Position Paper on the IFRS Interpretations Committee Staff Paper [Agenda Paper 4, November 2018] – Over time transfer of constructed good (IAS 23)

THE ISSUE

This paper has been prepared to present our view as an industry, to the discussion about the capitalisation of borrowing costs in relation to the construction of a residential multi-unit real estate development (building), particularly within the Philippine context.

The fact pattern described in the Agenda Paper 4, as follows:

(a) a real estate developer (entity) constructs a residential multi-unit real estate development (building) and sells the individual units in the building to customers;

(b) the entity borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection with that borrowing;

(c) before construction begins, the entity signs contracts with customers for the sale of some of the units in the building (sold units);

(d) the entity markets for sale the remaining units (unsold units). Accordingly, the entity intends to enter into contracts with customers for the unsold units as soon as it finds suitable customers; and

(e) the terms, and relevant facts and circumstances of the contracts with customers are such that, applying paragraph 35(c) of IFRS 15, the entity transfers control of each unit over time and therefore, recognises revenue over time. The consideration promised by the customer in the contract is in the form of cash or another financial asset.

The request asks whether an entity has a qualifying asset as defined in IAS 23 and, therefore, capitalises any directly attributable borrowing costs.

THE TENTATIVE DECISION

The IFRS Interpretations Committee has tentatively decided that the entity in the said fact pattern does not have a qualifying asset and, accordingly does not capitalise borrowing costs in relation to the construction of the building. Particularly, as follows:

a. any receivable that the entity recognises is not a qualifying asset. Paragraph 7 of IAS 23 specifies that financial assets are not qualifying assets.

b. any contract asset that the entity recognises is not a qualifying asset. The contract asset (as defined in Appendix A to IFRS 15) would represent the entity's right to consideration that is conditioned on something other than the passage of time in exchange for transferring control of a unit. The intended use of the contract asset—to collect cash or another financial asset—is not a use for which it necessarily takes a substantial period of time to get ready.

c. any inventory (work-in-progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition—i.e. the entity intends to sell the partially-constructed units as soon as it finds suitable customers and, on signing a contract with a customer, transfers control of any work-in-progress relating to that unit to the customer.

It concludes further that the unsold units are ready for their intended sale in their current condition and would not necessarily take a substantial period of time to get ready for such sale.

OUR VIEW

In our view, real estate inventory or work in progress development, **both sold and unsold residential units** should be treated as a qualifying asset.

The situation (or economic background) which gives rise to the arguments herein are analogous, but may not be exactly identical to the fact patter in the Agenda Paper 4.

The arguments for consideration are as follows:

A. Recognizing immediately as an expense the borrowing costs of real estate developers relating to work in progress development does not give a faithful representation of the cost of the real estate asset. Going back to the Basis for Conclusions of IAS 23, it states:

BC 9:

"During the period when an asset is under development, the expenditures for the resources used must be financed. Financing has a cost. The cost of the asset should include all costs necessarily incurred to get the asset ready for its intended use or sale, including the cost incurred in financing the expenditures as a part of the asset's acquisition cost…"

If we can add one important fact to the discussion, it is that in real estate development, the borrowing cost of the expenditure during construction is incurred by the developer, not by the buyer. There is no duplication of borrowing cost capitalisation since the buyer can only borrow against the unit once the project is completed, not during construction of the condominium unit. Even if the work in progress development is sold in the legal sense of the word, the real estate asset is not physically complete for whatever purpose (use, sale or lease) in its current condition and will need substantial cost to complete it (pre-selling model). Such expenditures, if financed through debt, will incur borrowing cost. Thus, a more faithful representation is to include the borrowing cost as acquisition cost of the real estate property.

The BC 9 mentioned above clearly suggests that the cost of an asset is *incurred until* the asset is ready for its intended use or sale. If we exclude pre-selling model for real estate development as qualifying asset, or cease the capitalisation based on the execution of a legal document for its sale, it would ignore the true nature of the transaction, i.e. the substantial and necessary expenditures including borrowing cost before, during and especially after the supposed sale (pre-selling model), and the continuing obligation of the developer to deliver a fully completed unit, which is ultimately a dwelling or habitable place for the buyer or his/her tenant, including the amenities thereon, and not merely selling a conceptual design on paper.

Pre-selling model happens when a real estate developer, after securing appropriate regulatory requirements, starts to market the residential units while construction is still in progress.

