PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS (Q&As)

Q&A No. 2020-05 (Supersedes Q&A 2018-14)

PFRS 15 - Accounting for Cancellation of Real Estate Sales

Background

- Company X is a real estate developer and is in the business of pre-selling condominium units while construction is not yet completed.
- As allowed under Philippine Financial Reporting Standards, Company X uses the percentage-of-completion (POC) method in accounting for its real estate sales.
- In January 20x1, Company X pre-sold a condominium unit at Php1,000,000, payable for 3 years on an installment basis[1]. Under the sale contract, legal title to the unit remains with Company X until full payment is made by the buyer.
- Estimated cost to construct the unit is Php800,000.
- As at December 31, 20x1, POC of the unit is at 30% and collection from the buyer is 15% of the selling price (Php150,000). Amounts recognized in the calendar year 20x1 financial statements follow:

	Amount in Php
Real Estate Revenue (1,000,000*30%)	300,000
Cost of Real Estate Sales (800,000*30%)	240,000

In June 20x2, the buyer defaulted on its payment and Company X agrees to the cancellation of the contract and subsequently repossessed the property[2]. Under the contract, the title of the property is retained by Company X until the entire selling price is collected.

At the time of repossession, the property was 50% completed (i.e. , at that point, Company X has already recognized revenue of Php500,000 and cost of sales of Php400,000). As agreed under the contract, Company X forfeits all payments previously made by the buyer.

- Assume the following for purposes of discussion:

	Amount in Php
Receivable balance[3]	350,000
Fair value[4] of repossessed property	550,000
Repossession cost[5]	5,000

It is assumed that fair value can be measured reliably.

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[1] For simplicity, accounting for significant financing component is ignored in the discussion.
[2] Upon default of the buyer, the developer has the option to pursue collection or to repossess the property.
[3] Under PFRS 15, this includes Contract Asset (unbilled revenue) balance
[4] Fair value should be measured in accordance with PFRS 13 and in this illustration, should consider that it is uncompleted.
[5] Refer to paragraph 10 of PAS 2, Inventories

<u>Issue 1.</u> How should Company X account for the sales cancellation and repossession of the property?

<u>Consensus:</u>

Any of the three approaches below are acceptable but each approach should be applied consistently.

Approach 1: The repossessed property is recognized at its fair value less cost to repossess

- As the repossessed property will be accounted for as inventory, it will be initially measured at cost under PAS 2.9. Cost as defined under the Conceptual Framework is the fair value of the consideration given at the time of acquisition. In this case, the consideration given in exchange for the property is the Receivable from the buyer. Just before the repossession happens, the Receivable has become a right to receive the property, so the fair value of the Receivable is the fair value of what Company X has claim to (i.e., the 50%-completed property) less any cost to repossess the property.
- Just prior to repossession, Company X has to update its impairment assessment on the Receivable. For example, if the fair value of the property to be repossessed less any repossession cost is higher than the carrying amount of the Receivable, then any previously recognized impairment on the Receivable has to be reversed (with reversal limited to the unimpaired amount).
- Upon repossession, the difference between the carrying amount of the Receivable to be derecognized and the fair value of the repossessed property less repossession cost will be recognized in profit or loss.
- In the case at hand, the Receivable is unimpaired just prior to repossession because the fair value less repossession cost of the property is Php545,000 and is greater than the outstanding amount of the Receivable of Php350,000. Upon repossession, a gain on repossession of Php195,000 will be recognized (Fair value less repossession cost of Php545,000 less carrying amount of the Receivable of Php350,000). The repossession cost of Php5,000 will be capitalized as part of the cost of the repossessed property but subject to impairment.

  See illustrative entries below (excludes the effect of taxation, Maceda law and any unamortized cost of obtaining a contract):

	Debit	Credit
Inventory	545,000	
Receivable		350,000
Gain from repossession*		195,000

	Debit	Credit
Inventory	5,000	
Cash/Payable		5,000

Approach 2: The repossessed property is recognized at its fair value plus repossession cost

- As there is no specific guidance in PAS 2 on accounting for repossessed property, reference can be made to the guidance in PAS 16.24 and PAS 40.27 for property acquired in exchange for a non-monetary asset/s or a combination of monetary and non-monetary assets. Under these paragraphs, the asset received (in this case, the uncompleted property) is recognized at fair value.
- Just prior to repossession, Company X has to update its impairment assessment on the Receivable. For example, if the fair value of the property to be repossessed less any repossession cost is higher than the carrying amount of the Receivable, then any previously recognized impairment on the Receivable[3] has to be reversed (with reversal limited to the unimpaired amount).
- Upon repossession, the difference between the carrying amount of the Receivable to be derecognized and the fair value of the repossessed property[2] will be recognized in profit or loss. Any cost incurred to repossess the property will be capitalized in accordance with PAS 2.15.
- In the case at hand, the Receivable is unimpaired just prior to repossession because the fair value less repossession cost of the property is Php545,000 and is greater than the outstanding amount of the Receivable of Php350,000. Upon repossession, a gain on repossession of Php200,000 will be recognized (Fair value of Php550,000 less carrying amount of the Receivable of Php350,000). The repossession cost of Php5,000 will be capitalized as part of the cost of the repossessed property but subject to impairment.

