Revenue Recognition:  
Effects of the Proposed Model on Real Estate Transactions  
May 5, 2010

PURPOSE OF THIS MEETING

1. The purpose of this meeting is to discuss the potential effects of the proposed model on the accounting for real estate transactions and to seek the Board’s view on the potential withdrawal of gain recognition guidance for real estate contracts if real estate is not an output of the entity’s ordinary activities.

EXISTING STANDARDS AND CURRENT PRACTICE

2. The guidance on real estate sales in Subtopic 360-20 of the FASB Accounting Standards Codification™ provides guidance for recognizing profit on all real estate transactions regardless of the nature of the seller’s business. Because the proposed revenue model would affect only an entity that enters into contracts to provide goods or services representing an output of the entity’s ordinary activities, there could be two models for similar real estate transactions.

3. Subtopic 360-20 specifies that profit is recognized in full when the real estate is sold if both of the following criteria are met:
   a. The profit is determinable; that is, collectibility is reasonably assured or the uncollectable amount can be estimated.
   b. The earnings process is virtually complete and the seller is not obligated to perform significant activities after the sale to earn profit.

Recognition of all or part of the profit should be deferred if both conditions are not met.
4. Subtopic 360-20 prescribes detailed rules requiring a specified amount of initial investment from the buyer for the seller to conclude collectibility is reasonably assured. If collectibility is not reasonably assured, full profit recognition is precluded and the entity must follow the deposit, installment, cost recovery, or reduced profit methods.

5. With respect to the criterion that the earning process be virtually complete, the transaction cannot be considered a sale if the seller has continuing involvement; in those circumstances, the seller would account for the transaction as a financing, leasing, or profit sharing arrangement.

Existing IFRS on Real Estate Transactions

6. Under IFRS, IAS 18, *Revenue*, and IAS 11, *Construction Contracts*, are the primary sources of guidance on accounting for the sale of real estate that is in the course of an entity’s ordinary activities. IFRIC 15, *Agreements for the Construction of Real Estate*, addresses whether real estate contracts that include construction activities are within the scope of IAS 18 or IAS 11. IAS 40, *Investment Property*, specifies that an entity should apply the criteria in IAS 18 for the sale of goods to determine the date of disposal of an investment property achieved by a sale. Additionally, IAS 40 and IAS 16, *Property, Plant and Equipment*, refer to IAS 18 to determine the timing of gain recognition.

POTENTIAL EFFECTS OF THE PROPOSED MODEL

Collectibility Is Reasonably Assured

7. Current guidance requires an entity to assess the risk of collectibility in determining if revenue should be recognized rather than the amount of revenue that should be recognized. Under the proposed model, an entity would adjust the transaction price to reflect the customer’s credit risk. When an entity satisfies a performance obligation, the entity would recognize revenue in the amount of consideration the entity expects to collect—that is, the probability weighted expected amount. The effects of subsequent changes in the assessment of credit risk are recognized as other income or expense. Both Boards support the measurement approach because it is consistent with the fundamental
premise that revenue recognition should reflect an entity’s performance of transferring goods and services to its customer in a contract.

**Continuing Involvement**

8. Continuing involvement in the context of current real estate guidance is much more prescriptive compared to the meaning of the term *continuing involvement* outside the context of real estate. Some of the indicators of continuing involvement in current real estate guidance do not relate to an evaluation of transfer of the asset; rather, they relate to other aspects of the proposed model such as determining whether a contract exists, identifying performance obligations, or determining the transaction price.

