The Impact of the New Revenue Standard on Real Estate Sales

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In May 2014, the FASB and the IASB jointly issued significantly revised standard on revenue recognition. The new standard becomes effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period with a one-year deferral for nonpublic entities. This paper examines the impact of the new revenue standard on the accounting for real estate sales transactions of U.S. companies. Issues related to buyer's initial and continuing investments, seller's participation in future profit without risk of loss, repurchase agreements, and condominium sales are examined. Examples are used to illustrate the impact of the new revenue standard on financial statements.

INTRODUCTION

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in May 2014 jointly issued significantly revised standard on revenue recognition after 12 years of joint discussions, meetings, public comments, and several proposals. The new standard becomes effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period with a one-year deferral for nonpublic entities.

The core principle of the new revenue standard [codified in the FASB Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*] is that "an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services" (ASC 606-10-05-3). To recognize revenue in accordance with that core principle, the standard indicates that an entity should apply the following five-step process:

Step 1: Identify the contract with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when or as the entity satisfies a performance obligation.

The new standard provides a single comprehensive principle-based revenue recognition model to be applied across industries and jurisdictions. It replaces the detailed and often disparate industry-specific guidance currently existed under U.S. accounting standards.

The focus of this paper is to examine the impact of the new revenue standard on the accounting for real estate sales transactions of U.S. companies. Issues related to buyer's initial and continuing investments, seller's participation in future profit without risk of loss, repurchase agreements, and condominium sales are examined. Examples are used to illustrate the impact of the new revenue standard on financial statements.

REAL ESTATE SALES

Sales of real estate to customers are accounted for under the new revenue standard in ASC 606. Customer is defined as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." (ASC 606-10-20). For sales of real estate to non-customers (that is when the real estate is not an output of the entity's ordinary activities), ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, generally applies.[1] In issuing the new revenue standard, the FASB also created ASC 610-20 to require entities to apply the guidance in ASC 606, for the derecognition of nonfinancial assets, on (a) the evaluation of the existence of a contract, (b) the measurement of the consideration of the contract, and (c) the determination of when control has transferred. For the issues discussion in this paper, the accounting treatments are practically identical for both sales to customers and sales to non-customers.

Buyer's Initial and Continuing Investments

To recognize full profit on a real estate sale under the current U.S. standard, ASC 360-20, *Property, Plant and Equipment – Real Estate Sales*, the buyer must satisfy specified minimum initial and continuing investment requirements. These adequacy requirements are intended to demonstrate the buyer's commitment to pay for the purchase. If the investment is not adequate, the sale may be recorded under the deposit method (no sale recognized), cost recovery method, installment method, or reduced profit method depending on the facts and circumstances. Over time, the method used to account for a sale transaction may move, with incremental investment from the buyer, from one to another with a portion of the profit recognized and eventually, to full profit recognition (under the full accrual method). In contrast, there are no explicit minimum initial or continuing investment requirements for the buyer under the new standard. Instead, the seller is required to evaluate whether it is probable that it will collect the consideration to which it will be entitled in exchange for the property transferred to the buyer. Assessing collectibility involves considering various factors such as the payment terms (including initial and subsequent payments), the importance of the property to the buyer's operations, the buyer's creditworthiness, prior experience with the buyer (if any), and whether the seller's receivable is subject to future subordination. These factors are to be evaluated collectively and no single factor is determinative as to whether collectibility is probable. If collectibility is probable and other conditions are met, revenue and profit are recognized when or as the control of the property transfers to the buyer. If collectibility is not probable, a sale contract does not exist, no sale is recognized, the seller will account for any consideration received as a deposit (similar to the deposit method under the current standard) and reassess each subsequent reporting period whether collectibility is probable and account for the transaction accordingly. The new standard does not permit the use of the reduced profit method, installment method, or cost recovery method.

