

Accounting Alert

Financial Reporting Standards

January 26, 2017

PIC Q&A on Sale of Residential Properties under Pre-completion Contracts

In December 2016, the Financial Reporting Standards Council (FRSC) approved the adoption of International Financial Reporting Standard (IFRS) 15, *Revenue from Contracts with Customers*, in the Philippines as Philippine Financial Reporting Standard (PFRS) 15, *Revenue from Contracts with Customers*, which will be mandatorily effective for annual reporting periods beginning on or after January 1, 2018. PFRS 15 will replace all existing revenue standards and interpretations, which include:

- Philippine Accounting Standard (PAS) 11, *Construction Contracts*
- PAS 18, *Revenue*
- Philippine Interpretations IFRIC¹ 13, *Customer Loyalty Programmes*
- IFRIC 15, *Agreements for the Construction of Real Estate*²
- Philippine Interpretations IFRIC 18, *Transfers of Assets from Customers*
- Philippine Interpretations SIC³-31, *Revenue – Barter Transactions Involving Advertising Services*

¹ Stands for International Financial Reporting Interpretations Committee, which is the interpretative body of the International Standards Board (IASB) – the entity that develops, maintains and issues IFRS.

² IFRIC 15 was not adopted in the Philippines.

³ Stands for Standing Interpretations Committee, the former interpretative body of IASB.

Relative to the approval and issuance of PFRS 15, the FRSC also approved the issuance of Philippine Interpretations Committee (PIC)⁴ Question & Answer (Q&A) No. 2016-04, *Application of PFRS 15, “Revenue from Contracts with Customers,” on Sale of Residential Properties under Pre-completion Contracts*, to provide implementation guidance, in relation to the mandatory adoption of the new revenue accounting standard in 2018, specifically on accounting for revenue from the sale of a residential property unit under pre-completion stage (i.e., construction is on-going or has not yet commenced) by a real estate developer that enters into a Contract to Sell (CTS) with a buyer—whether the sale meet the criteria for revenue recognition over time. The Q&A, however, does not deal with the accounting for other aspects of real estate sales such as variable considerations, financing components, commissions and other contract costs, timing of sales of completed properties, etc.

PIC Consensus and Basis of Consensus

Under PFRS 15, an entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Paragraph 35 of PFRS 15 provides three criteria, where only one needs to be met, before an entity can recognize revenue over time since in these cases, the entity transfers control of a good or service over time and, therefore, satisfies a performance obligation over time. The following are the criteria:

- (a) the customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs;
- (b) the entity’s performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or,
- (c) 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.

The first criterion was assessed to be not relevant in determining whether revenue from sale of residential property under pre-completion stage is recognized over time since the buyers generally do not consume all of the benefits of the property as the developer constructs the property. Those benefits will be consumed when the property is completed. The second criterion considers whether the customer controls the asset as it is created. However, based on the normal terms of a CTS, it is assessed that the buyer cannot be able to control the property under development as the buyer cannot make changes to it nor direct its use. Hence, the second criterion was not met.

⁴ The principal objective of the PIC is to issue implementation guidance on PAS, PFRS and related Interpretations (collectively referred as PFRS) adopted by the FRSC from accounting pronouncements issued by the IASB. PIC implementation guidance, as approved by FRSC, shall be considered part of PFRS to which it relates. Accordingly, compliance with the PIC implementation guidance is required for the fair presentation of financial statements in accordance with PFRS.

In assessing the third criterion, the developer shall consider whether:

- (i) the developer's performance does not create an asset with an alternative use to the entity; and,
- (ii) the entity has an enforceable right to payment for performance completed to date.

Developer's Performance Does Not Create an Asset with an Alternative Use

The PIC assessed that the promised property under the CTS does not have an alternative use to the developer based on the guidance of paragraphs 36⁵ and B6⁶ of PFRS 15. The promised property is specifically identified in the CTS by its plot, lot and parcel number and its attributes (such as its size and location). The buyer could enforce its rights to the promised property if the developer seeks to sell the unit to another buyer. This contractual restriction on the developer's ability to direct the promised property for another use is considered substantive as the property is not interchangeable with other properties that the entity could transfer to the buyer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

Developer Has an Enforceable Right to Payment for Performance Completed to Date

In deciding whether the developer has an enforceable right to payment for performance completed to date, paragraphs 37⁷ and B11⁸ of PFRS 15 should be considered. The developer should also consider the rights and obligations of the buyer under the CTS and under the Philippines laws. In accordance with the provisions of the CTS, the buyer is contractually obliged to make payments to the developer according to the payment schedule.

