



Land Development Accounting Manual

Version: 1.0

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1. Introduction

Defence Housing Australia (“DHA”) is a Government Business Enterprise established in 1988 with its primary role to provide housing and related services to Defence members and their families in accordance with the *Defence Housing Australia Act 1987* (“DHA Act”) and supply agreements with the Department of Defence (“Defence”). With effect from 1 July 2014 DHA reports under the *Public Governance, Performance and Accountability (Financial Reporting) Rule 2015* (“PGPA”) and continues to comply with the Australian Accounting Standards (“AAS”) and interpretations issued by the Australian Accounting Standards Board (“AASB”).

This manual covers guidance for accounting policy issues for land development activities.

2. Classifying a Project

DHA is active through-out Australia in residential housing and investment markets, in its role to supply housing to Australian Defence Force members and their families as required by the Department of Defence (“Defence”). To fulfil its role DHA is involved in development, construction, acquisition and leasing programs. DHA will buy and construct properties with assistance from the private sector and purchase new and established properties as required. Further, capital to meet provisioning commitments is generated by selling and leasing back selected properties, selling land and excess property from major developments and disposing of surplus and non-compliant properties.

Projects can be typically grouped into the following categories:

- Land purchased and titled into lots for property development and on sale outright or sale and lease back to the public/third party
- Acquired or constructed properties for Defence provisioning
- Development of major greenfield sites and the construction of medium to high density dwellings
- Other land development activities undertaken on behalf of Defence or third party (e.g. local council)
- Investment properties (e.g. commercial sites) generating rental income
- Land sites / properties held for indefinite period and undetermined future use
- Sale of land
- Projects with dual purpose – i.e. part of development site to be disposed to public and part retained for investment purposes.

For accounting purposes projects should be classified into the following three classifications:

- Inventory (see AASB 102: ‘Inventories’)
- Investment properties (see AASB 140: ‘Investment Properties’)
- Property, plant and equipment (see AASB 116: ‘Property, Plant and Equipment’)

DHA must determine whether the project or part thereof should be classified as inventory, investment property or property, plant and equipment in accordance with Australian Accounting Standards (“AAS”). The classification is important as it drives the associated accounting treatment. Incorrect classification could prevent users of the financial statements from understanding the nature of projects and may result in misstatements in the financial statements due to inappropriate measurement and disclosures.

Inventory is typically those projects that DHA holds to sell to the public and/or lease back during ordinary business operations in the short to medium term.¹ During the early stages of a project often the longer-term use of the site is not yet determined or committed. As such, DHA’s policy is in the first instance, unless there is evidence to the contrary, to assume that the project will be sold in the ordinary course of business and therefore classify as inventory. If a decision has been made that the project or a significant part thereof (see note 2 of Project Classification Decision tree on page 6) will

¹ AASB 102 *Inventories* paragraph 6

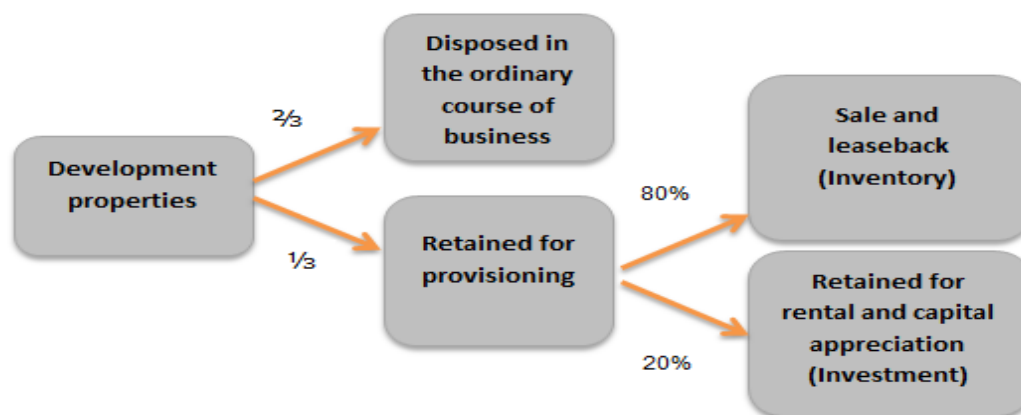
be held to generate rental income and / or capital appreciation then it is classified as investment property.² In the rare case where a decision is made that a project or part thereof will be used in the production or supply of goods or services or for administrative purposes then it is to be classified as property, plant and equipment.³ Given classification as property, plant and equipment would be rare for a DHA land development project this has not been considered further in this manual

As the project evolves and if the use of the development site changes (e.g. will no longer be held for sale, but will now be developed and property leased to earn rental income), then the classification will be changed from inventory to investment property or vice versa depending on the evidence supporting the change in use. Each quarter DHA finance team and project accountants together review a sample of projects to check that there has been no evidence of a change in the intention of use requiring a classification change. A comprehensive review of all existing projects is performed at each financial statement reporting date.

Sometimes the use of a project can change in a relatively short-time frame. For example, the first 6 months of a project may commence with a commercial property generating rental income. Subsequently, this property will be redeveloped, sold to the public and leased back by DHA. As the use as a commercial property is less than a reporting period and the intention is to develop and sell the property in the short-term as part of ordinary business operations, DHA takes a practical approach and classifies the entire project as inventory. Any rent received during the 6 month period is included in other income as it does not represent a reduction in the cost of inventory.

Where the 6 month period crosses over a year end reporting period or the commercial property is significant in dollar value (e.g. rental income > 5% of year-to-date DHA revenue), then further assessment is required as to whether the project should be first classified as an investment property and DHA may seek expert technical advice.

Based on past history the composition of DHA's development projects tends to be illustrated as follows:



² AASB 140 *Investment Properties* paragraph 5

³ AASB 116 *Property, Plant and Equipment* paragraph 6

Example Classification of Project:

Example: Classification of property leased prior to sale.

DHA is engaged in developing and constructing for sale residential properties consisting of several units. DHA hopes to make a profit in the short term from the development and the construction of property rather than in the long term from general price increases in the property market. The sale of property following the construction is therefore in the ordinary course of DHA's business.

When construction is complete and DHA is waiting for prospective buyers, it leases the property units at market rates to earn revenues partly to cover expenses, such as interest, management fees, real estate taxes, and repairs.

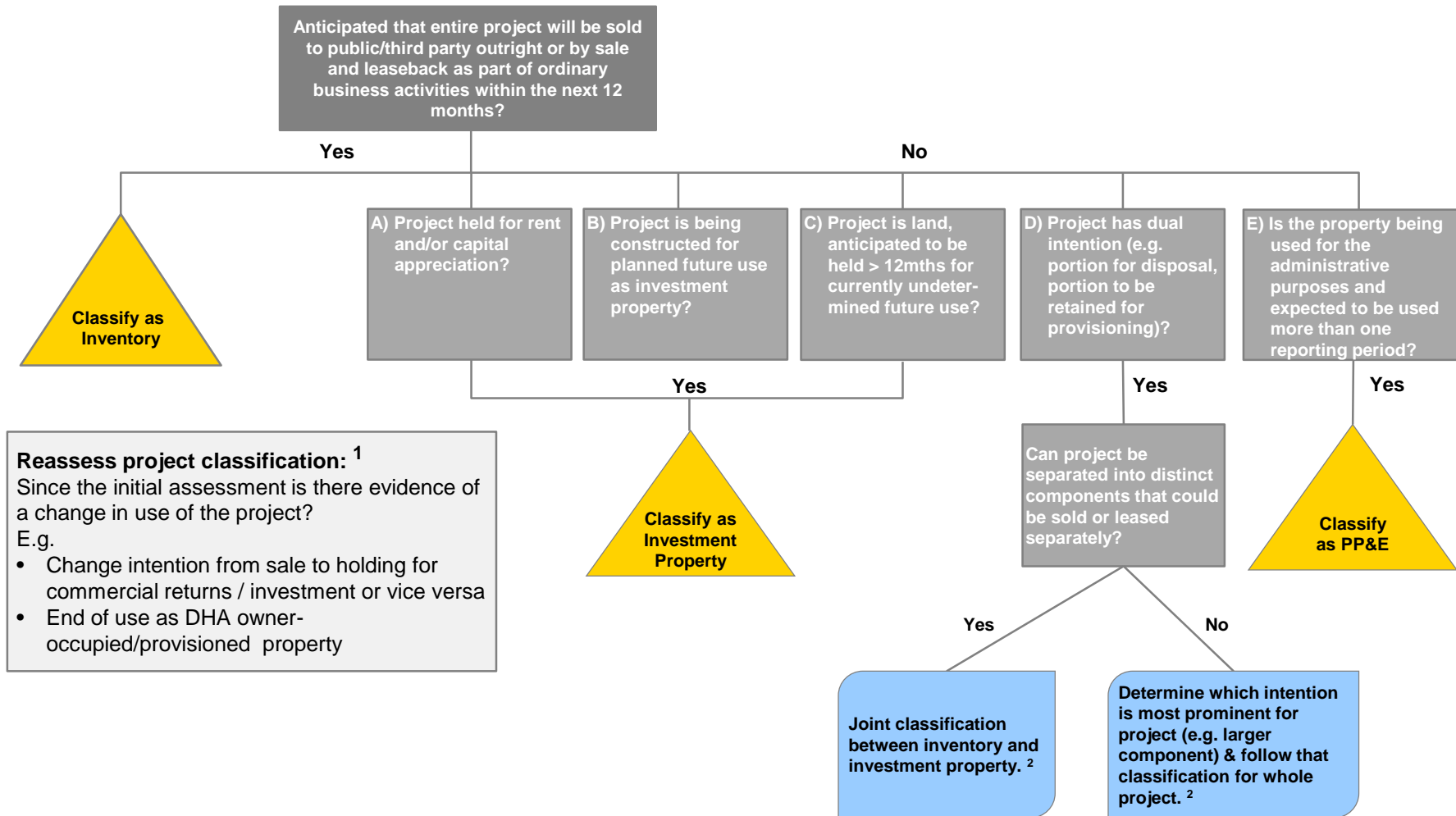
Analysis

Because it is in DHA's ordinary course of business to hold property for short-term sale rather than for long-term capital appreciation, the entire project (including the leased units) is accounted for and presented as inventory, as long as it remains the intention to sell the property in the short term. The rent received is included in other income and does not represent a reduction in the cost of inventory.