  See illustrative entries below (excludes the effect of taxation, Maceda Law and any unamortized cost of obtaining a contract:

Inventory	550,000	
Receivable		350,000
Gain from repossession*		200,000
Inventory	5,000	
Cash/Payable		5,000

Approach 3:
The cancellation is accounted for as a modification of the contract (i.e., from non-cancellable to being cancellable). The scope has also changed because Company X will no longer construct the property for the customer. Applying the provisions of modification of a contract, Company X will have to reverse the previously recognized revenues (PFRS 15.21B) and related costs recognized. Paragraphs 20 and Par 21A of PFRS 15 do not apply since there is only one obligation in the contract and there are no remaining performance obligations at the time of the cancellation/modification.

[2] Upon default of the buyer, the developer has the option to pursue collection or to repossess the property.
[3] Under PFRS 15, this includes Contract Asset (unbilled revenue) balance

See illustrative entries below (excludes the effect of taxation, Maceda Law and any unamortized cost of obtaining a contract):

Inventory	400,000	
Receivable		350,000
Gain from repossession*		45,000
Cash/Payable		5,000

Sales	500,000	
Cost of Sales		400,000
Gain from Repossession		100,000

*All approaches above should consider payments to buyers required under the Maceda Law and the write off of any unamortized portion of cost of obtaining a contract in its determination of gain/loss from repossession.

Given the history of cancellations, real estate developers should continuously revisit whether the established level of down payment over the total contract price (equity down payment) is still the level which indicates that it is probable that it will collect the entire consideration under the contract, which is one of the criteria to be met before the revenue recognition model applies.

QUESTION 2

Would the accounting for the repossession change if the repossessed property is already 100% completed?

Consensus:

No, the state of completion of the repossessed property will not impact the accounting treatment. It is only relevant in determining the fair value of the property.

Transition and Effective Date

The consensus in this Q&A is effective from the date of approval of the FRSC and will be applied prospectively from the date of approval of FRSC.

Date approved by PIC: November 6, 2020

PIC Members

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Date approved by FRSC: **November 11, 2020**

REFERENCES

PAS 2.9
Inventories shall be measured at the lower of cost and net realizable value.

PAS 2.6
Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

PAS 2.7
Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

PAS 2.10
The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

PAS 2.11
The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

PAS 2.15
Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

Conceptual Framework 4.55
A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

1. (a) *Historical cost*. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

PAS 16.24
One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it

also applies to all exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired item is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

PAS 40.27
One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an investment property is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

PAS 18.16
If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:
(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and
(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

PFRS 13.24
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

PFRS 15.18
A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply this Standard to the existing contract until the contract modification is approved.

PFRS 15.21B
An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (ie the adjustment to revenue is made on a cumulative catch-up basis).

PFRS 15.20
An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

(a) the scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 26–30); and

(b) the price of the contract increases by an amount of consideration that reflects the entity's *stand-alone selling prices* of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the stand-alone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

PFRS 15.21
If a contract modification is not accounted for as a separate contract in accordance with paragraph 20, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (ie the remaining promised goods or services) in whichever of the following ways is applicable:

(a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 22(b)) is the sum of:

- (i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue; and
- (ii) the consideration promised as part of the contract modification.

[Refer: Basis for Conclusions paragraphs BC78, BC79 and BC81(c)
Illustrative Examples, example 5 Case B and examples 6 and 7]

(b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (ie the adjustment to revenue is made on a cumulative catch-up basis).
[Refer: Basis for Conclusions paragraphs BC80 and BC81(c) and Illustrative Examples, examples 8 and 9]

(c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

PFRS 15.B20
In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:
(a) a full or partial refund of any consideration paid;

(b) a credit that can be applied against amounts owed, or that will be owed, to the entity; and
(c) another product in exchange.

PFRS 15.B21
To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognise all of the following:
(a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned);
(b) a refund liability; and
(c) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

PFRS 15.B22
An entity's promise to stand ready to accept a returned product during the return period shall not be accounted for as a performance obligation in addition to the obligation to provide a refund.

PFRS 15.B23
An entity shall apply the requirements in paragraphs 47–72 (including the requirements for constraining estimates of variable consideration in paragraphs 56–58) to determine the amount of consideration to which the entity expects to be entitled (ie excluding the products expected to be returned). For any amounts received (or receivable[2]) for which an entity does not expect to be entitled, the entity shall not recognise revenue when it transfers products to customers but shall recognise those amounts received (or receivable[2]) as a refund liability. Subsequently, at the end of each reporting period, the entity shall update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognised.

PFRS 15.B24
An entity shall update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity shall recognise corresponding adjustments as revenue (or reductions of revenue).

PFRS 15.B25
An asset recognised for an entity's right to recover products from a customer on settling a refund liability shall initially be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity shall update the measurement of the asset arising from changes in expectations about products to be returned. An entity shall present the asset separately from the refund liability.