⁵ Paragraph 36 of PFRS 15 states, “An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception.”

⁶ Paragraph B6 of PFRS 15 clarifies that “In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.”

⁷ Paragraph 37 of PFRS 15 states, “An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.”

⁸ Paragraph B11 of PFRS 15 states, “In some contracts, a customer may have a right to terminate the contract only at specified time during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligation in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).”

On the other hand, the buyer is protected and has rights under the following laws:

- Republic Act No. 6552, *An Act to Provide Protection to Buyers of Real Estate on Installment* (also known as, the “Realty Installment Buyer Act” or the “Maceda Law”); and,
- Presidential Decree (PD) No. 957, July 12, 1976, *Regulating the Sale of Subdivision Lots and Condominiums, Providing Penalties for Violations Thereof* (also known as, “The Subdivision and Condominium Buyers’ Protective Decree”)

PD 957 provides the buyer with the right to terminate the CTS only if the developer fails to develop the property in accordance with the approved plans and within the approved time limit. However, the buyer does not have the unilateral right to terminate the CTS.

Similarly, the developer does not have the unilateral right under the CTS to terminate the CTS except in the event of default by the buyer.

The Maceda Law also provides protective rights to the buyer in the case of defaults in payments, among them are settlement of unpaid installments due without additional interest within a certain grace period and the right to refund installments payments made. However, before the buyer could invoke its rights to refund under the Maceda Law, the following conditions must be met: (1) the buyer has paid at least 2 years of installments; and, (2) there should be a notarized notice of cancellation issued by the developer.

The Maceda Law further provides that in case where less than two years of installments were paid, the seller shall give the buyer a grace period to settle the installment due. If the buyer fails to pay the installments due at the expiration of the grace period, the seller may cancel the contract after 30 days from receipt by the buyer of the notice of cancellation or demand for rescission of the contract by a notarial act.

Whether default happens before or after the buyer has paid two years of installments, the seller has to issue a notice of cancellation for the CTS to be cancelled. Without the cancellation by the seller, the CTS is considered valid and binding, and the developer may continue to fulfill its performance (i.e., complete construction) and require exact performance from the buyer (i.e., pay the consideration agreed in the CTS).

The Real Estate Industry Group⁹ has obtained legal opinion confirming the position that the Maceda Law cannot be enforced unless the developer agrees to a cancellation, and that without such consent, the developer can continue to fulfill its obligation and take legal action against the buyer for specific performance.

⁹ Comprised of: Subdivision and Housing Developers Association (SHDA), Asia-Pacific Real Estate Association (APREA), Chamber of Real Estate and Builders’ Association (CREBA), Organization of Socialized Housing Developers of the Philippines Inc. (OSHDP), and National Real Estate Association (NREA)

The PIC noted that the developer's past business practices of terminating the CTS in the event of default by the buyer do not affect the developer's contractual right to continue to perform the contract and be entitled to all of the promised consideration.

On the basis of the said legal opinion, notwithstanding that the developer could terminate the CTS, the developer has a right to payment for performance completed to date because the developer could choose to complete the construction of the property and enforce its rights to full payment under the CTS. The fact that the developer may choose to terminate the CTS in the event the buyer defaults on its obligations would not affect the assessment as the developer's rights to require the buyer to continue to perform as required under the CTS are enforceable and the developer is entitled to all of the promised consideration when construction is completed. Hence, criterion on whether the developer has an enforceable right to payment for performance completed to date is met.

Overall, based on the foregoing, the PIC concluded that the sales of residential properties under pre-completion stage meet the third criterion under paragraph 35(c) of PFRS 15; and therefore, revenue therefrom shall be recognized over time.

Transition and Effective Date

The consensus in the Q&A is effective on the same date as the effective date of PFRS 15.

Copy of the PIC Q&A No. 2016-04

Refer to the file attached below for the copy of the PIC Q&A No. 2016-04, including its attachments.



**Q&A No.
2016-04.pdf**



**Q&A No.
2016-04_Appendix A**



**Q&A No.
2016-04_Appendix A**



**Q&A No.
2016-04_Appendix A**

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