If the circumstances change such that DHA decides that it will be more profitable to continue to hold the property for rental instead of short-term sale, AASB 140 *Investment Property* would require that the property to be transferred from inventories to investment properties.

The decision tree below illustrates the process DHA follows to classify projects between inventory and investment property.

Project Classification – Decision Tree



¹ The classification assessment is made at the beginning of the project, however it needs to be reassessed through-out the project life and at least at each reporting date to confirm that there is no evidence of a change in use for the project that would trigger a reclassification between inventory, investment property or PP&E classes.

² Technical advice may need to be sought to assist with componentising the project correctly between inventory and investment property. Further, if it is not possible to separate the components assistance may be required to determine the significant component. Some key considerations that may be used to determine the significant components is the percentage of return from sale, rental or capital appreciation (calculated based on square meters compared to total area of the property or costs compared to total project costs)

3. Measurement of Inventory

Inventories are separated into the following categories:

- a. Completed properties – completed properties held for resale on normal trading cycle;
- b. Land held for future development; or
- c. Work in progress – incomplete construction projects.

DHA considers finished products to be inventory land lots (including superlots) that are available for sale and completed inventory dwellings which are available for sale or held strategically as investment properties. The inventory stock is then sold over time (via disposal or Sale and Lease Back) to realise a benefit and / or manage liquidity.

This Chapter covers the measurement of inventory in accordance with AASB 102 *Inventories* and provides guidance on initial and subsequent measurement in particular the types of project costs that can be capitalised on the balance sheet and the method of allocation of these project costs.

3.1 Initial Measurement

Consistent with AAS, DHA's policy is to initially recognise inventory projects at cost.

The cost is to include all costs of purchase, costs of conversion and other costs necessarily incurred to have the development site in a condition ready for sale.

A development project can be typically classified within 3 phases:

- Phase 1 – Concept Development and Feasibility Study (Financial and Economic Business Case)
- Phase 2 – Project Delivery (Approval Obtained)
- Phase 3 – Post Construction and Sale of the property

As a general rule, costs incurred during Phase 2 if directly related to the project can be capitalised on the balance sheet and costs incurred in Phases 1 and 3 are expensed immediately to the income statement.

Costs that are clearly associated with the acquisition, development, and construction of a project should be capitalised as project costs. Direct costs include costs such as the cost of land acquisition, building materials, or project plans. Indirect project costs should be capitalised if they clearly relate to the specific project or several different projects (all of which qualify for capitalisation) under development. Indirect project costs that are clearly related to a construction may include construction administration costs (e.g., costs associated with a field office at a project site), legal fees, and various other costs (e.g., cost accounting and design).

Indirect costs that do not clearly relate to the acquisition, development, or construction of a real estate project, including most general and administrative costs, should be charged to expense as incurred.

It may often be difficult to distinguish between indirect project costs that should be capitalised and general and administrative costs that should be charged to expense. In general, there is a presumption that shared costs should not be capitalised unless they are incremental to development. (i.e., the costs would not have been incurred in the absence of the project or projects under development). Some further practical considerations for determining whether a cost may be directly attributable are:

- Was the cost forecast or expected in the budget;
- Is the cost ad-hoc or one off or is it usually incurred in developments of a similar nature and likely to be incurred in all similar developments; and
- Would a reasonable person or customer expect the product to have required that cost when they pay for it.

Example: Project Costs

DHA incurs the following costs in relation to a construction project during Phase 2.

Directly attributable project costs

Cost of land acquisition
Building materials
Cost of project plans

Indirect project costs

Construction administration costs (costs associated with a field office at a project site)
Legal fees
Other costs (cost accounting and design)
Proportion of Project Manager's salary
Project Manager's flights and accommodation to visit and inspect site progress

Indirect other costs

Electricity costs of the DHA head office
Internet rental fee of the DHA head office
Project Manager's Administrative Assistant's salary

Costs that are clearly associated with the acquisition, development and construction of a real estate asset are capitalised as project costs.

However, the costs that do not relate to the project such as general administration costs (indirect other costs) are not capitalised unless they can be proven to be incremental to the development (i.e. the costs would not have been incurred in the absence of the project or projects under development).

In some instances, DHA may obtain approval and secure the opportunity to develop a site but actual activity may not occur for a period of time. Once approval has been obtained and the intention is set this triggers the recognition of a development project (Phase 3) upon which costs directly related to the site can be capitalised. It does not matter if there is a time lag in the process as long as the intention to develop and sell/lease back the project does not change.

The cost matrix to follow provides guidance on treatment of potential cost items during a typical DHA project.

PHASE	Description	Potential Costs	ACCOUNTING TREATMENT ¹
Phase 1.1 – Concept Development	The potential land site or property has been identified and preliminary investigations are being performed to understand its feasibility	<ul style="list-style-type: none"> ▪ Staff Costs of Project Team ▪ Travel costs to view site ▪ Research activities 	Expense
Phase 1.2 - Feasibility Study (Financial and Economic Business Case)	The site is being investigated for feasibility, pre-acquisition costs: <ul style="list-style-type: none"> - Project feasibility study and cost benefit Analysis. - Discussions held with local council - Preliminary investigations into tenders and likely contractors 	<ul style="list-style-type: none"> ▪ Staff Costs of Project Team ▪ Consultant costs ▪ Travel Costs of Project Team ² ▪ Tender Costs ▪ Legal Fees and other Due Diligence Fees 	Expense
Phase 2.1 - Approval Obtained. Early Design Phase	Approval has been obtained and the project is likely to deliver future economic benefits to DHA. Costs directly attributable to construction of the property that will be sold outright or sold/leased back can now be capitalised. <ul style="list-style-type: none"> - DA Submission may have been made - The project is put to tender - Consultants are contracted to begin design work for the project 	<ul style="list-style-type: none"> ▪ Staff Costs of Project Team ▪ Consultant Costs - e.g. architectural/ engineer/design consultant costs ▪ Travel Costs of Project Team ² ▪ Legal Fees and other Due Diligence Fees ▪ Tender Costs 	Capitalise
		<ul style="list-style-type: none"> ▪ Administrative staff costs or other 'back-office' costs which cannot be directly attributable to the project 	Expense
Phase 2.2 – Construction	The project has gone to tender and awarded to a contractor. <ul style="list-style-type: none"> - Pre-construction activities such as acquisition of land, demolition of existing buildings (if applicable) and relocation of staff to the construction site. - Tender awarded - Construction has begun on the project and milestone payments are made to the contractor - Some fixed assets are acquired and attributed to the property - A sales office is constructed 	<ul style="list-style-type: none"> ▪ Acquisition of Land ▪ Demolition of existing buildings ▪ Costs to convert into single land lots or dwellings ▪ Legal Fees and other Due Diligence Fees ▪ Stamp Duty and other Acquisition Taxes/Fees ▪ Earth Works ▪ Civil Works ▪ Public Works ▪ Ancillary Works ▪ Milestone Construction payments ▪ Construction/ Maintenance of Sales Office ▪ Staff Costs of Project Team ▪ Insurance Costs ▪ Tender Costs ▪ Relocation costs ³ ▪ Travel costs of Project Team ² 	Capitalise
		<ul style="list-style-type: none"> ▪ Administrative staff costs or other 'back-office' costs which cannot be directly attributable to the project 	Expense

PHASE	Description	Potential Costs	ACCOUNTING TREATMENT ¹
Phase 2.3 - Fit Out	Construction of the property has been completed and is being finalised for sale: <ul style="list-style-type: none"> - Tender for a contract for fit-out - Purchase and Installation of fit-out items 	<ul style="list-style-type: none"> ▪ Consultant Costs - e.g. interior design consultant ▪ Tender costs ▪ Staff Costs of Project Team ▪ Fit-Out Costs ▪ Travel costs of Project Team ² ▪ Insurance Costs 	Capitalise
		<ul style="list-style-type: none"> ▪ Administrative staff costs or other 'back-office' costs which cannot be directly attributable to the project 	Expense
Phase 3 - Post Construction and Sale of the property	The property has been completed and is ready to be sold or sold/leased back: <ul style="list-style-type: none"> - Costs associated with removal/relocation/clean-up of the property - Minor costs associated with getting the property ready for sale - Costs associated with the advertisement and sale of the property 	<ul style="list-style-type: none"> ▪ Payment towards body corporate costs ⁴ ▪ Bushland regeneration and make-good costs (exit/close-out costs) ⁵ 	Capitalise
		<ul style="list-style-type: none"> ▪ Costs associated with the sale such as advertising, valuation, commission, legal fees, signage and other marketing 	Expense

Notes:

1. Once a cost has been expensed, it cannot be reinstated as a capital item on the balance sheet (e.g. feasibility costs expensed).
2. Travel costs – where these are incurred for a specific project that is committed to proceed and provide a future benefit to DHA – e.g. travel by a project manager to a site to inspect its building progress and status against council requirements, the costs are capitalised.
3. The project may involve the construction of new housing and upgrades to existing dwellings. Current tenants in existing dwellings may be relocated to a different property site while the construction is being performed. These costs are a necessary part of undertaking the construction activity and as such, DHA capitalises these costs into total project cost WIP on the balance sheet.
4. In some situations, as part of the completion of the property, DHA is required to contribute towards the body corporate strata fund. Once the project is complete these costs may be refunded. DHA elects to capitalise these costs as they directly relate to the project. Any refund reduces the amount capitalised.
5. Exit/close out costs – DHA may be required to perform additional activities at council request to finalise the development project, but subsequent to all dwellings being completed. For example, bushland regeneration and construction of a basin for the site. These costs continue to be capitalised if they were a condition of being permitted to construct and sell the properties. This includes project management costs incurred specifically relating to performing these activities on the site. This may result in a possible provision depending on the information available at the time. Refer to the chapter on provisions for further information.