Example 1:

Company S sells an office building with a carrying value of $1,200,000 to Company B for $2,000,000. Company B plans to use the building as its corporate office. The consideration includes a $200,000 cash down payment and an $1,800,000 non-subordinated mortgage note to Company S. The note requires Company B to make five annual payments of $211,427 based on a twenty-year amortization period and a market interest rate of 10% with a balloon payment for any remaining outstanding principal at the end of the fifth year. Company S transfers title and physical possession of the building to Company B on the closing date of the transaction and has no continuing involvement with the property.

Under the current standard, the down payment of $200,000 (10% of sales value) does not meet the minimum initial investment threshold, which is 15% for owner-occupied office building. Assuming the recovery of the cost of the property is reasonably assured if the buyer defaults, the installment method will apply. Under the installment method, the sale is recognized. However, the profit recognized is limited to the principal payment from the buyer multiplied by the ratio of total profit to the sales value. In this example, this ratio or profit margin is 40% [($2,000,000 sales value − $1,200,000 cost) / $2,000,000 sales value]. Therefore, Company S will recognize a profit of $80,000 ($200,000 down payment × 40% profit margin) at the closing date when the down payment is paid. With a deferred profit of $720,000 ($800,000 profit − $80,000 profit recognized), Company S will report a net receivable of $1,080,000 ($1,800,000 receivable − $720,000 deferred profit) on the balance sheet (see Table 1). The payment of $211,427 made at the end of the first year consists of principal payment of $31,427 and interest payment of $180,000. Company S will recognize additional profit of $12,571 ($31,427 principal payment × 40% profit margin) and interest income of $180,000. The balance of the net receivable at the end of the first year will be $1,061,144 [$1,768,573 ($1,800,000 – $31,427) remaining receivable − $707,429 ($720,000 − $12,571) remaining deferred profit]. Payments of $211,427 made at the end of the second year consists of principal payment of $34,570 and interest payment of $176,857. Company S will recognize profit of $13,828 ($34,570 principal payment × 40% profit margin) and interest income of $176,857. The balance of the net receivable at the end of the second year will be $1,040,402 [$1,734,003 ($1,800,000 – $31,427 – $34,570) remaining receivable − $693,601 ($720,000 − $12,571 – $13,828) remaining deferred profit]. At the end of the fifth year, in addition to the annual payment of $211,427, Company B will make the balloon payment of $1,608,133. Meanwhile, Company S will recognize profit of $661,658 [($46,013 principal payment + $1,608,133 balloon payment) × 40% profit margin] and interest income of $165,415.

TABLE 1
INSTALLMENT METHOD

A	B	C	D	E	F	G	H
	Cash Received	Receivable	Interest Income	Principal Received	Profit Recognized	Profit Deferred	Net Receivable
		2,000,000 $-\sum$ E	C × 10%	B − D	E × 40%	800,000 $-\sum$ F	C − G
At Closing	200,000	1,800,000		200,000	80,000	720,000	1,080,000
End of Year 1	211,427	1,768,573	180,000	31,427	12,571	707,429	1,061,144
End of Year 2	211,427	1,734,003	176,857	34,570	13,828	693,601	1,040,402
End of Year 3	211,427	1,695,976	173,400	38,027	15,211	678,390	1,017,585
End of Year 4	211,427	1,654,146	169,598	41,830	16,732	661,658	992,487
End of Year 5	211,427	1,608,133	165,415	46,013	18,405	643,253	964,880
Balloon Payment	1,608,133	0		1,608,133	643,253	0	0

If, instead, the recovery of the cost of the property is not reasonably assured in case that the buyer defaults, the cost recovery method will then apply according to the current standard. Under the cost recovery method, the sale is recognized although no profit is recognized until the cost of the property is recovered. In this case, Company S will not recognize any profit for the first four years as the total payments from Company B in the first four years of $1,045,708 ($200,000 down payment + 4 × $211,427 annual payment) is less than the cost of the property of $1,200,000. When Company B makes the final payment of $1,819,560 ($211,427 annual payment + $1,608,133 balloon payment) at the end of the fifth year, Company S will recognize $800,000 profit from the sale of the property and interest revenue of $865,268 ($1,045,708 total payments in the first four years + $1,819,560 payments in the fifth year − $2,000,000 sale price of the property). In other words, all the income from the transaction (gross profit from the sale of the property and interest revenue) is recognized in the fifth year under the cost recovery method in this example.

