HKFRS 15 – How the new standard affects revenue of real estate developers if significant financing component exists?

This is the final article in a series of articles that discusses the impact of HKFRS 15 *Revenue from Contracts with Customers* on real estate developers in Hong Kong. Earlier articles in this series are:

- "How the new standard affects revenue recognition of Hong Kong real estate sales before completion" in *A Plus*' August 2015 issue; and
- "How to account for sales incentives and selling costs incurred on real estate apartment sales contracts" in *A Plus*' June issue.

This article considers whether a significant financing component exists within the different payment schedules offered by Hong Kong developers, and if so how to account for it. This assessment is part of step 3 of HKFRS 15's five-step model, to determine the transaction price of the contract (HKFRS 15.47-72). The example in this article illustrates how to calculate the adjustment of revenue in arrangements that contain a significant financing component.

HKFRS 15 does not define significant financing components but provides guidance about when a significant financing component exists in a contract. HKFRS 15.60 states "In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract."

In Hong Kong, it is common for developers to offer different payment schemes to customers. For example, customers may be offered a discount if they opt to pay the purchase price in full within 30 days of signing a formal agreement for sale and purchase (ASP), even though the apartment unit will only be completed and delivered to the customer after a year or more. Alternatively, a developer may agree to accept deferred payment for some of the purchase price, for example, if the customer is having difficulty securing a large enough mortgage. If developers consider that the payment terms of the contract provide the benefit of financing to the customer (and vice versa) and the financing effects are significant, HKFRS 15 requires developers to account for the financing component separately from revenue.

What deferred payments and payments in advance mean in substance

In the context of pre-completion sales of apartment units in a multi-storey residential building in Hong Kong, the article in *A Plus*' August 2015 issue considers that revenue on these pre-completion sales contracts will generally be recognized at a point in time under HKFRS 15.

When the timing of payments is different from the timing of revenue recognition, HKFRS 15.60 applies. This requirement applies to both deferred payments and payments in advance:

- When payments are to be made after the goods and services have been delivered to the customer, the developer may be providing the customer with financing. If so, and the financing is significant, the developer will need to recognize a portion of the cash consideration as interest income over the financing period in accordance with HKFRS 15.65. Consequently, the revenue for the goods and services recognized will be less than the cash received under the contract. Developers generally recognize interest income as other income, together with other types of incidental income, unless providing finance is one of its ordinary activities.
- In the reverse situation, when payments are made before the goods and services are delivered to the customer, the customer may be providing the developer with financing. If so, and the financing is significant, the developer will need to accrue interest expenses over the financing period in accordance with HKFRS 15.65. Consequently, the revenue recognized for the goods and services will exceed the cash received.

Developers will also need to observe the requirements under HKAS 23 *Borrowing Costs* regarding the capitalization of borrowing costs that are directly attributable to the construction of a qualifying asset.

Does a significant financing component exist?

A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract. HKFRS 15.63 nevertheless provides a practical expedient that allows developers to disregard the time value of money if the period between the transfer of the goods and services and the timing of the payment is one year or less.

Developers will need to apply judgment in determining whether a financing component within a pre-completion sales contract is significant. In doing so, HKFRS 15.61 requires developers to consider all relevant facts and circumstances, including:

a. The difference, if any, between the amount of promised consideration and the cash selling price of the goods and services; and
b. The combined effect of both of the following:
   (i) The expected length of time between when the developer will recognize the revenue from the sale of the goods or services and when the customer pays; and
   (ii) The prevailing interest rates in the relevant market.

If, however, the difference between the promised consideration and the cash selling price arises for reasons other than the provision of finance to the developer (or customer) and the difference between those amounts is proportional to the reason for the difference, that amount does not represent financing (HKFRS 15.62).

In the case of property developments, advance payments received from customers may be considered as providing a significant financing benefit to developers, depending on the facts and circumstances. For example, although developers are required by the Consent Scheme of the Lands Department in Hong Kong to place all deposits and periodic payments received from the pre-completion sales in a stakeholder account, the developer is able to benefit from those advance payments as it can withdraw money from that account to pay for expended construction costs on the project. In this case the advance payments received in effect reduce the developer's need to rely on other sources of financing for the project.