3.2 Cost Capitalisation - Practical Examples

1. Costs must be specific

Example: Capitalised costs not directly identifiable with a specific property

Following approval of the project (Phase 3), DHA is committed to constructing a building to be sold or sale and leaseback purposes to third parties in NSW. Management is currently evaluating three potential sites and believes it is probable that one of these sites will be acquired. However, no one site is more likely to be acquired than any of the others. DHA has incurred \$50,000 in costs to establish local construction contacts and research zoning and building codes.

Analysis:

Although DHA believes it is probable that one of the three potential sites will be acquired, because it is not probable that any one site will be acquired, the costs incurred are not directly identifiable with a specific property that is probable of being acquired. Therefore, the \$50,000 in costs incurred to establish local construction contracts and research zoning and building codes should be charged to the income statement as an expense when incurred.

2. Support / Internal Costs

DHA has internal staff and project managers that assist with supporting the development of a project site that will be sold to the public. For example, the internal staff may be dealing with local council and contractors.

If a staff member is 100% allocated to a project then all of that staff members' salary is charged to total project costs (e.g. project manager for a specific site). If a staff member spends only a proportion of their time on specific projects (e.g. 70%), then DHA's policy is to capitalise the specific project time on the balance sheet and expense the remaining time spent on supporting the DHA business as a whole. For example, a project manager may oversee a number of developments. DHA uses historical evidence of the time spent on projects by project managers to apply a proxy percentage of time spent to calculate the proportion of costs to capitalise.

Further, DHA's policy is to not capitalise support office costs to assist a project manager as the work that the support team performs is not considered directly related to the project.

Further, at times there may also be ad hoc contributions and time spent from operational staff on a project – e.g. advice to assist with review of strategy for project development. It is a matter of materiality and judgement on whether the additional administration time is warranted to capitalise the employees' ad hoc time. As a 'rule of thumb' where an employee regularly spends two days a week or more on a specific capital project then the time should be capitalised to the total project costs.

Example: Accounting for internal costs

Defence has identified a requirement for housing in Queensland and has obtained approval for the project (Phase 3). DHA has agreed to build an apartment complex that will be sold to the public and leased back by DHA, subject to locating an appropriate parcel of land and council approval. DHA has an internal acquisition department that incurs \$50,000 in costs while evaluating three potential sites for the complex. Once one of the three sites is selected and is deemed probable of being acquired, the internal acquisition department incurs an additional \$10,000 in costs directly associated with acquiring the selected property. Further, two staff members assist on an adhoc basis during this process providing 4 hours of strategic support a week for one month (deemed insignificant).

Analysis:

Because DHA is planning to construct the apartment complex on the land acquired, DHA should capitalise the \$10,000 in costs that were incurred after it was probable that the property would be acquired. The \$50,000 in costs incurred before the acquisition of the specific land site should be charged to expense as incurred see example above. DHA also expenses the ad hoc staff time as it is not deemed significant.

3. Selling Costs

Costs incurred to sell properties are capitalised if the costs are recoverable and incurred for

- (1) Tangible assets that are used directly throughout the selling period to aid in the sale of the project or
- (2) Services that have been performed to obtain regulatory approval for sales.

Costs that do not meet the above criteria such as advertising, and sales overhead costs, should be charged to expense as incurred.

Example: Capitalising costs incurred to sell properties

DHA is in the process of completing a housing project that will include 50 single-family homes. The selling price of each home is \$100,000 and the cost of each home, including allocated common costs, is \$60,000. DHA has incurred costs of \$40,000 for model home furnishings, \$5,000 for semipermanent signs, \$5,000 for newspaper advertisements and \$15,000 for a sales office, which are used throughout the selling process.

Analysis

Costs incurred to sell the homes are capitalised if the costs are recoverable and incurred for tangible assets that are used directly throughout the selling period to aid in the sale of the project or for services that have been performed to obtain regulatory approval of sales.

Therefore, the costs of the model home furnishings, semipermanent signs, and sales office are capitalised if the costs are recoverable through the sale of homes in the project. Because the total estimated profit on the project of \$2 million $(\$100,000 \text{ sales price} - \$60,000 \text{ cost}) \times 50 \text{ homes}$ is in excess of the \$60,000 cost of the furnishings, signs and sales office, these permitted selling costs are capitalised. The \$5,000 advertising costs are expensed immediately in the income statement as incurred.

3.3 Borrowing Costs

DHA currently does not finance its developments through borrowings and therefore the below analysis is currently provided for information purposes only, and will be implemented should DHA change its current practices.

Borrowing costs relate to interest expense and other associated costs incurred by DHA in connection with borrowing funds to finance its land development activities.

Borrowing costs are eligible for capitalisation if they are *directly attributable* to the acquisition or construction of an asset that takes a substantial period of time to construct. DHA considers greater than 12 months as a substantial period of time. As such the construction of property that will be sold outright, or sold and leased back, will generally meet that criteria.

'Directly attributable' means a direct relationship between the borrowings and the land development activity / construction of the property. For instance, the loan was specifically entered into to fund the project or group of projects.

Once determined that the costs are directly attributable, they can be capitalised on the balance sheet as part of the project costs (and cost base of the asset), when the following three criteria are satisfied:⁴

- a. The borrowing cost is incurred
- b. Costs associated with construction have been incurred (e.g. DA approval)
- c. Construction of the underlying project has commenced.

Therefore, where the land has been acquired but no development activities have yet commenced, DHA does not start capitalisation of borrowing costs.

⁴ AASB 123 Borrowing Costs paragraph 17

Capitalisation of borrowing costs must cease when the property is constructed and is ready for sale. If construction is suspended for an extended period of time, borrowing costs should be expensed for the period of the suspension. If construction is temporarily delayed for a short period of time (e.g. temporary adverse weather conditions, delayed in sourcing materials etc) then borrowing costs can continue to be capitalised.

If DHA borrows funds in advance of construction of the asset, uses a portion to commence construction and temporarily invests a portion of the funds and generates investment income, DHA nets the income against the borrowing costs and only capitalises a net amount to total project costs.⁵

Example: Specific borrowings with investment income

On 1 April 2015 DHA engages in the development of a property, which is expected to take five years to complete, at a cost of \$6m. A bank loan of \$6m with an effective interest rate at 6% was taken out on 31 March 2015, The total interest charge for the year ended 31 December 2015 was consequently \$270,000.

Funds were progressively drawn-down and used in the construction of the project (e.g. \$0.6m in the first 3 months, with an unapplied balance of \$5.4m). Investment income was earned at 3% on the unapplied funds during the period as follows:

	\$
$\$5,400,000 \times 3\% \times 3/12$	40,500
$\$5,000,000 \times 3\% \times 3/12$	37,500
$\$4,800,000 \times 3\% \times 3/12$	<u>36,000</u>
	114,000

Consequently, the amount of interest to be capitalised for the year ended 31 December 2015 is:

	\$
Total interest charge	270,000
Less: investment income	<u>(114,000)</u>
	156,000

Other Considerations

DHA may borrow funds generally and then apply them to the construction of the land site (i.e. the funds are not directly borrowed for a specific site). In this case, DHA determines the amount of borrowings that are eligible for capitalisation by applying a capitalisation rate to the expenditure for the land site. The capitalisation rate is the weighted average of the total DHA borrowings outstanding during the period, other than those borrowings that were directly sourced for the purposes of construction of the property. When performing these calculations DHA ensures that the amount capitalised does not exceed the amount of borrowing costs it incurred during that period.

If the funds are borrowed from multiple sources, then the average borrowing rate must be applied in calculating the interest costs to be capitalised.

Example: General and specific borrowings – capitalisation rate

⁵ AASB 123 *Borrowing Costs* paragraph 14

On 1 April 2015 DHA engages in the development of a property, which is expected to take five years to complete, at a cost of \$6m. A bank loan of \$6m with an effective interest rate at 6% was taken out on 31 March 2015.

The bank loan was drawn down to match the development expenditure on 1 April 2014, 1 July 2014 and 1 October 2014. Expenditure was incurred on the development as follows:

1 April 2014	\$0.6m
1 July 2014	\$0.4m
1 October 2014	<u>\$0.2m</u>
	<u>\$1.2m</u>

The bank loan at 6% p.a. is a new borrowing specifically to finance the development. The amount of interest to be capitalised for the year ended 31 December 2015 would be the amount of interest charged by the bank of \$42k

$$((\$0.6m \times 6\% \times 9/12) + (\$0.4m \times 6\% \times 6/12) + (\$0.2m \times 6\% \times 3/12)) = \$42k$$

Assume the facts are the same, but the borrowings of DHA are as follows:

- \$6m bank loan for specific project with 6% effective interest rate
- \$2.5m bank loan for no specific project with 5.5% effective interest rate
- \$1m bank loan drawn for no specific project with 7% effective interest rate
- \$0.7m facility with no interest

Assume that 2 of the borrowings were general (i.e. the bank loan at 5.5% and bank loan at 2.5% was not specific to the development) and would have been avoided but for the development. The amount of interest to be capitalised would be:

(Total interest expense for the period / Weighted average total borrowings) x Development expenditure

Total interest expense =	
\$1.2m (as above)	\$42k
\$2.5m x 5.5%	\$137.5k
\$1m x 7%	<u>\$70k</u>
	<u>\$249.5k</u>

