

HKFRS 15 - Impact on real estate developers

How to account for sales incentives and selling costs incurred on real estate apartment sales contracts

Introduction

The Institute published an article in *A Plus* August 2015 issue, the first in a series of articles, which discusses the impact of HKFRS 15 *Revenue from Contracts with Customers* on real estate developers. The article considers pre-completion sales contract for an apartment unit in a multi-storey residential building in Hong Kong and concludes that revenue on such contracts will generally be recognized at a point in time instead of over time under HKFRS 15, after taking the facts and circumstances specific to Hong Kong into consideration. The article also discussed at which point in time control of properties under pre-completion sales is considered to have transferred to the customer under HKFRS 15.

This article discusses the accounting treatment of different types of sales incentives and selling costs incurred on real estate apartment sales under HKFRS 15. These could arise in relation to pre-completion sales contracts or when selling finished apartments. As is the case with all financial reporting standards, the requirements of HKFRS 15 apply to the extent that the effect is material.

Sales incentives provided by developers

The option to purchase additional goods or services

Developers sometimes provide customers with the option to purchase additional goods or services once they enter into a preliminary agreement for

sale and purchase (PASP). For example, developers may offer customers the option to purchase additional apartment units or a car park space at a discount to list price.

Under HKFRS 15, developers are required to identify, at contract inception, all promised goods and services under the PASP and to determine whether each of the promised goods or services represents a separate performance obligation.

HKFRS 15.B40 states that if, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that the customer would not receive without entering into that contract. For example, an option provides a material right if the option grants the customer the right to purchase further goods or services at a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that market.

However, if the option simply provides the customer with the ability to acquire additional goods or services at a price reflective of its standalone selling price, then this option does not provide a "material right" even though such an option may only be obtained as a result of entering into the contract. In such cases, the option is not a separate performance obligation.

At its October 2014 meeting, the International Accounting Standards Board

and the United States Financial Accounting Standards Board Joint Transition Resource Group for Revenue Recognition discussed the need to exercise judgment when assessing whether customers are granted a material right under an option. An entity should consider both the quantitative and qualitative factors as well as factors that are outside the current transaction when making the assessment.

If a developer grants an option to the customer to purchase additional goods or services, then the developer needs to consider these requirements of HKFRS 15 to ensure that appropriate amounts of revenue are recognized at each point of delivery. This means that if the developer determines that the option provides a customer with a material right, a portion of the total transaction price must be allocated to this option based on its relative standalone selling price. The developer recognizes revenue when the underlying goods or services are transferred to the customer or when the option expires.

HKFRS 15.B42 states that if the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity shall estimate it. Factors such as the incremental discount provided with the option as compared to discounts obtained by customers without the option, and the likelihood that the option will be exercised should be considered when determining the standalone selling price of the option.

Example 1: Material rights

A developer is offering apartments in phase I of a development for HK\$5,000,000 each. The developer offers an incentive with the pre-completion sale whereby if the customer commits to buy an apartment in phase I at the list price then the customer has the option to buy a second apartment in phase II for HK\$4,000,000, provided that the customer commits to the purchase of this second apartment within the next nine months and provided there are still unsold units available at that time. For the purposes of this example, assume that the apartments in phase I and phase II are equal in all respects except that the phase II apartments will be ready for customers to move in six months later than the phase I apartments, and that the effects of time value of money is immaterial.

The developer estimates that the standalone selling price of an apartment in phase I is HK\$4,700,000. The estimation is based on the current market condition and the price of similar transactions without the option.

To estimate the standalone selling price of the customer's option, the developer may take into account factors such as the amount of the discount, the life of the option, the expected market condition of the property market and the likelihood of exercising the option. Having taken into account these factors, the developer estimates the standalone selling price of the option to be HK\$600,000.

Based on these estimations, the combined standalone selling price of the apartment in phase I and the option is HK\$5,300,000 (HK\$4,700,000 + HK\$600,000). The developer allocates the transaction price (HK\$5,000,000) of the pre-completion sales to the apartment in phase I and the option to buy apartment in phase II on a relative standalone selling price basis as follows:

- Price of apartment in phase I = HK\$4,433,962 (HK\$5,000,000 x HK\$4,700,000/HK\$5,300,000)
- Price of option to buy apartment in phase II at a discount = HK\$566,038 (HK\$5,000,000 x HK\$600,000/HK\$5,300,000)

Under HKFRS 15 the entity should recognize the revenue allocated to the option when the future goods or services underlying the option are transferred (together with the price paid by the customer for the additional goods or services when exercising the option), or when the option expires.

Example 2: Revenue recognition associated with the option

Based on the assumptions in example 1, the developer should recognize allocated revenue of HK\$4,433,962 when transferring the phase I apartment to the customer.

If the customer has exercised its option to buy an apartment in phase II, then on transfer of the phase II apartment to the customer the developer would recognize revenue of HK\$4,566,038 (HK\$4,000,000 purchase price plus allo-

cated revenue of HK\$566,038 in respect of the option).