The precursor standard - SFAS No. 34, specifically mentioned real estate development in paragraph 9b, interestingly as an example to qualifying assets intended for sale or lease. It takes physical, technical and administrative activities to make an asset ready for its intended use or sale (IAS 23.19 and IAS 23.23). If all that was done was to draft a contract while substantial cost is yet to be incurred, then clearly the asset lacks readiness for its intended purpose, whether it is for own use, sale or lease. We have to look at it as a complete transaction, what makes sense (for a commercial transaction) to both the buyer and the seller.

IAS 23.23

"An asset is normally ready for its intended use or sale <u>when the physical construction of the asset is complete</u> even though routine administrative work might still continue…"

B. Including the cost of borrowing as necessary cost of acquiring a real estate asset (pre-selling model) would enhance comparability among real estate entities. Consider the following situations:

1) Entity A does pre-selling activity before construction begins. Entity B markets the units when construction work in progress is at 20%. Entity C markets the units when construction work in progress is nearing completion (c.75%).

Following the conclusion of the Committee, these entities will have different treatment of borrowing cost related to the construction of the real estate development. Entity A should recognize it as outright expense, Entity B probably needs to consider the period of time in reaching the 20% completion, so it may or may not be allowed to capitalise. Entity C probably can capitalise its borrowing cost. But looking deeper, all of the entities are similarly situated, they incur borrowing cost to finance the construction of the real estate development that they are pre-selling. The buyer of any of these units will not accept anything less than full completion and delivery of those units. Not at 0%, 20% or even 75%. The construction work is not affected by the timing of pre-selling work. In fact, those three situations could happen in a single entity i.e. it allocates some units for sale at the start, then allocate other units for sale at a certain stage or time as part of its marketing and pricing strategy, and hold on to a number of remaining units for a future decision to sell or even to lease depending on market conditions.

It is the expenditures for the materials, labor, and other resources used in creating the real estate asset and the borrowing cost incurred that is central to the issue of capitalisation, and not the stage of pre-selling work, as it varies depending on many factors such as market conditions, marketing strategy, regulatory requirements and more.

Furthermore, it is only logical to assume that the pricing schemes of the residential units under construction (0%, 20%, or 75% stage) would take into account the total borrowing costs incurred by the developer during the development phase. Thus, to enhance comparability among real estate entities in the same jurisdiction, irrespective of pre-selling activity, capitalisation of borrowing cost should be allowed.

2) Entity A initially designates a real estate asset in progress for its own use. But when the asset was completed, Entity A decided to maximize the cash flow potential of the real estate asset at the time that it will be for sale immediately. While Entity B initially designates its real estate asset for pre-selling work at an early stage. Failing to close a sale until it was finally completed, Entity B reassessed that given prevailing market conditions, the best use of the asset was for leasing.

Under the Tentative Agenda Decision, Entity A would be allowed to capitalise the borrowing cost until the asset is completed, regardless whether its purpose has changed at completion. While Entity B is required to expense the borrowing cost during construction as it is pre-selling at an early stage, irrespective of the subsequent change in the use of the asset. A case of two assets, both incurs borrowing cost to finance its construction but are treated differently. They are treated opposite to the actual use or value of the assets.

3) Entity A starts pre-selling activity before construction begins, and has sold all the units to a single buyer. Nearing the completion of the project, the buyer's credit standing deteriorated, and he defaulted on the remaining payments. The seller resorted to cancellation of the sale after charging penalties and surcharges. Entity A repossessed the real estate asset and is now contemplating on selling it again to another party. While Entity B starts pre-selling activity after a substantial period of time for construction (c50%), and sold the units to multiple buyers with different credit conditions.

Using the Tentative Agenda Decision, Entity A should recognize the related borrowing cost as expense even though in the end it still controls the asset, while Entity B can capitalise borrowing cost during construction even though it no longer has control in the end. But looking closely at the situation of both parties, they are actually more similar than what their initial pre-selling transactions suggest. If Entity A proceeds with the sale to the second buyer, the selling happened after a substantial period of time, same as Entity B. If Entity A doesn't sell, then it will own a real estate asset under construction that it plans to sell in the foreseeable future.

Regardless of the timing of the pre-selling activity, borrowing cost is continuously incurred by the real estate developer as necessary cost to finance the long-term construction of the asset. Capitalisation should only stop when the real estate asset is ready for its intended use or sale. A sale in this context, we believe, requires that substantially all the activities would have been completed, not just the act of selling and executing legal documents performed by the seller.

