New on the Horizon: Revenue recognition for real estate investment and development

Revised proposals will impact revenue recognition for real estate

In November 2011, the IASB and the FASB published a revised joint exposure draft on revenue recognition (the 2011 ED). The proposals issued in June 2010 (the 2010 ED) were revised to address a number of concerns expressed by constituents, including entities in the real estate industry.

The revised proposals will have a direct impact on many common transactions in the real estate industry, affecting both developers and investors. Notably, the 2011 ED features new criteria for recognising revenue over time and includes an example illustrating the application of those criteria to sales of residential real estate. However, a key concern remains as to whether the revised proposals are clear enough to be applied consistently across the industry.

This publication focuses on the issues relevant to real estate entities; other issues relevant to the building and construction entities are covered in our publication New on the Horizon: Revenue recognition for building and construction. For a fuller discussion of the revised proposals, see our cross-sector publication New on the Horizon: Revenue from contracts with customers.

Key impacts

- The criteria for identifying separate performance obligations have been revised, introducing a clearer test to determine when the land and building elements of a real estate transaction should be accounted for separately.
- The criteria for recognising revenue over time (similar to current percentage of completion accounting) have been revised with real estate transactions in mind but questions remain regarding the recognition of apartment sales.
- The threshold for recognising revenue on transactions in which a vendor retains risk exposure or ongoing involvement in a property, e.g. through rental guarantees, would be lower than under current standards.
- The recognition of performance-based fees contingent on hard to predict outcomes, for example fund manager fees for above-market performance, would generally be deferred until the end of the performance period.
- Increased qualitative and quantitative disclosure requirements are proposed. New internal processes may be required to collate the underlying data.
The five-step model

The 2011 ED retains the five-step model for determining when to recognise revenue, based on the core principle that revenue is recognised when or as an entity transfers control of goods and services to customers.

The five steps to apply the model are:
1. Identify the contract with the customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations in the contract
5. Recognise revenue when (or as) each performance obligation is satisfied

Each step of the model has been revised since the 2010 ED. In order to apply the model, entities would be required to make judgements and estimates at each step. We discuss below some of the key judgements that are likely to be relevant to entities in the real estate development and investment industry.

Critical judgements for real estate development

How to identify separate performance obligations?

Identifying separate performance obligations is a key step in the model, as the performance obligation – not the contract – is the unit of account for recognising revenue. It is the proposals in this area that will be a key determinant of whether, for example, a developer can recognise upfront revenue (and hence profit) on the land component when it enters into a pre-sale agreement for an uncompleted building.

Under the 2011 ED, a performance obligation is a promise in a contract to transfer a good or service to the customer, and may be stated explicitly in the contract or may be implicit. Activities that an entity must undertake to fulfil a contract but that do not transfer a good or service to the customer (e.g. administrative tasks) are not performance obligations.

An entity would account for a promised good or service as a separate performance obligation if it is distinct. However, if the pattern of transfer of control to the customer of the distinct goods and services is the same, an entity could account for distinct goods and services as if they were one performance obligation. Additionally, the 2011 ED requires the bundling of goods and services into a single performance obligation if they are highly inter-related, the entity provides a significant service of integrating those goods and services, and the whole bundle is significantly modified or customised to fulfil the contract.

Criteria for identifying separate performance obligations

A performance obligation is a promise (implicit or explicit) in a contract with a customer to transfer a good or service to the customer

- Pattern of transfer of the good/service differs from other goods/services
- Good or service is ‘distinct’
  - Vendor regularly sells good or service separately
  - Customer can use the good or service on its own or with readily available resources

Account for separately unless: (1) highly inter-related and significant integration service and (2) bundle is significantly modified or customised for customer
KPMG observations

There are likely to be two key application issues for real estate developers when identifying separate performance obligations: whether the sale of land is a separate component of an arrangement; and whether the construction element of a transaction is one or many performance obligations.

On the first question, the criteria for identifying separate performance obligations are clearer and more detailed than the general guidance on splitting arrangements into components in currently applicable IFRSs. If a developer enters into a single contract to transfer an interest in land to the customer, and then to construct an office building on that land, then the criteria provide a framework to assess whether the transfer of the land interest is a separate performance obligation.

On the second question, the revised proposals in the 2011 ED may be considered good news for real estate developers. In particular, the requirement to bundle goods and services together when the goods and services are highly inter-related, the developer performs a significant integration service and the bundle is modified or customised, is likely to mean that many construction components within development contracts will be found to contain a single performance obligation.

However, some challenges are likely to remain in this area, for example when a developer plans to construct an apartment block and pre-sells apartments to multiple buyers before construction begins. The 2011 ED includes an illustrative example on this topic but it does not appear to envisage separate accounting for the land and construction elements of the transaction. It is unclear whether the undivided share of land relating to the purchase of an apartment should be separated from the construction activities in such cases.