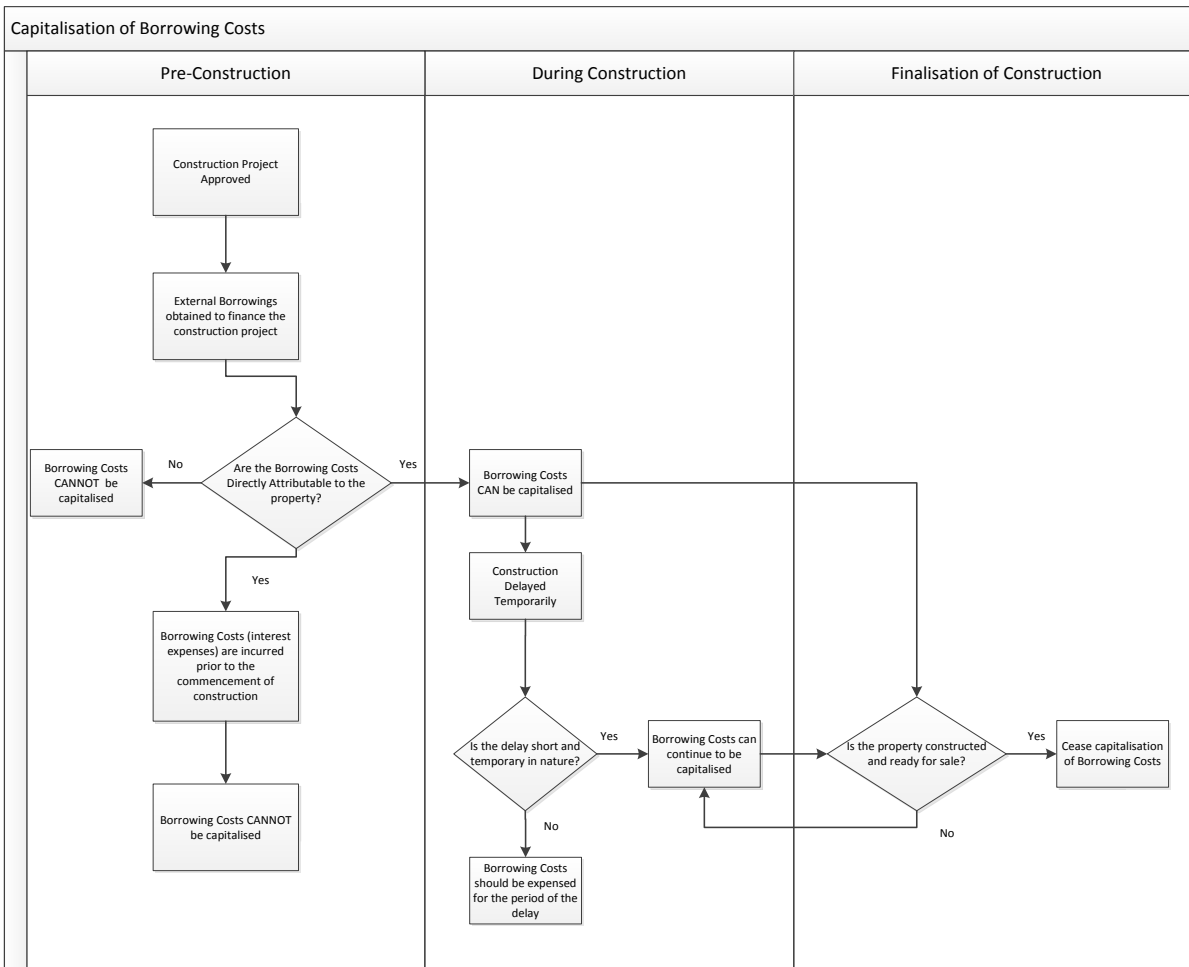
Therefore the capitalisation rate would be calculated as:

$$\$249.5k / (\$3.5m + \$0.7m) = 5.94\%$$

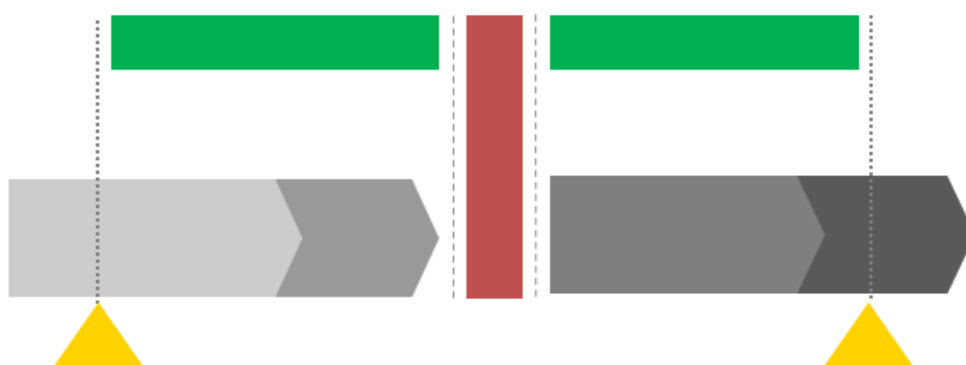
The capitalisation rate would then be applied to the expenditure on the qualifying asset, resulting in an amount to be capitalised of \$41,580 as follows:

\$0.6m x 5.94% x 9/12 =	\$26,730
\$0.4m x 5.94% x 6/12 =	\$11,880
\$0.2m x 5.94% x 3/12 =	\$2,970

A decision tree for determining the capitalisation of borrowing costs and project timeline is graphically illustrated below.



Project Timeline



Commencement of capitalisation

- Borrowing cost is incurred
- Construction cost is incurred
- Construction is physically commenced

Suspension of capitalisation

- construction work is interrupted by an undue event

Cessation of capitalisation

- Asset is brought to its intended use.



Interest capitalised



Interest not capitalised when the construction work is interrupted by an undue event

3.4 Subsequent Measurement

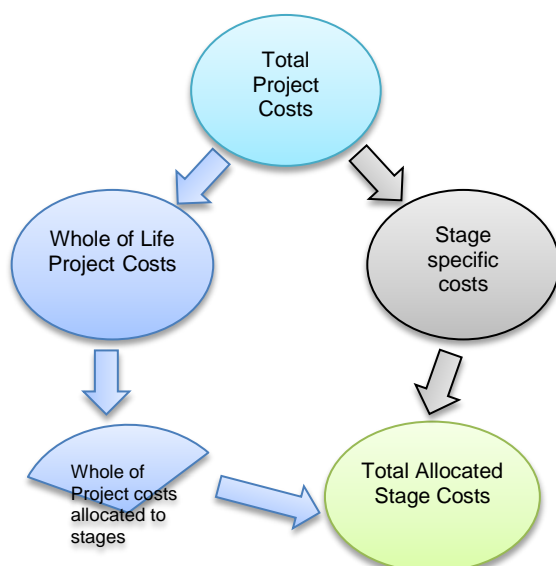
Subsequent to initially recognising the inventory project at its cost on the balance sheet, DHA applies the guidance in AAS and at each reporting date assesses the value of the inventory balance to ensure that it is being recorded at the lower of cost and net realisable value.⁶

If a project is abandoned or is no longer probable to proceed, the balances capitalised in the construction WIP account should be expensed to the Income Statement at the time when the decision not to proceed is made. DHA's policy is to review the recoverability of all WIP balances on a bi-annual basis at 31 December and 30 June reporting dates. Any WIP balances that have been on the balance sheet with no cost additions for a period greater than 12 months are considered for immediate write-off, unless there is strong evidence to support the lack of activity and recoverability for the project.

3.5 Cost Allocation Methodology

A project is often constructed in stages and may contain different land lots for individual sale. The project costs incurred may relate to a particular stage of the project (referred to as stage specific costs) or may relate to the development site as a whole (referred to as Whole of Life Project costs). Whole of Life project costs are incurred to benefit the entire project / all land lots – e.g. a road constructed between different dwelling blocks within the complex, and are allocated on a proxy basis to all stages and land lots.

All project costs capitalised are first accounted within one WIP general ledger account and at the end of each stage, both whole of site and staged costs are allocated to the product produced from that stage as illustrated in the diagram below.



DHA's policy provides three alternative options for the allocation of total project costs to the stages. The cost allocation method selected is a proxy for the cost of each developed land lot and should systematically allocate the costs to each inventory asset. The alternative options are summarised as follows:

Allocation Methodology	Description of Methodology
Square meters	Total project costs are allocated to each stage / lot, based on the size of the area / lot constructed.
Revenue contribution of each lot	Total project costs are allocated based on their revenue contribution. The estimated future revenue from the sale of the lot is based on market value obtained from external valuation service provider on specified projects.
Valuation of land lots	Total project costs are based on the valuation of the land lot. Depending on when the valuation is performed it may or may not take into account what has been approved for construction on the site.

There is varying practice within the industry and no one set approach required under the AAS.

⁶ AASB 102 *Inventories* paragraph 9

Each of the methodologies takes into account different factors which may or may not be representative of the actual costs incurred to construct the property. Therefore, DHA considers the methodology on a case-by-case basis.

3.6 Measurement of Accrual for Whole of Life and Project Costs

To calculate the project margin DHA estimates total project costs and at each month-end close, DHA accrues an estimate for total project costs to completion. This accrual should be capitalised with the other side of the transaction being recognised as a provision. The estimate is escalated to take into account a CPI factor to reflect future cost inflation. Where the estimate of costs is for more than a 12 month period, DHA discounts the balance to present value using the effective interest rate method. This method calculates an interest rate that exactly discounts the future value to today's amount.

4. Measurement of Investment Properties

DHA initially measures a project classified as investment property at cost, including any transaction costs incurred (e.g. stamp duty, legal advisors). The cost is the amount of cash that was paid to acquire a completed investment property or the costs that were incurred that clearly relate to the acquisition of land, development, and construction of the investment property. The same cost capitalisation considerations as [section 3.1 above] for the measurement of inventory are also relevant here.

Specifically, DHA does not increase the cost base of an investment property by:

- a) Start-up costs (e.g. feasibility and research)
- b) Operating losses incurred before the investment property achieves the planned level of occupancy; or
- c) Any abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

Further, DHA expenses to the income statement any maintenance and day-to-day servicing costs of the investment property.

Subsequently DHA measures the investment properties at cost, less any impairment losses. DHA depreciates investment property over a useful life of 50 years.

If an investment property is impaired as discussed in [section 9.2 below], the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount on a systematic basis over its remaining useful life.

DHA follows this policy consistently for all projects classified as investment property in its Annual Financial Statements.

For the purposes of reporting into the Commonwealth 'Whole of Government Accounts', the PGPA requires that investment property be subsequently measured at fair value and revalued at least annually. As such, DHA engages external valuers independent to DHA to assist each reporting period. The valuers are members of the Institute of Valuers of Australia. DHA discloses the fair value as a note disclosure within the narrative to the financial statements.

The AAS do not permit a revaluation reserve for investment property and any gains or losses would be recognised in the income statement. However, as noted this is only relevant for DHA's Whole-of-Government Reporting.