9. Under the current real estate guidance, an entity is required to evaluate the nature of continuing involvement to determine whether it is a financing, leasing, or profit sharing transaction. The staff thinks that on withdrawal of this guidance, the entity would need to apply judgment in determining the appropriate accounting model. The staff thinks that the entity would need to consider the following guidance, for example:

   a. Guidance on product financing arrangements in Subtopic 470-40 to evaluate transactions involving a seller’s obligation to repurchase the property at a price greater than the initial sale

   b. Guidance on leases in Topic 840 to evaluate transactions involving an obligation to repurchase the property at a price lower than the initial sale price

   c. Guidance on variable consideration principle under the proposed revenue model for transactions involving seller guarantees

   d. Guidance on identifying separate performance obligations under the proposed revenue model for transactions involving property management services, support operations, or development contracts

   e. Guidance on identifying the contract under the proposed revenue model for evaluation of commercial substance of the transaction and determining when parties to the transaction are committed to satisfying their respective performance obligations

   f. Guidance on consolidation in Topic 810 to evaluate involving intra-entity transactions or those in which the buyer is not independent of the seller.
The Potential Withdrawal of Gain Recognition Guidance for Real Estate Contracts

10. The Board has the following alternatives to address accounting for an entity when the sale of real estate is not an output of the entity’s ordinary activities:

   a. **Alternative A:** Amend Subtopic 360-20 so that it would apply only when an entity sells real estate that is not an output of the entity’s ordinary activities. Sales of real estate that are part of the entity’s ordinary activities would be accounted for in accordance with the proposed revenue model.

   b. **Alternative B:** Require that an entity apply the proposed revenue model for the sale of real estate. If real estate is part of an entity’s ordinary activities, the entity would recognize revenue in accordance with the proposed model. Otherwise, an entity would recognize gains when applying the proposed revenue model.

   c. **Alternative C:** If the sale of real estate is not part of an entity’s ordinary activities, then the entity would account for the real estate in accordance with the guidance on subsequent measurement of property, plant, and equipment in Section 360-10-35. The entity would derecognize the real estate when the buyer obtains control of the real estate and would recognize a gain for the fair value of the consideration in excess of the carrying amount of the real estate.

**Staff Recommendation**

11. The staff recommends the following for the Board’s consideration:

   a. If the sale of real estate is part of an entity’s ordinary activities, the entity would apply the proposed revenue model to account for the sale of real estate.

   b. If the sale of real estate is not part of an entity’s ordinary activities, the entity would:

      1. Account for the real estate (that is, before it is transferred to the buyer) in accordance with the guidance in Section 360-10-35.

      2. Derecognize the real estate when the buyer obtains control of the real estate (in accordance with the guidance on control in the proposed revenue model).

      3. Recognize a gain at the date of transfer to the extent that the fair value of the consideration received exceeds the carrying amount of the real estate.

**Question 1 for the Board**

Does the Board agree with the staff’s recommendation?
Purpose

1. The purpose of this meeting is to discuss the boundary of an insurance contract. The contract boundary determines which future cash flows are included in the measurement of the insurance contract.

Previous Recommendations and Decisions (IASB)

2. The chart below provides the staff recommendation included in Agenda paper 11A/44A and the IASB’s resulting decision from that meeting.

<table>
<thead>
<tr>
<th>Staff Recommendation- April 2010 Board Meeting</th>
<th>IASB Decision- April 2010 Board Meeting</th>
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<tbody>
<tr>
<td>The contract boundary is defined as including all cash flows arising under the contract as a result of events occurring during the period ending on the earlier of:</td>
<td>The boundary of an insurance contract is the point at which the insurer either is no longer required to provide coverage or has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.</td>
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<tr>
<td>• The contract coverage period (as extended by any renewal options available to the policyholder) and</td>
<td></td>
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<tr>
<td>• The point at which the insurer</td>
<td></td>
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has an unrestricted ability to cancel or re-underwrite and re-price coverage of the individual contract. For this purpose, restrictions would be ignored if they have no commercial substance (i.e., no discernible effect on the economics of the contract).

Background

The contract boundary issue

3. When measuring a contract liability using the model proposed in this project, the insurer includes the expected (that is, unbiased, probability-weighted average) present value of all future cash flows expected to arise as the insurer fulfills the obligation, including:

(a) Premiums
(b) Benefit and claim payments
(c) The effect of contract options and guarantees on the cash flows in (a) and (b)
(d) Policyholder dividends. (The FASB decided tentatively to recognize policyholder dividends when the entity has an obligation to make the payments.)