Once a financing component has been established, HKFRS 15.BC234 explains that an entity will not need to adjust the promised amount of customer consideration if the effects of the financing component will not materially change the amount of revenue at a contract level. A developer could therefore disregard the financing effects if they are insignificant at the contract level, even if the combined effects for a portfolio of similar contracts would be material to the developer's financial statements as a whole. This is because, as explained in HKFRS 15.BC234, it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

Nevertheless, HKFRS 15 does not preclude an entity from accounting for financing components that are insignificant at a contract level. This is if the entity considers it will be less burdensome to implement HKFRS 15 by accounting for the financing component across all contracts in its portfolio instead of having to apply two methods of accounting (that is, accounting for financing component to some and not to other contracts). This was discussed at the March 2015 meeting of the International Accounting Standards Board and the United States Financial Accounting Standards Board Joint Transition Resource Group for Revenue Recognition (agenda reference 30).

How to compute the significant financing component

HKFRS 15.61 states that the objective of adjusting the promised amount of consideration for the effects of a significant financing component is to reflect, in the amount of revenue recognized, the "cash selling price" of the underlying good or service at the time that the good or service is transferred.

The "cash selling price" may be estimated either by considering the alternative transactions that are being offered to customers of the same or similar goods or services; or in the case of deferred payments, by computing the present value of the nominal consideration receivable using an appropriate discount rate. In principle, these are the same concepts under HKAS 18 *Revenue* for determining the cash price when a seller offers deferred payment terms.

Therefore, even when computing the significant financing component for payments received in advance, the following approach is taken:

- The amount of the financing component is estimated at the inception of the contract. In the case of pre-completion sales of apartment units, the financing component is estimated at the time that the preliminary agreement for sale and purchase (PASP) is entered into and the payment plan is confirmed by the customer; and
- After contract inception, the discount rate is not updated for changes in interest rates or other circumstances, such as a change in credit risk (HKFRS 15.64). Instead, the effective interest rate method is used to amortize the amount of the financing component over the period of the financing. In the case of payments in advance, the period of financing would be from the time that the payment is received until the transfer of the goods or services to the customer.

When estimating the significant financing component using discounting techniques, the "appropriate discount rate" should be the rate that would be used in a separate financing transaction with the customer. That rate has to reflect the credit characteristics of the borrower in the contract (HKFRS 15.64).

Example: Calculating revenue adjustments when an arrangement contains a significant financing component

A customer decides to buy a particular apartment unit from a developer before the construction is complete. The list price of the apartment is HK$15,000,000.

The developer offers the customer a choice between two payment plans. Both plans require 10 percent of the consideration to be paid as the deposit by the time the ASP is signed. The plans vary as follows:

- Plan A: The customer only pays the remaining 90 percent of the consideration when the ASP is completed. There is no discount offered on the list price, but the customer is eligible for other sales incentives (e.g. reimbursement of legal fees and stamp duty) worth HK$339,000.
- Plan B: The customer will receive an 8 percent discount on the list price provided they agree to pay the remaining 90 percent of the purchase price within 90 days after the PASP is signed. However, they will not be eligible for any of the other sales incentives.

At the time of signing the PASP the developer estimates that the customer will be able to take possession of the apartment unit in two years' time.

The customer selects Plan B when the PASP is signed. The key dates of the transaction are as follows:

- 1 June 20X1 – PASP is signed and a deposit of 5 percent of the consideration is paid
- 4 June 20X1 – ASP is signed and another deposit of 5 percent of the consideration is paid
- 29 August 20X1 – the remaining balance of the consideration after discount (i.e. payment in advance) is paid under Plan B
- 15 April 20X3 – Certificate of Compliance is issued by the Lands Department
- 1 June 20X3 – the ASP is completed (i.e. the legal title of the apartment unit is transferred to the customer)

At contract inception the developer makes the following judgments:

- The developer estimates that the offer under Plan A provides a relevant estimate of the cash selling price of this apartment unit as the 90 percent payment will only be made when the apartment unit is transferred to the customer. After taking the sales incentives into account, the developer therefore estimates that the cash selling price of this type of apartment unit is HK$14,661,000 (HK$15,000,000 less incentives of HK$339,000).
- The developer notes that under Plan B the cash to be received from the customer (i.e. promised consideration) is HK$13,800,000 (92 percent of HK$15,000,000), which is HK$861,000 less than the estimated cash selling price of HK$14,661,000.
- The developer assesses that the period during which the developer is provided with the significant benefit of financing only starts once the developer receives the 90 percent payment from the customer under Plan B. This is because the initial deposit of 10 percent of the considerations which is payable by all customers when entering into the PASP and ASP, arises for reasons other than financing. That is, the deposit is intended to protect the developer from customers who fail to complete their obligations under the contract and the amount of the deposit is proportionate to this intended reason.