Example: Adjustment of treatment for investment property for Whole-of-Government Reporting

DHA constructed an investment property costing \$1m during the financial year ended 30 June 2015. Construction was completed on 1 January 2015. DHA earns \$12K a month in rent. As at 30 June 2015 independent valuers assessed the value of the property to be \$1.2M. DHA has assessed that the useful life of the investment property is 5 years. DHA accounts for this transaction as follows:

DHA's Books	Whole-of-Government Books
Dr WIP (Investment Property) \$1M Cr Cash/Payable \$1M	Dr WIP (Investment Property) \$1M Cr Cash/Payable \$1M
<i>To record the construction costs of the investment property</i>	<i>To record the construction costs of the investment property</i>
Cr WIP (Investment Property) \$1M Dr Investment Property \$1M	Cr WIP (Investment Property) \$1M Dr Investment Property \$1M
<i>On 1 January to transfer the investment property from WIP to investment property upon completion.</i>	<i>On 1 January to transfer the investment property from WIP to investment property upon completion.</i>
Cr Rent \$72K Dr Cash/receivable \$72K	Cr Rent \$72K Dr Cash/receivable \$72K
<i>On 30 June to record the rent earned for the period.</i>	<i>On 30 June to record the rent earned for the period.</i>
Dr Depreciation Expense \$100K Cr Accumulated Depreciation \$100K	Dr Investment Property \$200,000 Cr Unrealised gains on investment Property \$200,000
<i>On 30 June to record the depreciation for the period.</i>	<i>On 30 June to record the movement in the fair value.</i>
Dr Accumulated Depreciation \$100K Cr Investment Property \$100K	
Dr Investment Property \$300,000 Cr Unrealised gains on investment Property \$300,000	
<i>On 30 June to record the movement in the fair value.</i>	

5. Rebase Lining and Project Margins

As part of the assessment of a project's financial feasibility, DHA performs an estimate of future project costs and revenues to calculate the project's margin. There are multiple approaches for calculating the project margin within the Development Feasibility Estate Master ('DF Estate Master') and Development Management Estate Master ('DM Estate Master') tools.

Approval for the decision to proceed with a project is made by the Executive Property Committee ("EPC") considering the project margin in DF Estate Master. Project performance is tracked against the margin within DM Estate Master.

The alternative approaches for the calculation of project margin are:

- Revenue approach
- Expense Approach

DHA's policy is to ensure that regardless of which method is selected the margin calculated within each system follows the same methodology to avoid the risk of inconsistent margins calculated on the same project.

5.1 Rebase Lining

The project margin and estimate of future costs set at the commencement of the project by the Project Accountants in DF and DM Estate Master, is not static and may be revised as the project evolves (e.g. due to scope changes or as new cost information arises). This is known as a re-baselining adjustment.

DHA's policy is to perform a re-baselining review at least on an annual basis, however it is performed more frequently if new information on the project comes to light or if a project is delayed or external conditions have changed so much that the original timeline and cost estimate is no longer feasible.

Example factors that may trigger a re-baselining assessment include:

- If the project falls behind schedule for a significant period 3 months or 10% of the remaining duration, whichever is less, for non-excusable delays;
- DHA determines that the contractor is behind mandatory specific milestones which will impact on future project costs and revenues;
- The contractor determines that the progress schedule requires revision or delays which impact on future project costs and revenues;
- Significant changes are identified by the Project Control Group such as scope additions, or deletions including facility design and construction changes (for example change in the number of dwellings built); and
- Change in market factors requiring revision of estimated costs and revenue (e.g. supplier costs increase, increase in the demand for rental properties in a particular area).

As the re-baselining assessment occurs due to new information and circumstances that were not known when the project margin was initially set, it is a change in an accounting estimate⁷. If the information should have been known at the time of setting the project margin (e.g. costs and revenue calculated on incorrect number of dwellings due to mistake in input in the calculation), this is an accounting error and treated differently.

Since the project margin was assessed based on DHA's best estimate given the known information at the time, rebase line adjustments arising from a change in estimate are accounted for prospectively.

As such, DHA applies the revised project margin and financials to all current and future stages of the project. The accounting for the project in previous financial periods is not reopened or revised.

Example: Change in accounting estimate

DHA has a development project for the construction of residential dwellings for sale to the public. The project is expected to take four years to complete over four stages, each expected to take 12 months. Blocks within each stage will be subdivided and sold at the end of each stage. Costs and revenue are expected to be incurred evenly throughout each stage and the total cost of the project is expected to be \$100M. Total revenue is expected to be \$120M. Therefore the margin for the project was

⁷ AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* Paragraph 5
Defence Housing Australia: Land Development Accounting Manual

estimated to be 20% at the beginning of stage 1.

In year 3 (stage 3) DHA realises that initial estimates of the cost of the project were understated and the total cost of the project is now expected to be \$105M with no change in the total revenue. Therefore the margin for the project is now expected to be 14.3%.

DHA should account for the change in the margin (estimate) prospectively by allocating the increased project costs to the future sales through the cost of sales account. No adjustment is required to restate the cost of sales in previous accounting periods for those lots sold in earlier stages.

Cost of sales for the project would therefore be as follows:

	Cost of Sales	Sales	Margin	Cumulative Margin
Year 1 (Stage 1)	\$25M	\$30M	20%	20%
Year 2 (Stage 2)	\$25M	\$30M	20%	20%
Year 3 (Stage 3)	\$27.5M	\$30M	9.1%	16.1%
Year 4 (Stage 4)	\$27.5M	\$30M	9.1%	14.3%

Although the margin for the project has reduced at the end of the second year, cost of sales expense recorded in previous years is not affected. Instead, the cost of sales is increased proportionately in years 3 and 4.

If however, the adjustment arises due to a known error, a retrospective restatement is made, which will affect prior reporting periods. Opening balances of comparative periods are required to be restated and narrative disclosures explaining the error made. Rebase lining adjustments in most cases will be a change in estimate and an error is expected to happen in rare circumstances.

Errors may occur in the recognition, measurement, presentation or disclosure of transactions or events. Determining whether an adjustment is an error versus a change in estimate can involve significant degree of judgement in some circumstances. Examples of errors may include:

- Mistakes in the application of accounting standards.
- Mathematical errors.
- Oversight or misuse of facts that existed at the time the financial statements were prepared.

Example: Errors

- DHA has a non-current physical asset used in construction, which has a useful life of 5 years and is being depreciated on a straight line basis but, for a period of time was being incorrectly depreciated at a rate of 30%. This is an error and would have to be corrected.
- DHA incorrectly capitalise expenses in relation to a 3 year project that don't directly relate to the project and thus do not meet the criteria to be capitalised as per AAS.
- DHA incorrectly classifies a long term project as inventory but it is being held for the generation of rental income and should have been classified as investment property.

Whilst the examples mentioned above are self-explanatory, some of the issues will require professional judgement to assist with the determination. DHA may consult with professional advisors familiar with the particular factual situation for advice before making any decisions. Typically greater judgement is involved and technical advice may be needed where there has been oversight or misinterpretation of the facts.

Any changes in cost and revenue estimates should be updated as soon as the new information is received or significant changes in the project are identified.

6. Treatment of Infrastructure Assets

As part of a land development site, DHA may be required to build and/or maintain infrastructure assets for a third party (i.e. the local council/government department) for a period of time and then return the asset for no consideration or a cash payment or 'credit-in-kind'. Each arrangement is unique and the terms can be complex.

Example infrastructure assets may include:

- Construction of a community facility/hall
- Construction and/or maintenance of sporting facilities
- Construction and/or maintenance of a road
- Construction and/or maintenance of a bridge
- Maintaining and preserving a parcel of environmental land

Accounting for the infrastructure assets depends on the terms of the arrangement with the government department, the intention for the construction of the infrastructure assets and the classification of the project as inventory or investment property (see classification discussion in [Section 2 above]).

6.1 Measurement of Infrastructure Assets

As noted in [Section 3.1 above], the cost of inventory is to include all costs of purchase, costs of conversion and other costs necessarily incurred to have the development site in a condition ready for sale.⁸

As noted in [Section 4 above], the cost of an investment property includes the costs of construction (or purchase price of property if already developed), transaction costs plus any other directly attributable costs incurred (i.e. the costs would not have been incurred in the absence of the project or projects under development) e.g. professional fees or legal services.⁹

In regards to inventory projects, typically the infrastructure assets are capitalised as an asset on the balance sheet as a whole-of-site cost if the construction is to provide benefit to the entire project and not an individual property (i.e. included in total project cost WIP). In this case, each developed dwelling lot would incorporate a proportionate share of the costs of constructing the infrastructure asset. Refer to further discussion in [Section 3.5 above] on allocation of costs.

If however, the construction of the infrastructure asset is not directly linked to a project and the underlying intention was the construction of an asset for public benefit it may be capitalised on the balance sheet as a separate asset to be transferred to the government department at a later point in time.

The capitalisation and exact characterisation of the asset is driven by the underlying terms of the arrangement. Where the infrastructure asset is [> than X% of total estimate project costs and/or contains unique terms not seen on other projects] DHA considers engaging external consultants to provide accounting guidance on the correct treatment for the project in question in accordance with AAS.

6.2 Accounting for consideration received for the construction of infrastructure assets

Under some arrangements, DHA may receive consideration from the government department for constructing the infrastructure assets on their behalf. The consideration received typically is in the form of a cash payment or a future 'credit-in-kind'. A 'credit-in-kind' is like an 'IOU' promise from the government department that provides that if another development is constructed in the same government area subject to specific conditions, the government will contribute an amount towards the project, reducing the future construction costs. Depending on the arrangement the credit-in-kind may have a life span that covers many years.

DHA assesses the underlying substance of each form of consideration received from the government department to determine the appropriate accounting treatment.

The AAS provide guidance on the treatment of transactions where a Government department transfers resources to an entity in return for past or future compliance with certain conditions relating to the

⁸ AASB 102 *Inventories* paragraph 6

⁹ AASB 140 *Investment Property* paragraph 20

operating activities of the entity. This may include the provision of funds to construct infrastructure assets. These types of arrangements are a grant or donation from the Government.