When to recognise revenue: over time or at a point in time?

Similar to the 2010 ED, the model in the 2011 ED does not feature percentage of completion accounting. However, it does envisage that entities may recognise revenue ‘over time’, if certain criteria are met. If a transaction meets these criteria, then the entity could apply an input or an output method to measure progress. In effect, the accounting outcome under percentage of completion accounting survives in a different guise. Assessing whether a transaction meets the criteria to recognise revenue over time would become a key accounting judgement in the real estate industry.

Under the 2011 ED, an entity recognises revenue when or as it satisfies performance obligations by transferring control of a good or service to a customer. Control may be transferred either over time or at a point in time. This assessment is made at the performance obligation level.

An entity first considers if a performance obligation meets the criteria for recognising revenue over time. If this is the case, then the outcome may be similar to current percentage of completion accounting. If a performance obligation is not satisfied over time, then it is satisfied at a point in time, when control of the goods or services passes to the customer.

Criteria for recognising revenue over time are included below.

### Performance obligations satisfied over time

- **Performance does not create an asset with an alternative use**
  - To the entity and any one of the below criteria is met
- **Performance creates or enhances an asset that the customer controls**
- **Customer simultaneously receives benefits as entity performs**
- **Task would not need to be reperformed**
- **Entity has right to payment for performance and expects to fulfill contract**

### Performance obligations satisfied over time

- **e.g.** Customer retains land if development agreement is terminated
- **e.g.** Customer makes progressive payments for off-the-plan apartment sales
- **e.g.** Project/development management services
- **e.g.** Transportation services

* An alternative use exists if the entity has an ability to direct the asset to another customer

In assessing whether an asset has an alternative use, an entity considers if it is unable, either contractually or practically, to readily direct the asset to another customer. Specifically, an asset would not have an alternative use if the contract has substantive terms that preclude the entity from directing the asset to another customer or if the entity would incur significant costs (e.g. costs to rework the asset) to direct the asset to another customer.

The 2011 ED includes an non-authoritative illustrative example which applies the proposals to sales of residential real estate. The key points of the example are as follows.
Illustrative example – Performance obligation satisfied over time

Company E, a developer of residential real estate (apartments), before beginning construction, has entered into binding contracts to sell individual apartments to customers when ready for occupancy.

Each customer pays a non-refundable deposit at contract inception and agrees to make progress payments until completion of the contract. Those payments are designed to compensate E for its performance to date rather than loss of profit caused by cancellation. The payments are non-refundable unless E fails to deliver a specified unit.

E’s contracts with its customers specify the apartment that the customer will receive and prohibits E from transferring apartments to other customers.

E’s performance obligation is satisfied over time based on the following criteria:
• E creates an asset with no alternative use because E may not transfer a specified apartment to another customer;
• E has a right to payment for performance to date; and
• E expects to fulfil the contract.

However, some challenges may remain with interpreting and applying the criteria consistently across the real estate industry. For example, to meet the criteria for recognising revenue over time, amongst other things, a real estate developer will need to demonstrate that progressive payments made by a customer reflect the developer’s right to payment for the performance to date. The 2011 ED itself refers only to the seller having a ‘right to payment’ whereas the illustrative example cited above seems to suggest that it is important that the buyer finances development. It is unclear therefore whether it is the right to payment or the actual financing arrangements that are key in the analysis. It is also unclear how closely the right to payment/progress payments are intended to relate to development activities. For example, is it necessary for an initial deposit to cover the land interest, which will not in itself be ‘constructed’?

KPMG observations

The 2011 ED broadens the scope of arrangements that would meet the criteria for recognising revenue over time compared to the 2010 ED. The 2011 ED includes additional criteria that have been developed, at least in part, with real estate transactions in mind. The 2011 ED’s illustrative example (discussed above), while not constituting authoritative guidance, indicates the potential significance of the new criteria to the real estate industry. Generally, real estate entities will welcome the efforts of the Boards to address common practice issues in this industry.

One point to note is that sales of real estate will typically meet the ‘no alternative use’ criteria. This is because the 2011 ED states in effect that an asset does not have an alternative use to the seller if the seller has agreed to deliver that specific asset to the customer. In a real estate transaction, the sale and purchase contract will generally specify the unique location of the property (e.g. lot number, or apartment number in a specific apartment block) and will not permit the developer to substitute the unit for another unit in a different location.