4. The contract boundary distinguishes between those premiums (and resulting benefits and claims) that arise from existing contracts (included in the measurement of an insurance contract) and those that arise from future contracts (not included in the measurement).
Previous Board discussions

5. In January 2010, the Boards tentatively decided that policyholder options (such as renewal options), as well as other options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a look-through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract).

6. In May 2009, the IASB tentatively decided the boundary between existing and new contracts is the point at which the insurer can cancel the contract or change the pricing or other terms.

Proposal based on re-underwriting and re-pricing constraints

7. As mentioned above, in May 2009, the IASB tentatively defined the contract boundary as the point at which the insurer can cancel the contract or change the pricing or other terms. In developing that conclusion further, the staff considered more specific proposals received from two external organizations and sought feedback on those proposals as part of its targeted field testing.

Proposals received from external bodies

International Association of Insurance Supervisors (IAIS) proposal

8. The IAIS suggested the following principle to determine which cash flows should be taken into account when measuring an insurance contract:
The relevant cash flows are bounded by the earlier of the following, if they exist:

- The contractual termination date as extended by any unilateral option available to the policyholder, or
- The insurer having a unilateral right to cancel or freely re-underwrite the policy, or
- Both the insurer and policyholder being jointly involved in making a bilateral decision regarding continuation of the policy.

**Industry groups**

9. The insurance industry groups suggested the following principle:

| The boundary of a given contract is defined by the cash inflows that are expected to fall within the contract’s term. For those purposes, the term of a contract is the shorter of the contract’s life and the point, if any, at which the policy can be freely re-priced by the insurer at the individual policyholder level (that is, up until the point at which the insurer has the ability both to reassess the risk profile of the individual policyholder and change the price for an individual without contractual constraint). |

**Staff Analysis**

**IASB Decision- April 2010**

10. The staff generally agrees with the decision made by the IASB at its April 2010 Board meeting. However, the staff believes that the language agreed to by the IASB should be more specific as to what price increases could be included in the existing contract without re-underwriting. Below are three possible examples where an entity would be allowed to re-price an insurance contract, without re-underwriting, with the resulting cash flows considered as part of the existing contract. To be considered part of the existing contract, the following examples must be specified in the original contract.
(a) Contractual re-pricing determined by an index (for example, adjusted for CPI).

(b) Certain portfolio-wide adjustments (for example, increases in historical cost of claims)

(c) Contractual discretionary adjustment with a specified maximum per year (for example, 3 percent per year).

Reasonable contractual re-pricing based on an index (for example, adjusted for CPI)

11. The staff believes that the ability to re-price a contract determined by an index without a reassessment of the individual policyholder’s risk profile would be considered part of the existing contract. The change in pricing is a result of a change in a specified index and not that of the entity that issued the contract. In addition, the insurance contract has provided the policyholder with something of value (that is, continuing insurance coverage without the need to undergo re-underwriting).

Reasonable portfolio-wide adjustments (for example, increases in historical cost of a claim)

12. Some contracts allow price changes for an entire class of insureds without re-underwriting. An example would be an increase in loss experience. Based upon the loss information of a class of insureds, an entity may increase the price for that entire class. The staff believes that if the contract does not permit the insurer to assess the risk profile of an individual, but rather the class as a whole, the resulting price change would be considered in the existing contract.

Contractual discretionary adjustment with a specified maximum per year (for example, 3 percent per year)

13. The staff believes that a contractual discretionary adjustment with a specified maximum per year would be considered in the cash flows of the existing contract because the existing contract constrains the insurer’s ability to increase prices. The staff believes that the specified maximum should be a reasonable amount to limit
the discretion of the entity when changing prices. As discussed in the April 2010 Board memos, the maximum price change should be limited to ensure that it will have no commercial substance on the contract (that is, no discernible effect on the economics of the contract).

Unit of account

14. The contract boundary principle recommended by the staff applies to an individual insurance contract for the following reasons:

(a) The project is dealing with rights and obligations that arise at the individual contract level (they do not change when assembled into portfolios)

(b) Re-underwriting and re-pricing (key components of the principle) occur at an individual contract level.

Staff recommendation and question for the Board

15. The staff recommends the following:

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