However, a grant or donation by its definition involves that the entity that transfers the resources does not receive an equivalent benefit. Therefore, DHA assesses what benefit the government department will receive from the constructed assets.

Where the cash consideration or future credit-in-kind:

- matches an exact element of a project (e.g. cash payment to cover additional cost of higher grade materials on a sports field) and
- the asset is never owned by DHA nor does it provide a benefit to DHA prior to its donation to the Government department

It is not considered to be a government grant as the government receives approximate equal benefit to its contribution.

As such, DHA treats these contributions as a cost sharing arrangement and reduces the benefit against total project cost WIP capitalised on the balance sheet (refer section 6.1 above). If however, the receipt is a government grant the accounting treatment in [section 7 below] is followed.

The receipt of future credit-in-kind's is dependent on the unique terms of the arrangement and will only be confirmed by the occurrence of future development activity subject to meeting a number of conditions and other associated uncertainties, which are not necessarily within the control of DHA. This meets the definition of a contingent asset under AAS.

DHA does not recognise the contingent asset but discloses it in the financial statements, when the receipt of the future reduction in costs / benefit from the government department is probable (more likely than not).¹⁰ For example, a new development site has been identified in a local government area where credit-in-kinds are available for utilisation and the approval process for construction is underway.

When the uncertainties relating to the project are removed and it becomes reasonable and virtually certain that DHA is going to be able to comply with the conditions attached to the credits-in-kind and that the benefit will be received, DHA at this point in time would recognise the reduction in total project costs.

Example 1: Local council contributes cash contribution to construction of infrastructure asset

DHA is currently developing a residential apartment complex in Sydney. A condition of the local council granting approval for the development was that DHA must construct an asphalt road between the development site and neighbouring community shopping centre. The road is to be dedicated to as a public road to the Council on its completion.

The total cost of the apartment complex is \$10m for 20 apartment lots. DHA incurred \$0.5m for the construction of the road and the local council contributed \$0.45m in cash.

At reporting date 10 apartment lots have been sold to the public, for \$2m each.

Accounting Treatment

The construction of the road is directly related to the apartment complex. DHA treats it as a whole-of-site cost as it benefits the entire complex and not an individual apartment lot.

The contribution from the government is considered to be a cost sharing arrangement and a reduction in total project costs.

Dr. Inventory \$10.5m
Cr. Cash \$10.5m

Capitalisation of construction costs for the 20 apartment lots and the road.

Dr. Cash \$0.45m
Cr. Inventory \$0.45m

Recognise contribution towards the costs of construction of the road.

¹⁰ AASB 137 Provisions, Contingent Liabilities and Contingent Assets paragraph 31, 34
Defence Housing Australia: Land Development Accounting Manual

Dr. Cost of sales \$5.025m

Cr. Inventory \$5.025m

Recognition of cost of sales on disposal of the apartment lots. Includes the \$0.05m of the road cost to each apartment lot

Dr. Cash/receivable \$20m

Cr. Sales revenue \$20m

Recognition of sales revenue on disposal of each apartment lot

Example 2: Local council contributes future credit-in-kind

DHA is currently developing a residential apartment complex in Sydney, within the Warringah local council district. A condition of the local council granting approval for the development was that DHA must construct an asphalt road between the development site and neighbouring community shopping centre. The road is to be dedicated to as a public road to the Council on its completion.

The total cost of the apartment complex is \$10m for 20 apartment lots. DHA incurred \$0.5m for the construction of the road.

In consideration of DHA constructing the road on the previous complex, the Warringah local council has agreed to contribute \$0.5m for a future construction within the same Council area for the construction of 10 apartment lots, if construction is performed within the next 7 years.

At reporting date, DHA has a number of projects currently being developed in other locations through-out Sydney. DHA has not identified a parcel of land within the Warringah Council or considered the feasibility of a future project within this area.

Accounting Treatment

The future benefit that may be received is contingent on a number of factors:

- completion of other projects for availability of funds
- identifying a parcel of land
- determining the feasibility of future project in this area

As such the credit-in-kind is currently a contingent asset as it is not probable whether any benefit will be received in the future. DHA discloses the nature of the contingent asset in the notes to the financial statements.

Example 3: No contribution from local council for the construction of the infrastructure asset

Assume the same background facts as example 1, but the Government does not contribute any cash towards the construction of the road.

Accounting Treatment

The construction of the road is directly related to the apartment complex. DHA treats it as a whole-of-site cost as it benefits the entire complex and not an individual apartment lot.

The cost of construction of road will be recognised in the income statement on sale of each of the apartment lots.

Dr. Inventory \$10.5m

Cr. Cash \$10.5m

Capitalisation of construction costs for the 20 apartment lots and the road.

Dr. Cost of sales \$5.25m

Cr. Inventory \$5.25m

Recognition of cost of sales on disposal of the apartment lots. Includes the \$0.25m of the road cost to each apartment lot

Dr. Cash/receivable \$20m

Cr. Sales revenue \$20m

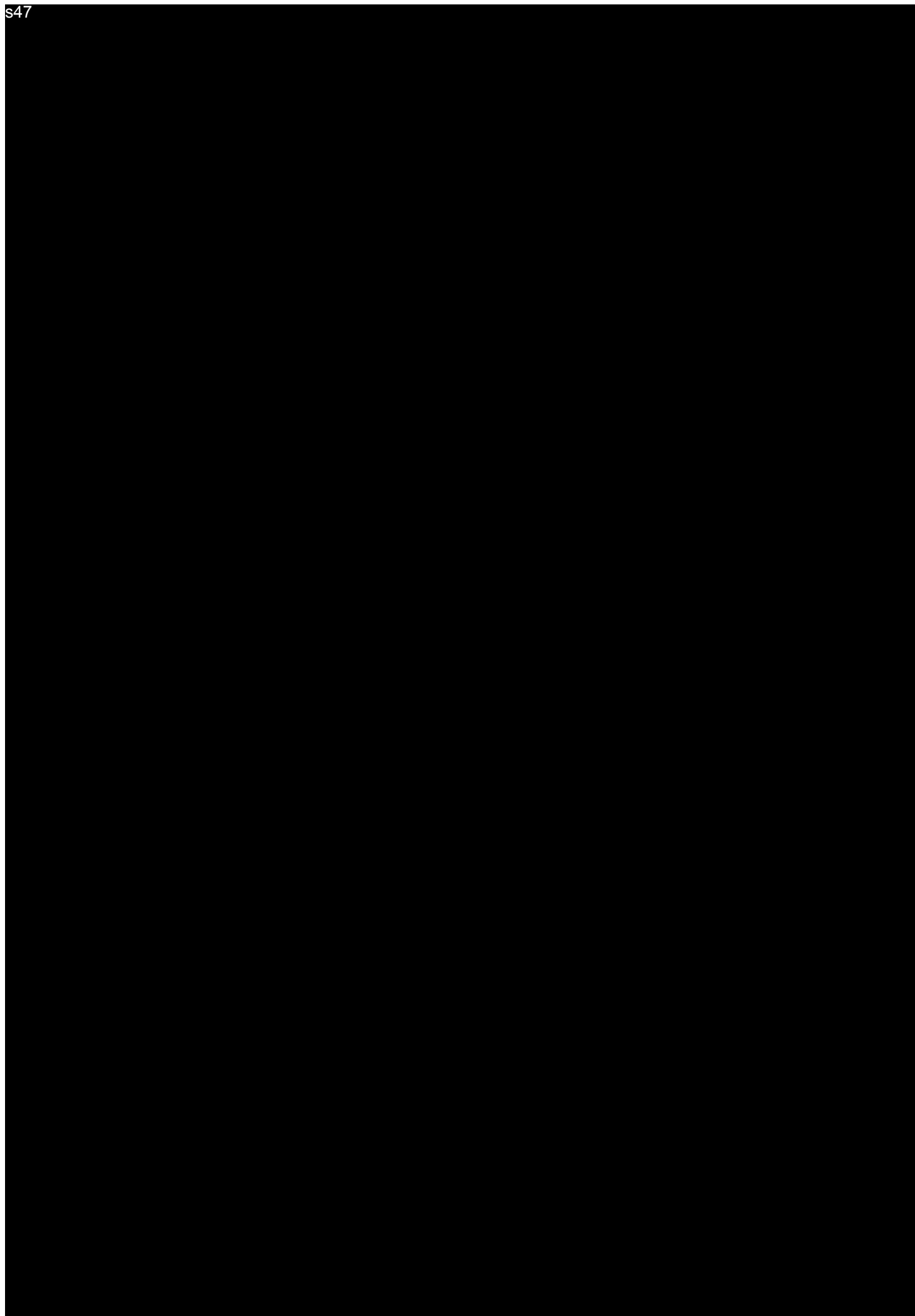
Recognition of sales revenue on disposal of each apartment lot

6.3 Record Keeping and Management of Credit-in-kind's

To manage the effective utilisation of the credit-in-kind's at a future point-in-time, DHA has implemented a policy of logging all 'credit-in-kinds' received in an excel database. The responsibility for recording these is that of the project manager. Key details relating to the credit-in-kind must be included such as:

- Local government area in which it can be applied and any particular terms that must be satisfied before the credit-in-kind can be utilised
- Time period / life of the credit-in-kind
- Monetary worth of the credit-in-kind
- Copy of agreement and any correspondence with the government department evidencing the entitlement to the credit-in-kind

Each time a feasibility study is performed for a new development in a local council area, the project accountants review the listing of 'credit-in-kinds' to determine if there are any available for utilisation on the new project. Further, each year the project accounting team performs an overall review of the listing to ensure that it is kept up-to-date and credits are being effectively utilised. The review includes discussions with project managers and other relevant staff who are closest to the details of each development to make sure that the listing and assessment is complete.



8. Revenue Recognition

The AAS define revenue as the gross inflow of economic benefits arising from the ordinary operating activities of an entity.²¹

DHA land development activities generate revenue from different sources including:

- Sale of inventory (i.e. completed property lots);
- Housing and allocation services (e.g. lessor management fees, defence rent and charges);
- Gain on disposal of investment properties; and
- Defence annuity properties and construction contracts.