Recognition of revenue at a point in time

If the transaction fails to meet any of the criteria for recognising revenue progressively over time, then the 2011 ED proposes revenue recognition at a single point in time. The 2011 ED provides indicators for determining when the customer has obtained control of a good or service (the asset), including the following:
• the entity has a present right to payment for the asset;
• the customer has legal title to the asset;
• the entity has transferred physical possession of the asset;
• the customer has the significant risks and rewards of ownership of the asset; and
• the customer has accepted the asset.
The list of indicators included in the 2010 ED was amended to remove ‘the design or function is customer specific’ indicator, and to include ‘risks and rewards of ownership’ and ‘evidence of the customer’s acceptance of the asset’ as indicators.

**KPMG observations**

Revenue recognition at a point in time is relevant to a number of common real estate transactions, for example for the land component that meets the criteria to be treated as a separate performance obligation.

Judgement will need to be applied to real estate transactions involving a single contract that covers both a land sale and construction/development of a building on the land. The key test here will be whether ‘control’ of the land component passes at contract inception or whether this occurs at completion of construction/development activity. Suppose that an entity has a single contract for both a land sale and construction/development but the land sale represents a separate performance obligation, the entity has a present entitlement to payment for the land and passes legal title of the land to the customer on contract inception, and the customer retains the land even if the construction element of the arrangement is terminated; the 2011 ED would suggest that revenue on sale of land would occur at this point in time.

When title to the land is passed to the customer and a land sale has been recognised, it is expected that revenue from the construction/development activity will typically be recognised progressively as the entity’s performance enhances an asset that the customer controls.

**Other critical judgements for real estate**

**When to recognise contingent revenue and at what amount?**

Many real estate transactions involve contingent pricing arrangements, in which a sales price or fee depends on the future value of an item of real estate, or whether the performance of a portfolio exceeds a benchmark return. The 2011 ED includes specific guidance on when the variable element of a transaction price may be recognised as revenue.

The amount of revenue an entity recognises when or as it satisfies a performance obligation generally reflects the amount of the transaction price allocated to that performance obligation. However, if the consideration payable by the customer is variable, then the cumulative amount of revenue an entity recognises is constrained to the amount that it is reasonably assured to be entitled to.

**Is the entity reasonably assured that it is entitled to receive the transaction price allocated to satisfied performance because:**

- the entity has experience with similar types of performance obligations (or access to other entities); and
- the entity’s experience is predictive of the outcome of the contract?

**Factors that make an entity’s experience less predictive:**

- consideration amount is highly susceptible to external factors;
- uncertainty about amount not expected to be resolved for a long time;
- entity’s experience with similar contracts is limited; and
- contract has large number of possible consideration amounts.
Rental guarantees

It is common for real estate sales, in particular sales of partially vacant commercial property, to include rental guarantees. That is, the seller will agree to guarantee that the buyer’s rental income from tenants will not be lower than a specified amount for a period of time. Through such guarantees, the seller retains a degree of risk exposure and continuing involvement with the property.

KPMG observations

Under existing IFRSs, it is general practice to recognise revenue unless the rental guarantee is so significant that it is concluded that the significant risks and rewards of ownership of the real estate have not passed to the buyer. In those circumstances in which the sale is recognised, the seller may in practice defer revenue or recognise a provision for its exposure under the rental guarantee.

Under the 2011 ED, it appears unlikely that a typical rental guarantee will preclude recognition of a sale of real estate. This is because revenue is recognised when the customer obtains control of an asset, and transfer of the risks and rewards of ownership is only one aspect of assessing whether control has passed. In effect, the threshold for recognising a sale when a rental guarantee is in place appears to be lower than under current IFRSs.

The 2011 ED does not discuss rental guarantees explicitly, though it appears that a rental guarantee may be a form of variable consideration. Under this approach, an entity would be required, on asset sale, to recognise revenue up to the amount that it is reasonably assured to be entitled to. The amount of revenue to which an entity expects to be entitled would be determined using one of the following methods, depending on which method is expected to be a better predictor:

- the expected value – sum of probability weighted amounts in a range of possible consideration amounts; or
- the most likely amount – the single most likely amount in a range of possible consideration amounts.

Management fees

Current practice for recognising management fees contingent on achieving specific targets, in particular performance fees for property fund managers, is varied across the real estate industry.

KPMG observations

Under the 2011 ED, the treatment of such contingent fees may also fall under the proposed guidance on variable pricing. The 2011 ED includes a non-authoritative illustrative example in which an asset manager will receive an incentive fee only if the assets under management outperform a specified index over the contract period. The illustrative example suggests that the asset manager should defer recognition of the incentive fee until the end of the period, as that is the earliest date on which it will be ‘reasonably assured’ that the incentive fee will be receivable.

