

PRS-PA-1: Introduction to Audits of Real Estate Entities

INTRODUCTION

The real estate industry generally centers around investment in real estate projects (e.g., land or buildings) in the following categories:

Residential Real Estate

- Apartment projects
- Townhomes
- Condominiums
- Single-family homes

Commercial Real Estate

- Office buildings and condominiums
- Warehouse and manufacturing facilities
- Convenience stores
- Restaurants
- Strip and neighborhood shopping centers and shopping malls

Multi-use Real Estate Developments

- Combined commercial and residential projects

ACCOUNTING STANDARDS FOR REAL ESTATE TRANSACTIONS OR THE REAL ESTATE INDUSTRY

The following FASB Codification Topics and Subtopics contain guidance that deals exclusively with real estate transactions or the real estate industry:

- *FASB ASC 310-10, Receivables—Overall* ([link](#)) . This Subtopic provides guidance to lenders on accounting for real estate acquisition, development, and construction (ADC) arrangements.
- *FASB ASC 360-20, Property, Plant, and Equipment—Real Estate Sales* ([link](#)) . This Subtopic provides accounting guidance for the sale of real estate other than retail land sales. The Subtopic prescribes criteria that must be met before a sale of real estate other than retail land sales can be accounted for under the full accrual method and the different criteria and profit recognition methods that apply if the full accrual method is not applicable.
- *FASB ASC 410-30, Asset Retirement and Environmental Obligations—Environmental Obligations* ([link](#)) . This Subtopic provides the guidelines for recognizing, measuring, displaying, and disclosing environmental remediation liabilities.
- *FASB ASC 470-30, Debt—Participating Mortgage Loans* ([link](#)) . This Subtopic establishes how borrowers should account for a participating mortgage loan when lenders participate in the operating results of the real estate project, appreciation of the project's market value, or both.
- *FASB ASC 840, Leases* . This broad transaction Topic provides specific guidance on accounting for leases involving real estate, including sale-leaseback transactions and sales-type leases of real estate.
- *FASB ASC 970, Real Estate—General* ([link](#)) . This Topic provides the guidance for (a) capitalizing costs that are associated with acquiring, developing, constructing, selling, and renting real estate projects and (b) allocating capitalized costs and costs that are not capitalized to individual components of a real estate project. This Topic also includes guidance on accounting for investments in real estate ventures in the form of corporate joint ventures, general and limited partnerships, and undivided interests.
- *FASB ASC 970-605, Real Estate—General—Revenue Recognition* ([link](#)) . This Subtopic provides guidance for recognizing income from real estate syndication activities. The Subtopic also discusses

determining the sales value of property and fee income, accounting for nonrefundable fees, exposure to losses, allocating cash payments, and recognizing partnership interests. Although real estate syndicates are generally organized as limited partnerships, trusts, or joint ventures, they are typically publicly held.

- *FASB ASC 972, Real Estate—Common Interest Realty Associations* ([link](#)) . This Topic provides accounting guidance for common interest realty associations (CIRAs), which include condominium associations, homeowners' associations, cooperative housing corporations, and timeshare developments.
- *FASB ASC 974, Real Estate—Real Estate Investment Trusts* ([link](#)) . This Topic applies to real estate investment trusts (REITs) and other entities making loans on or investments in real estate. REITs are generally required to have at least 100 owners and are usually publicly held.
- *FASB ASC 976, Real Estate—Retail Land Sales* ([link](#)) . This Topic provides accounting guidance for retail land sales. It includes the profit recognition methods available to retail land sales.
- *FASB ASC 978, Real Estate—Time-sharing Activities* ([link](#)) . This Topic provides accounting guidance for real estate time-sharing transactions, including determining sales value and selling costs, assessing the buyer's commitment, and accounting for uncollectible receivables.

Other Reporting Frameworks

Due to the complexities often encountered in accounting for real estate project costs and revenue recognition, financial statement preparers may use a special purpose framework (often referred to as an other comprehensive bases of accounting, or OCBOA) to prepare financial statements. If a special purpose framework is used, it is typically the income tax basis.