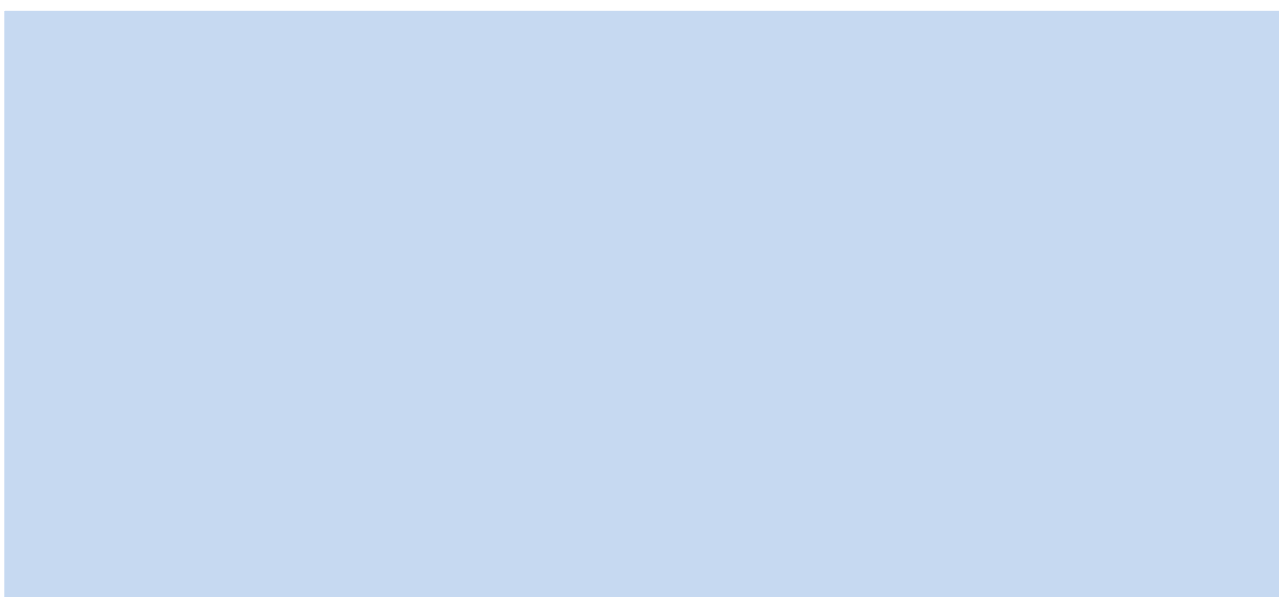
Revenue is measured at the fair value of the consideration received or receivable and recognised when prescribed conditions are met, which depend on the nature of the revenue.²² DHA's policy for accounting for each of these revenue sources is discussed below.

8.1 Sale of Inventory

A typical sales process for the sale of a constructed inventory property can be summarised as follows:

1. An offer to purchase the property is made to DHA by a prospective buyer
2. The offer is accepted by DHA and the buyer pays a deposit to secure the property
3. Conveyancing and legal work is undertaken to confirm the property and sales transaction is in order and all terms are understood
4. DHA and the customer exchange contracts
5. Settlement of the contract occurs. The buyer pays the final balance of the purchase price and DHA transfers property title to the customer

DHA recognises revenue on the sale of inventory (i.e. development sites and dwelling blocks – as per Section 1), when all of the following factors are demonstrated.²³



DHA has assessed the nature of the sale of its inventory assets and takes the approach that the above factors are demonstrated on settlement of the sale of the inventory (i.e. when property title is transferred to the customer). As such DHA's policy is to recognise revenue at this point in time.

8.1.1 Upfront Deposits

In some instances, DHA may receive a deposit from the acquirer upfront, before completion of construction of the property. At the time of receiving the deposit, the sale may not be unconditional and

²¹ *The Framework for the Preparation and Presentation of Financial Statements*, definitions

²² *The Framework for the Preparation and Presentation of Financial Statements*, paragraph 83

²³ AASB 118 *Revenue* paragraph 14

the factors in [section 8.1 above] satisfied. DHA recognises these deposits as deferred income (liability) on the balance sheet and releases the deposit to the income statement as revenue on ultimate sale of the property.

Any selling costs incurred relating to the disposal of the inventory are expensed as incurred unless it can be demonstrated that they are directly related to the specific contract and provide a future benefit until settlement. If so, DHA considers whether it is possible to capitalise these costs on the balance sheet as an asset and amortise to the income statement over the period to settlement date (e.g. intangible asset for locating customer to purchase the property – sales commission costs).

8.2 Provision for Services

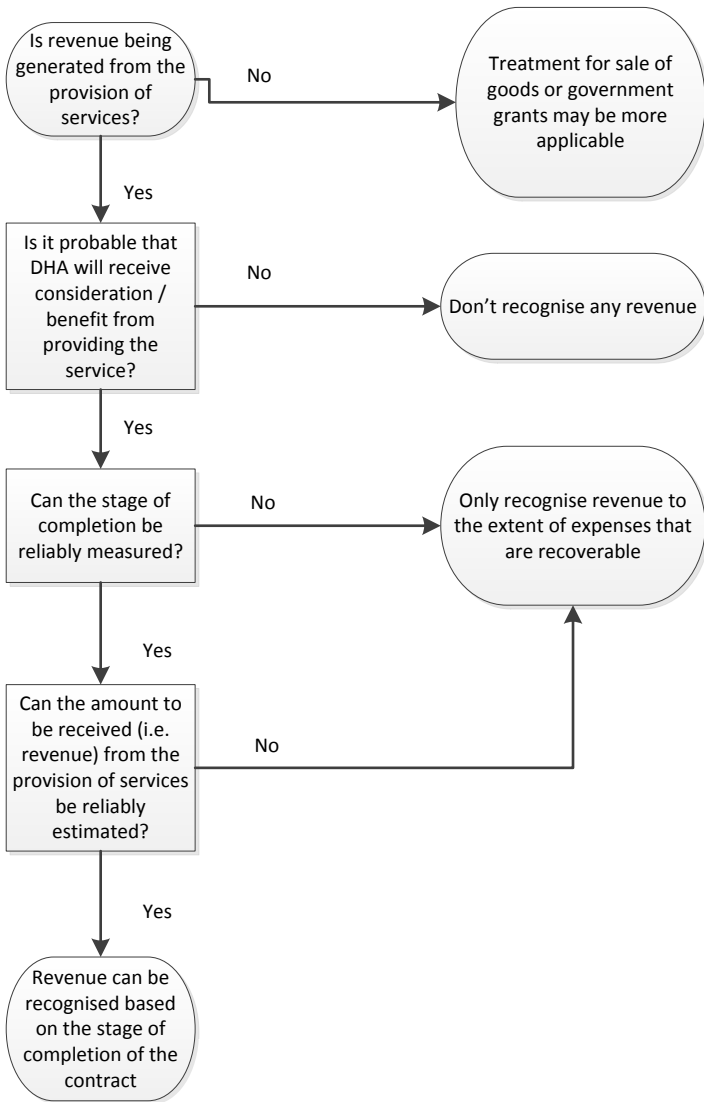
DHA generates revenue from the provision of housing and development services. DHA considers the relevant land and development service revenue streams include:

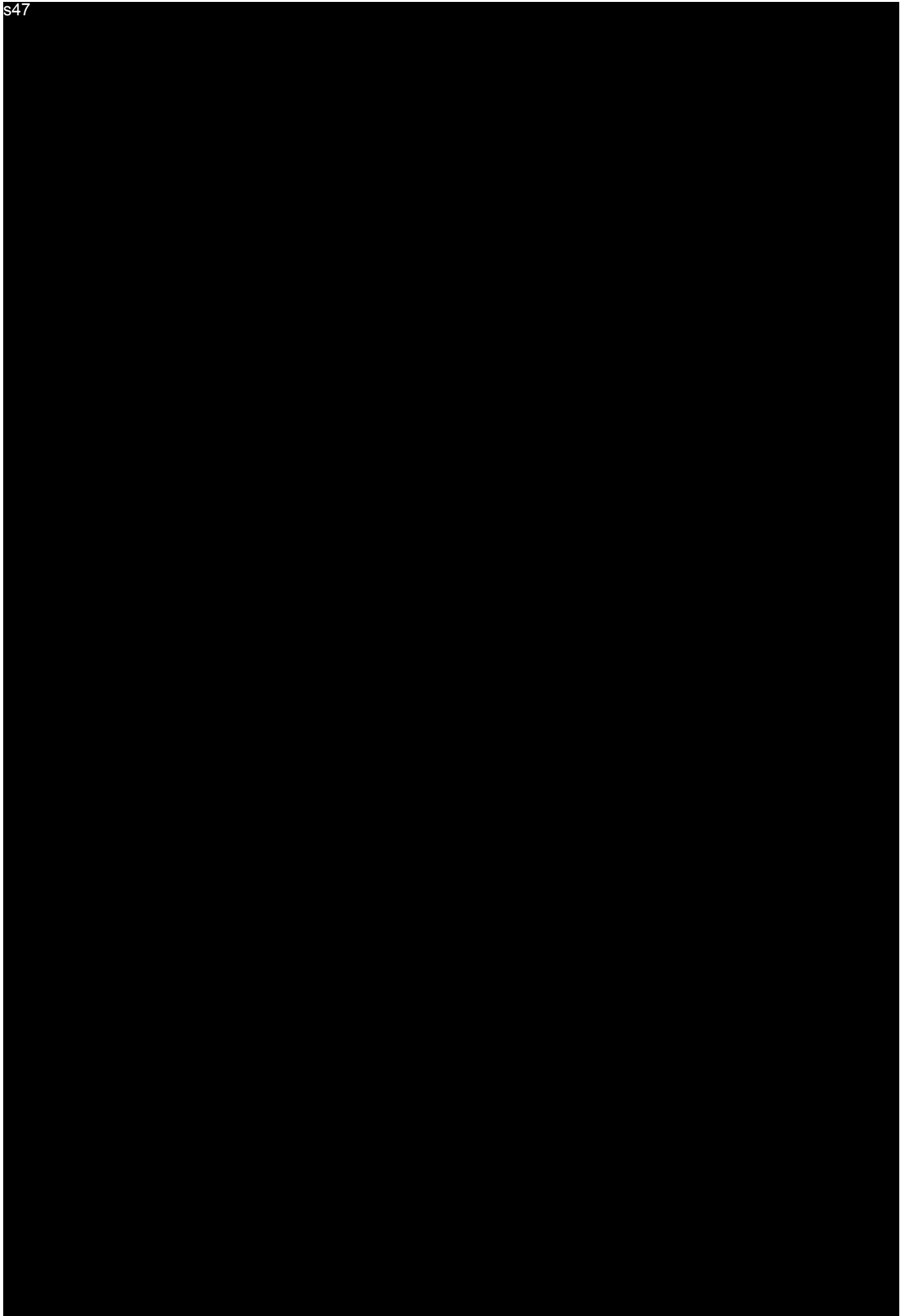
- Defence rent and charges.
- Lessor management fees.
- Annuity revenue.
- Allocation administration fees.
- Other revenue (defence and other).