The criteria for recognising revenue contingent on achieving specific performance targets under the 2011 ED may be viewed as a fairly high threshold, which may be difficult to achieve prior to the end of the contract. For some real estate entities it may result in a change in practice and in revenue recognition at a later date than at present.

How to account for transactions involving financing arrangements?

It is not uncommon for real estate transactions to include some form of financing arrangement, whether implied through deferred settlement terms, or subject to specific financing contracts such as the provision of vendor finance.

KPMG observations

Under the 2011 ED the sale transaction and the vendor finance at fair value would be considered separate performance obligations. Assuming that the transaction is priced at fair value, then the full sales value would be recognised as revenue at the point of sale (as control of the asset has been transferred to the buyer), and a receivable (which would be accounted for under the financial instruments standard) would be recognised in relation to the vendor finance, which would derive interest income.

In the event that vendor financing is in the form of deferred settlement as opposed to a separate finance agreement, an entity would adjust, through the discounting of future cash flows, the transaction price to reflect the implied financing element of the contract. This would result in a lower revenue amount being recognised at the date of sale and interest income being recognised progressively up until the point that the purchase price consideration is settled.
How should an investor account for rental income and other leasing transactions?

Rights and obligations under a lease contract are outside the scope of the 2011 ED. Instead, lease accounting is the subject of a separate joint project by the IASB and FASB. A real estate investor will only have a full picture of the impact of the current round of standard setting once both projects are finalised.

Key points to note about the interaction of the revenue and leases projects, based on tentative decisions made by the IASB and FASB up to the end of 2011, include the following.

- **Rental income** – Rental income will be within the scope of the leases standard, not the revenue standard. However, in 2011 the IASB decided tentatively that lessors of investment property would not be required to apply the ‘right-of-use’ model that forms the basis of the leases project. Instead, lessors of investment property would generally continue to recognise rentals from investment property on a straight-line basis, similar to current operating lease accounting.

- **Other services** – If a lessor provides other services to tenants, then it would consider whether the rent and other services should be accounted for separately. The lessor would use the guidance in the leases standard to make this assessment, and to allocate consideration between the lease and service elements of the arrangement. The lessor would then use the guidance in the revenue standard to account for the other services that have been separated in this way.

- **Sale and leaseback transactions** – An entity would be required first to assess whether the sale leg of the transaction meets the criteria in the revenue standard to be recognised as a sale. If this is the case, then the entity would apply the lessee ‘right-of-use’ model to the leaseback leg. This means that even if the sale leg qualifies as a sale, the entity would still recognise a financial liability for its obligation to pay rentals under the leaseback. In effect, all sale and leaseback transactions would be ‘on-balance sheet’ under this approach, though there may be measurement differences compared to current practice.

The IASB and FASB are continuing to debate the lease proposals, which remain subject to change. At the time of writing, a revised ED on lease accounting is expected in mid-2012. You can follow developments on the leases project by reading our Leases Newsletter.

Disclosures

The 2011 ED proposes that entities disclose qualitative and quantitative information with respect to their contracts with customers and significant judgements and changes in judgements made in applying the requirements.

Some key disclosure impacts are as follows.

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<th>Proposed requirement</th>
<th>KPMG observations</th>
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<td>Disaggregation of revenue from contracts with customers into primary categories depicting how the nature, amount, timing and uncertainty of revenues and cash flows are affected by economic factors.</td>
<td>New internal processes may be required to collate the data for the new, increased disclosure requirements. For companies with a large number of contracts, the preparation of these disclosures may be an onerous task.</td>
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<td>Detailed information about an entity’s performance obligations, including when an entity typically satisfies its performance obligations, significant payment terms, ongoing obligations (rental guarantees etc.) and explanations as to what amount of the transaction price is deferred at the end of a reporting period (including an explanation of when the entity expects to recognise the deferred amount as revenue). Disclosure of opening to closing reconciliations for contract assets and liabilities. Disclosure of the liability recognised for onerous performance obligations, including an opening to closing reconciliation.</td>
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Conclusions

The 2011 ED may be seen as good news for real estate entities, as it addresses some of their previous concerns, especially in relation to separation of performance obligations and the criteria for recognising revenue over time. However, it remains to be seen whether some areas of the proposals are clear enough to ensure consistent application across the real estate industry.

Additionally, some of the revenue recognition issues for real estate investment entities are closely linked to lease accounting. The IASB and the FASB continue working together on the revised leasing proposals, which are expected to be published for comments in mid-2012.

The new revenue standard is expected to be effective not earlier than annual periods commencing on or after 1 January 2015. Entities in the real estate industry should therefore look at their current processes and identify whether gaps exist in respect of the enhanced disclosure requirements.

The IASB has invited comments on the 2011 ED by 13 March 2012 and real estate entities may use this additional opportunity to influence the proposals.

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