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Understanding Revenue Recognition

Get ready for new accounting rules for commercial-property revenues.

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The Financial Accounting Standards Board recently changed revenue-recognition standards, introducing many new aspects for those in the commercial real estate industry that took effect in 2018 for public companies. In 2019, these new aspects will take effect for private companies. The new standards outline five steps to recognizing revenue:

- **1.** Identify the contract(s).
- **2.** Identify the performance obligations in the contract.
- **3.** Determine the transaction price.
- **4.** Allocate the transaction price to the performance obligations in the contract.
- **5.** Recognize revenue when (or as) the entity satisfies a performance obligation.

In addition, the new standards require significantly expanded disclosures about revenue recognition pertaining to construction and leasing activity. Some of the new disclosures will include disaggregation of reported revenue and information about a company's specific performance obligations. In addition, significant judgments used to determine revenues will need to be explained, particularly those regarding the timing of satisfaction of performance obligations, the determination of transaction price, and if applicable, how the transaction price is allocated to the performance obligations.

To comply with the disclosure requirements under the new standards, entities may have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems.

One nuance of the new standards will be the analysis on the legal enforceability of the arrangements for the purpose of determining revenue recognition. The new standards include an example describing three cases in which a real estate developer enters into a contract to sell a specified condominium unit once construction is complete. The developer receives an up-front nonrefundable deposit. In addition, the contract legally obligates the developer to complete construction of the asset and to transfer the specified unit to the customer.

In Case A, the developer does not have an enforceable right to payment for the performance completed to date; in Cases B and C, the developer has such a right. While the developer may determine that its performance under the contract creates an asset that does not have an alternative use for the developer (i.e., the developer cannot use or sell the asset to anyone else), the analysis focuses on whether the developer has an enforceable right to payment for its performance to date. The example indicates that the developer should consider the legal precedent in the particular jurisdiction to determine whether the rights and obligations under the contract are enforceable. If the developer determines that its rights and obligations are legally enforceable, the entity would recognize revenue over time.

Alternatively, the developer would be required to recognize revenue at the point in time at which control of the specified unit is transferred to the customer. This guidance may delay the recognition of revenue for developers of multifamily condominium complexes.

The new principles-based approach to revenue recognition for the sale of real estate is largely based on the transfer of control. As a result, more transactions may likely qualify as sales of real estate, and revenue (i.e., gain on sale) will be recognized sooner than it is now. Specifically, the new standards eliminate the requirements for assessing (1) the adequacy of a buyer's initial and continuing investments and (2) the seller's continuing involvement with the property. When evaluating whether it can derecognize real estate under the new standard, an entity will need to assess whether it is "probable" that it will collect the consideration to which it will be entitled. In addition, rather than preventin de-recognition, a seller's post-sale involvement with the disposed asset may need to be accounted for as a separate performance obligation.

At this point, entities should have already started examining the standards and assessing the impact it may have on their current accounting policies, procedures, systems, and processes. Consider this opportunity as a chance to seiz value from the required chang by translating compliance into operational improvements.

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