

Changes to accounting for revenue from real estate under construction

What is the issue?

Earlier this month the International Financial Reporting and Interpretations Committee issued Interpretation 15 (IFRIC 15) to clarify how entities that construct real estate (either directly or via subcontractors) should account for the associated revenue. The interpretation clarifies whether an entity recognises revenue as construction progresses or at a single time once the completed property is handed over to the buyer. As construction generally takes place over more than one accounting period, IFRIC 15 could have a significant impact on the financial results of affected entities. It applies to entities with annual periods beginning on or after 1 January 2009, with retrospective application required.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Who does it impact?

Real estate developers that construct all types of real estate, including the development of residential estates, apartments, houses, and other commercial developments. For example, real estate developers that pre sell apartments 'off the plan' or sell the rights to residential house and land packages once they are complete.

What does the interpretation clarify?

It clarifies the appropriate accounting for the three types of real estate construction agreements.

1. In real estate construction agreements where the buyer can specify major structural elements of the design of the property (e.g. moving the location of walls), the buyer is, in substance, purchasing a construction service. For these arrangements the associated revenue should be recognised by the developer as construction progresses, following the rules in AASB 111 *Construction Contracts*.
2. In real estate construction agreements where the buyer can only specify minor changes to the real estate (e.g. by requesting a different shade of carpet), the buyer is, in substance, purchasing a good. For these arrangements the associated revenue should be recognised by the developer once the control and significant risks and rewards of ownership have passed to the buyer, following the rules in AASB 118 *Revenue*. This will usually be only once construction is complete.
3. In real estate construction agreements where the developer pays for the rendering of services (e.g. hiring a builder only for the provision of manual labour; not for the provision of construction materials) the revenue should be recognised as construction progresses. These agreements are accounted for under AASB 118.

How does the interpretation affect current practice?

It standardises practice in this area. Entities that currently recognise revenue from real estate as construction progresses (that is, based on the percentage of the real estate that has been constructed to date) will be significantly affected if their arrangements do not qualify as construction contracts. In most cases these entities will recognise the revenue only once the real estate has been transferred to the buyer.

Entities should revisit past agreements and consider if there really has been a sale of real estate

Determining which type of real estate arrangement your entity has will depend on the terms of the agreement and its specific facts and circumstances. We encourage entities to revisit their arrangements and carefully consider whether they have sold a service or a good. Entities are also advised not to presume that a sale has actually occurred – again, this will depend on the terms of the agreement.

For example, in some cases real estate may be sold with such a degree of continuing involvement by the seller that effective control and the risks and rewards of ownership are not transferred when the buyer obtains possession. Common examples of this in practice are sale and repurchase agreements that include put and call options, agreements whereby the seller guarantees occupancy of the property for a specified period, or agreements whereby the seller guarantees a return on the buyer's investment for a specified period.

In such cases, the nature and extent of the seller's continuing involvement will determine how the transaction should be accounted for. For example, it may be accounted for as a sale, or as a financing, leasing or some other profit-sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

PwC insight: Be wary of the continuous transfer of risks and rewards of ownership

The interpretation envisages an arrangement where the risks and rewards of real estate transfer to the buyer 'continuously' as construction progresses, rather than at a point in time when construction is complete. This might occur in instances where the buyer has the right to the work in progress if the developer fails to deliver the finished product. In this case, revenue is recognised as the risks and rewards transfer to the buyer as construction progresses. In our view these arrangements would be rare in practice, so entities should not expect to apply this accounting approach.

Hedge accounting - your chance to argue for change

What is the issue?

The IASB has issued a discussion paper (DP) that aims to reduce the complexity in reporting financial instruments. It is the first step towards the longer term goal of creating a new financial instruments standard. The DP explores possible changes to the way that financial instruments are measured and new rules for hedge accounting.

In this article we consider the hedge accounting proposals, specifically those that concern the hedge documentation and hedge effectiveness testing rules.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✗

Who will be impacted by the proposed simplifications to hedge accounting?

Entities that hedge exposures and want to achieve hedge accounting.

Why do the hedge accounting rules need to be simplified?

The hedge accounting rules are detailed and complex, and meticulous care is required for each hedging transaction, particularly for documentation and effectiveness testing. The rules can be difficult to understand and apply, and entities around the globe have called on the IASB to simplify the accounting requirements.

What are the main proposed simplifications to hedge accounting?

The three main proposals are listed below. Proposals 1 and 2 are alternatives, while proposal 3 could be adopted in isolation or with proposal 1 or proposal 2.

Proposal 1. Require all financial instruments to be measured using fair value. Currently, financial instruments are measured at fair value or amortised cost. This principle is simple and reduces complexity for some hedges of financial assets or liabilities. However, it increases complexity in measuring financial instruments and increases volatility in earnings.

Proposal 2. Allow gains and losses on hedging instruments to be recognised in equity. Cash flow hedge accounting allows gains and losses on the hedging instrument to be recognised in equity. This proposal would allow similar treatment for fair value hedges. This would simplify hedge accounting by reducing the number of hedging models available, however, it is unlikely to lead to less complexity for preparers.

Proposal 3. Simplify the current rules by relaxing its requirements. This could be achieved by:

- **Relaxing documentation requirements.** This would reduce the current level of administration required to document hedges for accounting purposes.
- **Simplifying the effectiveness test by replacing the quantitative effectiveness test with a qualitative test.** Currently any movement in the hedging instrument needs to match the movement of the hedged item, within a strict 'bright line', being the 80/125 percentage test. This test currently stops many hedges from achieving hedge accounting. The question is whether this line should be broadened or removed altogether and then what kind of test should replace it.
- **Eliminating the need for retrospective effectiveness testing and only require prospective testing.** This could result in more hedges achieving hedge accounting and reduce the current level of administration needed to monitor hedges for accounting purposes.
- **Making the designation of hedge accounting irrevocable.** This would eliminate the rules for starting, stopping and re-commencing hedge accounting. However, these rules are commonly used strategies in practice and would significantly reduce managements' flexibility to achieve hedge accounting.

What do impacted entities need to do?

We encourage entities to read and respond to the IASB's discussion paper 'Reducing complexity in Reporting Financial Instruments' by 19 September 2008. It is available at www.iasb.org.

PwC insight: Engage now

The best opportunity that entities have to impact the direction of the proposals is at the discussion paper stage. If entities have particular views on how they want hedge accounting to be 'fixed', this is their chance to share their ideas and influence the debate. Remember, any changes to hedge accounting rules resulting from the IASB's DP are likely to last for some time, so focus on it now and engage with the IASB.

Finally, although this DP may simplify the rules, it won't reduce the complexity of the hedging transactions themselves. Some entities may find that a more principles-based model actually increases the level of judgement required.

Resources to help you keep up to date with IFRS developments

- **AASB Action Alert** covers the activities of the Australian Accounting Standards Board and how it will respond to recent IASB pronouncements. It is usually published monthly and is available at www.aasb.com.au
- **IASB Update** covers the activities of the IASB and decisions reached at its most recent meeting. It is usually published monthly and is available at www.iasb.org
- **IFRIC Update** covers the activities of IFRIC and tentative decisions reached at its most recent meeting. It is usually published every two months and is available at www.iasb.org