Based on this assessment and the developer's forecasts of construction activity, at contract inception the period of the significant benefit of financing is expected to be approximately 21 months long (from 29 August 20X1 to 1 June 20X3). The practical expedient under HKFRS 15 cannot be used in this case as the apartment unit will be delivered more than one year after the advance payment from the customer is received.

To calculate significant financing component, the initial deposit of 10 percent (i.e. HK$1,500,000) of the consideration should be deducted from both the estimated cash-selling price (HK$14,661,000) and the promised consideration under Plan B (HK$13,800,000) as the initial deposit is not considered as providing the benefit of financing to the developer. Therefore, the adjusted balances of the estimated cash-selling price and promised consideration under Plan B are HK$13,161,000 and HK$12,300,000 respectively, which indicates an implied discount rate of 4 percent with a total cumulative interest expense of HK$861,000. The developer evaluates that the implied discount rate of 4 percent is similar to its incremental borrowing rate and that the discount of HK$861,000 is a significant financing component under Plan B.

Interest calculation under the effective interest method

Period (21 months)	Contract liability	Interest expense at 0.33 percent (monthly rate – 4 percent/12)
Sep 20X1	HK$12,300,000	HK$41,685
Oct 20X1	HK$12,341,685	HK$41,826
Nov 20X1	HK$12,383,511	HK$41,968
Dec 20X1	HK$12,425,479	HK$42,110
Jan 20X2	HK$12,467,589	HK$42,253
	Continue for each period...	
May 20X3	HK$13,161,000	-

The following journal entries illustrate how the developer would account for the amounts arising under Plan B, including this significant financing component:

For 20X1 financial year

	Debit	Credit
1 June 20X1: inception of the contract		
Cash (HK$15,000,000 x 5 percent)	HK$750,000	
Contract liability		HK$750,000
5% down payment upon the signing of PASP		
4 June 20X1: ASP signed and payment of further deposit		
Cash (HK$15,000,000 x 5 percent)	HK$750,000	
Contract liability		HK$750,000
A further 5% payment upon the signing of ASP		
29 August 20X1: receipt of payment in advance		
Cash (HK$13,800,000 – (HK$750,000 x 2))	HK$12,300,000	
Contract liability		HK$12,300,000
Remaining payment received from customer		
31 December 20X1		
Interest expense	HK$167,589	
Contract liability		HK$167,589
Amortization of significant financing component using the effective interest method		

Costs that are incurred for the construction of the apartment unit, including the interest capitalized under HKAS 23, are recognized as an asset (for example, property under development) during the construction period and released to profit or loss when the ASP is complete. Those journal entries are not illustrated in this example.

For 20X2 financial year

	Debit	Credit
31 December 20X2		
Interest expense	HK$516,590	
Contract liability		HK$516,590
Amortization of significant financing component using the effective interest method		

For 20X3 financial year

	Debit	Credit
1 June 20X3: completion of ASP and finalization of costs of apartment unit		
Interest expense	HK$176,821	
Contract liability		HK$176,821
Amortization of significant financing component using the effective interest method		
Contract liability (HK$13,800,000 + HK$861,000)	HK$14,661,000	
Sale of apartment unit		HK$14,661,000
Revenue recognized for the transfer of the apartment unit		

Plan ahead

HKFRS 15 contains a new revenue model that will change some current accounting practices in the real estate industry. HKFRS 15 becomes effective in less than 18 months, i.e. 1 January 2018. Entities are therefore highly recommended to assess the impact of HKFRS 15 on their financial statements and decide how to transition to and implement the new standard as soon as possible.

Entities are also reminded that they should disclose the possible impact of new standards issued but not yet effective in their financial reports as required under paragraph 30 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Disclosures are expected to evolve at each reporting date as more information about the effects of HKFRS 15 becomes available.