account for standard warranties for defects in constructed property by accruing for the estimated warranty costs. This accounting is no different from current IFRS.

How we see it

We strongly encourage all real estate entities including REITs, funds, homebuilders and construction companies to use the opportunity to re-evaluate and field test the revised model, before providing feedback to the Boards. This is essential to ensure a robust standard is developed that serves the interests of all stakeholders.

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