If the customer chooses not to exercise the option then the allocated revenue of HK\$566,038 is recognized when the option expires (i.e. nine months after the original transaction was entered into). This may be before or after the recognition of revenue on the phase I apartment (HK\$4,433,962), depending on the facts and circumstances.

Although the standard requires a portion of the total transaction price to be allocated to a material right (if any), there is a view in practice that it is only necessary to compute an amount to be allocated to a material right if:

- a. Revenue from the goods and service that would be acquired under the right would be recognized at a different date from the rest of the contract (in example 1 the apartments in phase II will be transferred to customers six months after the apartments in phase I are transferred to customers); or
- b. The option expires at a different date from when revenue from the other

goods or services will be recognized (in example 1 the option expires after nine months); or

- c. The allocation is needed for some other purpose, for example if the option relates to a different category of goods or services, from the rest of the contract and is therefore disclosed separately from those goods or services when disclosing disaggregated revenue under HKFRS 15.114.

For example, if the customer had committed to buy the second apartment and both apartments would be transferred to the customer at the same time, then the developer would recognize total

revenue of HK\$9,000,000 for phase I and phase II apartments on the date when those two apartments are transferred. In this case, it is not necessary to compute the allocated revenue amount between the different components as the transfer of control of both apartments happens at the same time and the revenue from both apartments would be disclosed in the same category of goods and services. However, if the option in question relates to a different category of product, the developer would need to allocate the contract consideration between the sale of the apartment and the option based on their relative standalone selling prices.

Free goods or services offered to customers

It is common for developers to offer "free" goods or services, such as furnishing products or services if the customer purchases a specified apartment unit. These free goods or services may or may not be specified in the PASP. Such goods or services should be evaluated under HKFRS 15.22 to determine whether they are separate performance obligations from the provision of the apartment unit.

If the free goods or services are considered as separate performance obligations and will be provided to the customer at a different time from when revenue will be recognized on the apartment sale, then the developer needs to

estimate the standalone selling prices of the various promised goods or services, and allocate the total consideration received on a relative standalone selling price basis to these different components. This is so that an appropriate amount of revenue can be recognized as and when the various components of the PASP are transferred to the customer, similar to that illustrated above for material options.

Reimbursement of legal fees and stamp duties incurred by customers on the purchase of the apartment units

Some developers may try to attract customers by offering to reimburse the customer's legal fees and/or stamp duties,

for example, if the customer agrees to purchase the apartment unit at the list price or agrees to make early instalment payments on the list price.

Reimbursement of legal fees and stamp duties incurred by the customer for purchase of the apartment unit is a form of consideration payable by the developer to a customer under HKFRS 15. As the developer does not receive any goods or services from the customer in return, the reimbursement of such items by the developer is required to be accounted for as a reduction of the transaction price, and therefore as a reduction in the amount of revenue recognized for the sale of the apartment unit (HKFRS 15.70).

Example 3: Consideration payable to a customer

A developer enters into a pre-completion sales contract with a customer to sell an apartment unit for HK\$2,500,000 and commits to reimburse the customer's 3 percent stamp duty on the condition that the customer makes payments on the apartment unit according to schedule. In accordance with HKFRS 15.70 the developer accounts for the amount of the

stamp duty as a reduction of the transaction price and should not recognize the reimbursement of the stamp duty as an expense. Therefore when the developer transfers the apartment unit to the customer, the developer recognizes revenue of only HK\$2,425,000 (HK\$2,500,000 less HK\$75,000, which has been effectively returned to customer).

Selling costs incurred by developers**Sales commissions paid to sales staff and/or external real estate agents**

Developers will often pay an incremental commission to their sales staff or to real estate agents if a customer introduced by the sales person or agent commits to purchase an apartment. Typically, the developers will commit to pay commission to their sales persons or agents as and when a formal agreement for sale and purchase (ASP) is signed with the customer. However, they will usually defer settlement of most of the commission until the ASP is completed (i.e. until the legal title of the apartment is transferred to the customer).

Under HKFRS 15.91, an entity is

required to recognize an asset for the incremental costs to obtain a contract that management expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained. The asset recognized would then be amortized i.e. charged as an expense on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates (HKFRS 15.99). The only exception is when the amortization period would be one year or less – in this case HKFRS 15 provides a practical expedient of permitting the entity to recognize the costs as expense when incurred (HKFRS 15.94).

Currently, there is diversity in the

accounting treatment of sales commission for signing a pre-completion sales contract. Going forward, given the requirements of HKFRS 15, the developer will need to capitalize such incremental commission as an asset when it is incurred and recognize it as an expense when revenue from the pre-completion sales contract that gave rise to the commission is recognized. The only exception would be if the developer is able to take advantage of the practical expedient, i.e. the apartment unit and any other goods or services under the pre-completion sales contract are expected to be transferred to the customer within one year from the time the commission cost is incurred by the developer.