In addition to special purpose frameworks, non-public companies in the U.S. are allowed to use International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board (IASB) to prepare general use financial statements. One of the differences between U.S. GAAP and IFRS relates to the option of reporting real estate held for use on a fair value basis, with changes in fair value reported through owners' equity. Companies that are having difficulties meeting loan covenants that involve owners' equity (net worth) might consider this option. However, preparers must ensure that lenders will accept IFRS-based financial statements.

WHAT IS THE SCOPE OF PPC'S PRACTICE AIDS FOR AUDITS OF REAL ESTATE ENTITIES?

These *Practice Aids* cover audits of nonpublic entities engaged in developing, managing, and owning real estate projects for their own use or for sale to others. That includes audits of real estate operators, real estate developers, and retail land sales developers. Retail land sales are sales on a volume basis of lots that are subdivisions of large tracts of land. The sales are characterized by very small down payments and a sales contract or buyer's note for the balance of the purchase price. Retail land sales are covered by [FASB ASC 976](#) .

As a general rule, if a real estate entity is developing land or constructing a building on its own property for its own use or for sale to others, the project is considered to be a real estate project, is accounted for under the requirements of [FASB ASC 360-20](#) and [FASB ASC 970](#) , and is covered by these *Practice Aids*.

Real Estate Entities Not Covered by These *Practice Aids*

These *Practice Aids* do not cover land development or construction activities taking place on property that is not owned by the real estate entity being audited. Those activities are subject to the accounting guidance in *FASB ASC 910, Contractors—Construction* ([link](#)) , and *FASB ASC 605-35, Revenue Recognition; Construction-Type and Production-Type Contracts* ([link](#)) , rather than the real estate accounting literature. *PPC's Guide to Construction Contractors* provides guidance on accounting for building costs under the requirements for construction contractors and practice aids for auditing those entities.

In addition, these *Practice Aids* do not cover the procedures necessary to perform an audit of the following real estate entities or activities:

- *Public Real Estate Entities*. Since real estate syndicates and REITs are typically publically held, they are not covered by these *Practice Aids*.
- *CIRAs*. *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* provides practice aids and guidance when auditing CIRAs.
- *HUD-assisted Multifamily Entities*. *PPC's Guide to HUD Audits* provides practice aids and guidance when auditing HUD-assisted multifamily entities.

- *Time-sharing Activities.* *PPC's Guide to Real Estate* provides guidance on accounting for time-sharing activities.
- Real estate entities involved in the hospitality industry, such as hotels.

What about Homebuilders? Homebuilders have many of the characteristics of construction contractors. However, they differ from construction contractors in that they ordinarily build on their own land. Their operations typically consist of the following activities:

- 1) Building homes under a contract with the customer—
 - a) on lots owned by the customer, or
 - b) on lots owned by the homebuilder; and
- 2) Building on a speculative basis, that is, without a sales contract.

If the home is built on a lot owned by the homebuilder, title typically does not pass until closing ([FASB ASC 970-360-55-4](#)). Therefore, the authoritative literature governing real estate applies both to building under contract and to speculative building, and audits of those homebuilders are covered by these *Practice Aids*. Alternatively, if the homebuilder enters into a contract to build on a lot owned by the customer, the authors believe that the homebuilder is functioning as a construction contractor and construction revenue recognition guidance would govern accounting for the contract. *PPC's Guide to Construction Contractors* provides the guidance and practice aids for auditing those activities.

Exclusion of Certain Audit Procedures

These *Practice Aids* do not cover the following procedures:

- Initial audit procedures.
- Internal audit procedures.

Auditors can refer to the initial audit programs in *PPC's Guide to Audits of Nonpublic Companies* (ASB) if they need further guidance and can modify those practice aids as necessary. [Section 907 of ASB](#) provides special considerations for an initial audit.

These *Practice Aids* do not address the procedures required when the real estate entity has an internal audit function. (The authors believe that situation would be rare.) SAS No. 128, *Using the Work of Internal Auditors* requires procedures to be performed *regardless* of whether the external auditor will use the work of the internal audit function to obtain audit evidence or the internal auditors will be used to provide direct assistance. Auditors can refer to the practice aids in *PPC's Guide to Audits of Nonpublic Companies* if they need further guidance and can modify those practice aids as necessary. [Section 904 of ASB](#) provides guidance when the entity has an internal audit function.