In contrast, under the new revenue standard, if collectibility is determined to be probable and other conditions are met, Company S will recognize the sale of the property, the $800,000 profit and a receivable of $1,800,000 on the closing date of the transaction. As payments are made by Company B, reduction of receivable will be reported and interest revenue will be recognized. If collectibility is determined to be not probable, a sale contract does not exist, no sale is recognized. No receivable is recognized nor is the property removed from the balance sheet by Company S. Instead, Company S will account for payments from Company B as deposits (a liability) and reassess each subsequent reporting period whether collectibility is probable and account for the payments accordingly. The size of the payments from Company B is only one of the factors to be considered in the continuing assessment of collectibility.

As can be seen from Example 1, Company S either recognizes all or none of the profit from the sale of the property under the new standard. In contrast, Company S could recognize all, some, or none of the profit at inception and then, in some cases, over time with incremental investments by the buyer, recognize more and more profit until all profit is recognized. Therefore, the financial impact of the new standard depends on the facts and circumstances.

Seller Participates in Future Profits without Risk of Loss

In some real estate sales transactions, the seller participates in future profits from the property without risk of loss, the contingent future profits are recognized only when they are realized under the current standard. In contrast, the new standard accounts for future profit participation as variable consideration and requires an upfront estimate at contract inception (and subsequent update at each reporting date) in the determination of transaction price (the amount of consideration to which the seller expects to be entitled). A seller will include in the transaction price its estimate of its share of future profits to the extent that it is probable a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. The seller is required to estimate variable consideration using either the expected value (the sum of probability-weighted amounts) approach or the most likely amount (the single most likely outcome) approach whichever better predicts the amount of consideration to which the seller will be entitled. The standard indicates that the most likely amount approach may be the better approach when there are only two possible outcomes such as a contract in which the seller is to receive all or none of a specified performance bonus.

Example 2:

Company Seller sells a commercial property with a carrying value of $570,000 to Company Buyer for $800,000 and a right to receive 5% of the operating profits from the property for the first year. Company Seller estimates the following future profit participation (which is 5% of the estimated operating profits from the property for the first year):

Future profit participation	Probability
$10,000	20%
$ 5,000	50%
$ 0	30%

Using the expected value approach, Company Seller estimates the variable consideration to be $4,500 [($10,000 × 20%) + ($5,000 × 50%) + ($0 × 30%)]. Assume that Company Seller determines that it is probable a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. Therefore, it includes $4,500 in the transaction price associated with the future profit participation. Company Seller will report a transaction price of $804,500 ($804,500 + $4,500) and a profit of $234,500 ($804,500 − $570,000) for the sale when the control of the property is transferred to Company Buyer (in contrast, the transaction price and profit would have been $800,000 and $230,000 respectively under the current standard when the control is transferred and additional profit, if any, is recognized when realized after one year). At each subsequent reporting date, Company Seller will update its estimation of and report (if necessary) adjustments to the transaction price until the uncertainty is resolved.

The standard provides factors that could increase the likelihood and the magnitude of a revenue reversal: (1) the amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility), (2) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, (3) the entity's experience with similar types of contracts is limited or that experience has limited predictive value, (4) the entity has a practice of changing the payment terms and conditions of similar contracts in similar circumstances, and (5) the contract has a large number and broad range of possible consideration amounts (ASC 606-10-32-12).

Repurchase Agreements

In some sales transactions, the seller has an obligation or option to repurchase the property back or the buyer has an option to force the seller to repurchase the property. In these cases, under the current standard, the transaction is accounted for as a financing, a lease, or a profit-sharing arrangement rather than as a sale (in other words, the seller is precluded from recording a sale and profit at the time of the transaction). However, no specific guidance is provided as to when to use each of the three methods.

