

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

Q&A No. 2006-01

PAS 18, Appendix, paragraph 9—Revenue recognition for sales of property units under pre-completion contracts

Background

The Appendix to PAS 18, *Revenue*, provides examples of the application of the Standard in the sale of goods and rendering of services. The examples generally assume that the amount of revenue can be measured reliably, it is probable that the economic benefits will flow to the entity and the costs incurred or to be incurred can be measured reliably.

On the examples provided on the sale of goods, the Appendix states that the law in different countries may determine the point in time at which the entity transfers the significant risks and rewards of ownership and that the examples in the Appendix need to be read in the context of the laws relating to the sale of goods in the country in which the transaction takes place.

Paragraph 9 in the Appendix to PAS 18 which provides guidance on revenue recognition on real estate sales, states that:

“Revenue is normally recognized when legal title passes to the buyer. However, in some jurisdictions the **equitable interest in a property may vest in the buyer before legal title passes** and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, **if the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognised as the acts are performed.** An example is a building or other facility on which construction has not been completed.” (emphasis added)

In the Philippines, a real estate company or developer may begin selling units before the completion of a real estate project (for example, a condominium project) or even before construction commences provided it is licensed by the House and Land Use Regulatory Board (HLURB)¹. The HLURB requires, among other things, the approval of the plan and specifications of the project and completion of the project within a year or such other period as may fixed by the Board.

Property units may be purchased on cash or on installment, usually made over the construction period. A contract to sell is executed when a buyer has paid the required minimum down payment, e.g., about 20% of the purchase price. The buyer may issue postdated checks or obtain financing for the unpaid amount. Title to the unit is transferred to the buyer upon full payment. Default by a buyer on scheduled payments would result in penalties, cancellation and rescission of the contract and forfeiture of amounts paid. A buyer may get a refund of a certain portion of the amounts paid depending on the number of payments made.

Issue 1: Does equitable interest vest in the buyer of a property unit before a condominium building is complete and before legal title passes?

¹ As prescribed under Presidential Decree (PD) 957, known as the *Condominium and Subdivision Buyers' Protective Decree*

Consensus

Equitable interest is defined as an interest held by virtue of an equitable title or claimed on equitable grounds, such as the interest held by a trust beneficiary.²

In the Philippines, equitable interest may vest in the buyer before a condominium building is complete and before legal title passes since the concept of equitable interest is recognized in PD 957³. PD 957 requires that, for the protection of the rights and interest of buyers under a contract to sell, such contract should be registered by the seller with the Register of Deeds of the province or city where the property is situated, whether or not the purchase price is paid in full.⁴ The developer may not mortgage the property without the prior written approval of the HLURB and, if approved, the mortgage loan shall be used for the development of the project.

The concept of equitable interest is also recognized by laws on registration of property⁵, the Civil Code (Republic Act No. 386), and various decisions of the Supreme Court on contracts to sell executed between a developer of a condominium project and a buyer of a unit in such projects. Under banking laws⁶, the buyer of a property unit in a condominium project, is allowed to avail of a loan secured by such property.

Issue 2: What conditions must be met in order that revenue is recognized as the acts are performed?

Consensus

Since local laws recognize that equitable interest in a property may vest in a buyer before legal title passes, revenue is recognized as the acts are performed for sales of property units under pre-completion contracts (referred to in practice as the percentage of completion method). Revenue is recognized under this method when all the following conditions are met:

- (a) equitable interest is transferred to the buyer,
- (b) the seller is obliged to perform significant acts,

The significant acts that must be performed by the seller are not specified in the Appendix to PAS 18. For purposes of accounting for sale of property units, construction, however, must be beyond the preliminary stage, i.e., engineering, design work, construction contract execution, site clearance and preparation, excavation and the building foundation are finished.

- (c) the amount of revenue can be measured reliably,

² Black's Law Dictionary, 7th edition, page 816.

³ See footnote 1.

⁴ PD 957 requires that such contract, whether or not the purchase price is paid in full, be registered by the seller in the Register of Deeds. The real estate company may not mortgage the property without the prior written approval of the HLURB and, if approved, the mortgage loan shall be used for the development of the project.

⁵ PD 1529, the Property Registration Decree, codifies laws relating to the registration of property. The Philippines adheres to the Torrens system of land registration whereby the rights acquired by the registrant are guaranteed by the government for which purpose there is an assurance which a registrant can draw upon for damages.

⁶ Under the Manual of Regulations for Banks, a buyer is allowed to avail of a loan secured by such property provided that the loan shall not exceed 70% of the appraised value of the real estate security, thereby implicitly recognizing the buyer's equity therein.

(d) the costs incurred or to be incurred can be measured reliably, and

With respect to items (c) and (d), consideration is given to sales volume, trends of unit prices, demand for the units, developer's experience and ability to complete the project, geographical location and environmental factors.

(e) it is probable that the economic benefits will flow to the entity

It is probable that economic benefits will flow to the entity when the sales prices are collectible. In accounting for sales of real estate, collectibility of the sales price is demonstrated by the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. It is presumed that initial and continuing investments by the buyer of about 20% would demonstrate the buyer's commitment to pay. Collectibility is also assessed by considering factors such as the credit standing of the buyer, age and location of the property.

Although the sale of property units under pre-completion contracts is not within the scope of PAS 11, *Construction Contracts*, the method of determining the stage of completion and revenue recognition as provided in that Standard may be referred to for guidance in determining revenue as the acts are performed. For sales of property units under pre-completion contracts, however, the revenue recognized is based only on units sold.

Effective Date

The consensus in these Q&As are effective from December 18, 2006, the date of approval by the FRSC.

NOTE: The discussion in paragraph 9 in the Appendix to PAS 18, *Revenue*, is currently under discussion by IFRIC. The consensus in the above Q&As may change when IFRIC issues an Interpretation that may amend paragraph 9 in the Appendix to PAS 18.

Date approved by PIC: November 7, 2006

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