Example 4: Incremental costs of obtaining a contract

A developer enters into a contract with third party sales agents for services of getting customers to commit to buy apartments which are on sale for HK\$4,000,000 each. According to the contract terms, the developer will pay the sales agents a 3 percent commission per each signed ASP. 40 percent of the commission will be paid on the

date the ASP is signed and the remaining 60 percent of the commission will be settled when the ASP is completed. Assuming an agent secures a customer for an apartment at HK\$4,000,000 and the effects of the time value of money is immaterial, the journal entries in respect of the commission would be as follows:

	Debit	Credit
On the date when an ASP is signed by the customer:		
Asset: capitalized costs of obtaining a contract (3 percent of HK\$4,000,000)	HK\$120,000	
Cash: 40 percent of commission pay to the agent on signing		HK\$48,000
Payable: 60 percent of commission due to the agent on completion		HK\$72,000
<i>To capitalize the full amount of the commission, recognize the payment of 40 percent of sales commission to the agent and accrue for the remaining 60 percent of the amount due</i>		
On completion of the ASP:		
Payable: 60 percent of commission due to the agent	HK\$72,000	
Cash		HK\$72,000
<i>To recognize the payment of the balance of commission due to the agent</i>		
Expense: amortize capitalized costs of obtaining a contract	HK\$120,000	
Asset: capitalized costs of obtaining a contract		HK\$120,000
<i>To recognize the capitalized sales commission as an expense when the ASP is completed</i>		

On completion of the ASP, the income statement would therefore include revenue from sale of apartment of HK\$4,000,000 and an expense of the cost of obtaining

the contract of HK\$120,000 (as well as all other costs relating to this apartment which had been released from inventory).

Other selling and marketing costs
Advertising costs, fixed salaries of sales staff and showroom expenditures are examples of other selling and marketing costs that are not incremental costs to obtain a contract. This is because the developer would incur those costs regardless of whether a

sale is made. Accordingly, developers should generally expense those costs when incurred under HKFRS 15.98. This would also be consistent with the principles in paragraphs 68 to 70 of HKAS 38 *Intangible Assets* which would prohibit the recognition of such expenses as prepayments.

The only exception would be if they qualify for recognition as an asset under another HKFRS. For example, generally showroom expenditures would be expensed when incurred, as maintaining a showroom is a form of advertising overhead, no different in nature from a catalogue, website or

other promotional material that should be expensed and cannot be deferred pending the success of that marketing activity. However, in some cases a developer may fully fit out an apartment unit as a show flat and then sell that apartment unit together with the fittings at the end of the marketing period. In that case, the cost of the fit-

tings that will be sold with the apartment would qualify for inclusion in the inventory cost of the apartment.

HKFRS 15.95 also includes requirements for recognizing costs that are incurred to fulfil a contract that are not in the scope of another standard. However, as concluded in the article issued in August 2015 in the context of pre-

completion sales, for most developers, costs incurred to fulfil a contract (e.g. the costs to construct a building such as materials and labour) are already within the scope of another standard (HKAS 2 *Inventories*). Therefore, these costs continue to be accounted for in accordance with HKAS 2 and are excluded from the scope of HKFRS 15.98.

Summary

The table below summarizes the accounting treatment for the above mentioned items under HKFRS 15.

Items	HKFRS 15 paragraph reference	Accounting under HKFRS 15
The option to purchase additional goods or services <i>For example, upon purchasing an apartment unit, a voucher for a discount on future purchase of an additional apartment unit or a car park space within a specified period of time is provided to a customer.</i>	B40	If a developer determines that an option to purchase additional goods or services provides a customer with a material right, the option gives rise to a separate performance obligation. Accordingly, a portion of the total transaction price must be allocated to this option based on its relative standalone selling price and the developer recognizes revenue when the underlying goods or services under the option are transferred to the customer or the option expires.
Free goods or services offered to customers <i>For example, a developer provides furnishing products or services if the customer purchases a specified apartment unit.</i>	22	If a developer provides free goods or services as separate performance obligations, the developer should separately estimate the standalone selling prices of the promised goods or services, and allocate the total consideration received to the components on a relative standalone selling price basis.
Reimbursement of legal fees and stamp duties	70	Such reimbursements promised by developers are a form of consideration payable to a customer which should be accounted for as a reduction of revenue.
Incremental sales commissions paid to sales staff and/or external real estate agents	91	Such incremental costs are costs to obtain a contract under HKFRS 15. Unless the practical expedient applies, developers should capitalize the incremental sales commissions as an asset when the commission is incurred and should recognize the asset as an expense when revenue from the related contract with the customer is recognized.
Other selling and marketing costs <i>For example, advertising costs, fixed salaries of sales staff and showroom expenditures.</i>	98	Developers generally should recognize other selling and marketing costs as expense in profit or loss as and when incurred.

Have you started implementing HKFRS 15?

Get in touch with the Institute's Standard Setting Department (outreachhk@hkicpa.org.hk) if you have any questions on or issues with implementing HKFRS 15. Also, look out for more Institute seminars on implementing HKFRS 15, which will be released soon.



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