Under the new standard, a sale transaction with a repurchase agreement is to be accounted for differently depending on the nature of the repurchase agreement. If the buyer has an option to require the seller to repurchase the property (i.e., a put option), the seller would determine whether to account for the transaction as a lease, a sale with a right of return, or a financing arrangement depending on the facts and circumstances: (A) If the repurchase price under the put option is lower than the original selling price, the seller would need to consider at contract inception whether the buyer has a significant economic incentive to exercise its option. If the buyer has such an incentive, the contract should be treated as a lease (unless the transaction involves a sale-leaseback, in which case it should be treated as a financing arrangement). If the buyer does not have such an incentive, the transaction should be accounted for as a sale with a right of return. (B) If the repurchase price under the put option is equal to or greater than the original selling price, the seller should treat the contract as a financing arrangement unless the expected fair value of the asset is greater than the repurchase price and the buyer does not have a significant economic incentive to exercise the option, in which case the transaction should be accounted for as a sale with a right of return. In contrast, if the seller has an obligation or option to repurchase a property it has sold (i.e., a forward or a call option), it should account for the sale as a financing arrangement unless the repurchase price is less than the original selling price and the transaction does not involve a sale-leaseback, in which case the transaction should be treated as a lease. It should be noted that (i) the new standard provides very specific guidance, (ii) it, under certain conditions, requires the recognition of a sale (with a right of return), which is not allowed under the current standard, and (iii) it does not allow the use of profit-sharing accounting for repurchase agreements. The financial impact of the new standard really depends on which methods the company is currently used for its repurchase agreements.

Condominium Sales

Under the current standard, if individual units in a condominium project are being sold separately and certain other conditions are met, profit is recognized using the percentage-of-completion method on the sale of individual units. When the revenue is recognized over time under the new standard, the patterns of revenue recognized by the seller/developer of condominium units could be similar to those using the percentage-of-completion method. However, condominium sales contracts generally are not structured to satisfy the criteria for revenue recognition over time [the applicable criterion for condominium sales is "the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date" (ASC 606-10-25-27)] resulting in point in time revenue recognition when control of the completed unit transfers to the buyer at closing. In other words, the seller/developer of condominium units will have to delay sale and profit recognition until closing under the new standard.

Example 3:

On January 1, 2016, Company D starts developing a condominium building and selling individual units during construction. The building consists of four units with unit selling price of \$300,000 and unit estimated cost of \$180,000. On July 1, 2016, Company D enters into a sales contract with Company Buyer to sell all four units. Company Buyer provides a 20% down-payment. The construction of the building is 50% complete by the end of 2016. Company Buyer is expected to settle all remaining consideration and take possession of the units on January 1, 2018. The construction of the building is finished on December 31, 2017. The sale of the four units to Company Buyer is closed on January 1, 2018.

Under the current standard, Company D will recognize revenue of \$600,000 (\$300,000 × 4 × 50%) and profit of \$240,000 [(\$300,000 − \$180,000) × 4 × 50%] in 2016 and revenue of \$600,000 (\$300,000 × 4 − \$600,000) and profit of \$240,000 [(\$300,000 − \$180,000) × 4 − \$240,000] in 2017. In contrast, Company D would not recognize any revenue or profit in 2016 and 2017 as the sales transaction is not yet closed until January 1, 2018. Revenue of \$1,200,000 and profit of \$480,000 would be recognized by Company D in 2018.

CONCLUSION

In May 2014, the FASB and the IASB jointly issued significantly revised standard on revenue recognition. The new standard becomes effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period with a one-year deferral for nonpublic entities. This paper examines the impact of the new revenue standard on the accounting for real estate sales transactions of U.S. companies. Issues related to buyer's initial and continuing investments, seller's participation in future profit without risk of loss, repurchase agreements, and condominium sales are examined.

ENDNOTES

1. If the real estate sold to a non-customer constitutes a business and is not an in substance nonfinancial asset, ASC 810, *Consolidation*, applies. However, common real estate sales usually do not satisfy the requirements to be accounted for under the guidance in ASC 810.

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