C. Allowing the capitalisation of borrowing cost is still consistent with over time revenue recognition for the sale of residential real estate units. It enhances the matching of revenue and costs incurred during construction which includes borrowing cost.

On the premise that the acquisition cost of acquiring an asset shall include all necessary costs incurred to bring it to the condition and location necessary for its intended use (own use, sale or lease), the borrowing cost incurred to finance expenditures during construction period is itself a part of the asset's acquisition cost.

Recognizing revenue over time demands matching of the directly attributable cost when such cost contributes to an entity's progress in satisfying the performance obligation. We submit that information is not faithfully represented in expensing immediately borrowing cost, when an entity intends to sell those units at the start of construction but takes some time for the sale transaction to actually happen. In this case, using the Tentative Agenda Decision, it is required to report borrowing cost as expense (pre-selling model) when the revenue flows have not occurred yet, leading to a mismatch of revenue and expense recognition.

Rationally, the expenditures during construction are incurred including borrowing cost because the entity expects that the economic benefit coming from the sale of the real estate asset will yield at least equal or greater than the sum of the costs that will have to be incurred to construct it. Otherwise, the entity presumably would not construct the asset. Therefore, we believe that the informational value of inventory historical cost as an indicator of an asset's cash flow potential is a good reason for capitalising borrowing cost.

As defined in paragraph 5 of IAS 23, "**a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale".**

Further, paragraph 17 sets out the conditions when an entity shall begin capitalising borrowing cost:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

The Committee has come out with an opinion that on signing a contract with a customer using revenue recognition over time, the entity would not have an inventory asset for the unit and thus would not have a qualifying asset.

We respectfully disagree. For real estate development (pre-selling model), it takes a substantial period of time to complete the asset, irrespective of when the pre-selling contract was executed. Developers incur construction expenditures, which result to real estate inventory. In financing the expenditures, it incurs borrowing cost throughout construction which is a necessary cost of real estate inventory. This is a separate and distinct activity from revenue recognition over time, which creates the receivable or contract asset. This is evidenced by the fact that the units are not marketed at the same time and that when there are cancellations, unsold units, and collection threshold in revenue recognition, the real estate asset is reported in the books of the developers.

Furthermore, for a pre-selling model, revenue recognition over time is not anchored on paragraph 35A of IFRS 15 because the benefits will be consumed in the future only when the inventory or property is completed. Most real estate developers are using paragraph 35C of IFRS 15 as basis for over time revenue recognition. Therefore, there is no inconsistency when we talk about over time revenue recognition and substantial period of time for a qualifying asset since the developers build the real estate inventory over time in which it incurs borrowing cost for the expenditures, and using paragraph 35C, a receivable or contract asset is created after real estate inventory is created. It is the justifiable reason behind the enforceable right to payment for performance completed to date. When beneficial interest over the real estate inventory is transferred over time, then revenue is allowed to be recognized over time. The cost of constructing real estate inventory consists of all necessary costs including borrowing costs.

This reasoning is very apparent for unsold units, since the real estate asset remains with the developer. However, it is equally valid for sold units as expenditures are first incurred for the construction of the inventory, and then using paragraph 35C of IFRS 15, it is derecognized over time resulting to a real estate receivable over time. Furthermore, not allowing capitalisation of borrowing cost for the sold units (pre-selling model), would result to a distortion of the commercial substance since borrowing cost related to construction expenditures is part of the necessary costs for both sold and unsold units. However, for the sold units, the capitalised borrowing cost is also derecognized over time as inventory becomes the cost of real estate sales.

D. A real estate inventory work in progress is still a qualifying asset depending on what constitutes a completed real estate sale under the laws and jurisprudence of each jurisdiction. Hence, if this is one of the main criteria to meet the definition of a qualifying asset as well as for cessation of capitalisation of borrowing costs, then it is more prudent to leave to the local interpretations body to address this issue of capitalisation of borrowing costs for real estate development.

THE PETITION

Based on the above considerations, it is hereby requested that the Tentative Agenda Decision be revisited to continue capitalising borrowing cost for real estate developers during construction period under jurisdictions such as the Philippines that allow pre-selling activities but still requires the seller to develop the real estate property in accordance with the approved plans and within the approved time limit.

Position Paper of the following Real Estate associations in the Philippines:

- Asia Pacific Real Estate Association
- National Real Estate Association
- Organization of Socialized and Economic Housing Developers of the Philippines
- Subdivision & Housing Developers Association
- Chamber of Real Estate and Builder’s Association