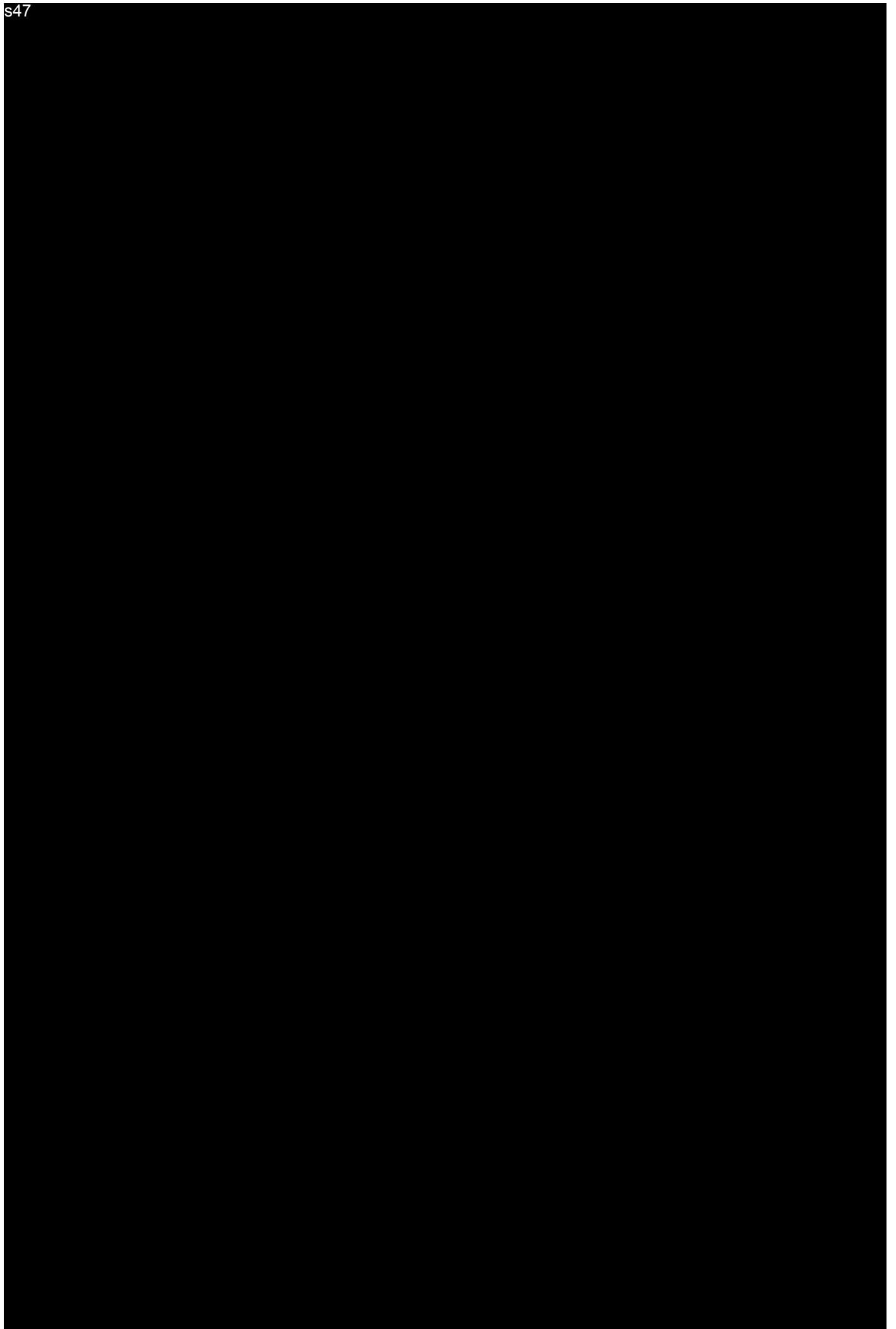
DHA recognises the revenue as it provides the service to Defence or the lessee. The revenue is recognised based on the stage of completion of the contract at reporting date. For example this may be assessed by:

- How far progressed is DHA against milestones of the contract?
- How many years are there left of the lease term?
- What proportion of costs have been incurred against total estimated project costs?

The process for the recognition of revenue from services is illustrated as follows:







8.2.7 Other Considerations – revenue generating assets – sale and lease back arrangements

DHA enters into sale and leaseback arrangements to fulfil the housing needs of Australian Defence Force members. As part of the sale and leaseback transaction, the property is sold by DHA and the same property is leased back to DHA by the purchaser. The lease payment and sale price are normally interdependent because they are negotiated as part of the same package. The determination of whether the lease is an operating or a finance lease is based on the substance of the arrangement at inception date.

These arrangements are classified as an operating lease because of the following:²⁶

- The lease does not transfer ownership back to DHA at the end of the lease term
- The lease term is not for a major portion of the life of the dwelling lot
- The leased dwelling lot is not specialised and could be used by other parties without major modification

Each of these indicators does not need to be satisfied and are used as a guide to assist with the classification and associated accounting treatment.

As operating leases DHA's policy is to account for any revenue on the sale as follows:

Transaction Price	Accounting Treatment
At Fair Value	Recognise profit or loss immediately in the income statement
Below Fair Value	Recognise profit or loss immediately in the income statement Unless If there is a loss that will be compensated by future lease payments at below market price, the portion of the loss attributable to below market rent should be deferred and amortised to the income statement
Above Fair Value	Excess of the sales price above fair value should be deferred on the balance sheet and amortised to the income statement over the term of the lease

²⁶ AASB 117 Leases paragraph 10

DHA recognises lease payments in the income statement on a straight-line basis over the lease term.

Example: Other Considerations – revenue generating assets – sale and lease back arrangements

DHA sells a property with a carrying amount of \$1.5m to Customer X and immediately leases it back, affecting a sale and lease back arrangement.

The lease is an operating lease and has a 3 year term.

Sales Price equal to Fair Value

Profit

The property sales price is \$2m.

Fair value of the property is \$2m, future lease payments over 3 year term of \$0.3m (i.e. \$0.1m p.a)

Carrying amount of property \$1.5m

DHA recognises a profit of \$500k immediately in the income statement

Journal Entries:

Dr Cash	\$2m
Cr Profit on sale	\$0.5m
Cr Property	\$1.5m

Recognition of gain on sale and leaseback of property

Each period DHA will recognise lease payments on a straight-line basis

Dr. Lease expense	\$0.1m
Cr. Cash	\$0.1m

Recognition of lease payment

Loss

The property sales price is \$1m.

Fair value of the property is \$2m, future lease payments over 3 year term of \$0.3m (i.e. \$0.1m p.a)

Carrying amount of property \$1.5m

DHA recognises a loss of \$500k immediately in the income statement

Journal Entries:

Dr Cash	\$1m
Dr Loss on sale	\$0.5m
Cr Property	\$1.5m

Recognition of loss on sale and leaseback of property

Each period DHA will recognise lease payments on a straight-line basis

Dr. Lease expense	\$0.1m
Cr. Cash	\$0.1m

Recognition of lease payment

Sales price below Fair Value

DHA is selling the property at below fair value but will be compensated for the loss by paying lower rent payments each period compared to market rates.

Loss

The property sales price is \$1m.

Fair value of the property is \$1.5m.

Current market rental is \$1m per period, but DHA will only pay \$0.5m each period.

DHA defers the loss of \$0.5m relating to \$0.5m lower rent each period and amortises it to the income statement across the term of the lease

Journal Entries:

Dr Cash	\$1m
Dr Deferred lease asset	\$0.5m
Cr Property	\$1.5m

Recognition of deferred lease asset on sale and leaseback of property

Example: Other Considerations – revenue generating assets – sale and lease back arrangements

Each period DHA will recognise lease payments on a straight-line basis and amortise deferred lease asset

Dr. Lease expense \$0.34m
Cr Cash \$0.17m
Cr Deferred lease asset¹ \$0.17m

Recognition of lease payment and amortisation of deferred loss

¹ \$0.5m / 3 yrs

Sales price above Fair ValueProfit

Lease term is 3 years

The property sales price is \$3m.

Fair value of the property is \$2.5m.

Current market rental is \$1.5m, but DHA will pay \$2m

DHA defers the excess above fair value of \$0.5m and amortises it to the income statement across the term of the lease.

Journal Entries:

Dr Cash \$3m
Cr Deferred lease liability \$0.5m
Cr Property \$2.5m

Deferral of excess gain above fair value on sale and lease back

Dr. Lease expense¹ \$0.5m
Dr Deferred lease liability \$0.17m
Cr Cash² \$0.67m

Amortisation of excess gain above fair value on sale and lease back and recognition of lease expense

¹ \$1.5m market rental / 3yrs

² \$2m cash payment / 3yrs

9. Impairment Methodology

DHA's accounting policy is that:

- Inventories are valued at the lower of cost and net realisable value (NRV).
- Investment properties are recognised at the lower of cost and recoverable amount.
- Property, plant and equipment ('PP&E') is measured at cost less any impairment losses.

At each reporting period, DHA assesses whether there are any indicators that inventory, investment properties and PP&E may be currently recorded at an amount higher than their recoverable amount (i.e. the asset may be impaired). The impairment process for PP&E and investment property held at cost is the same.²⁷

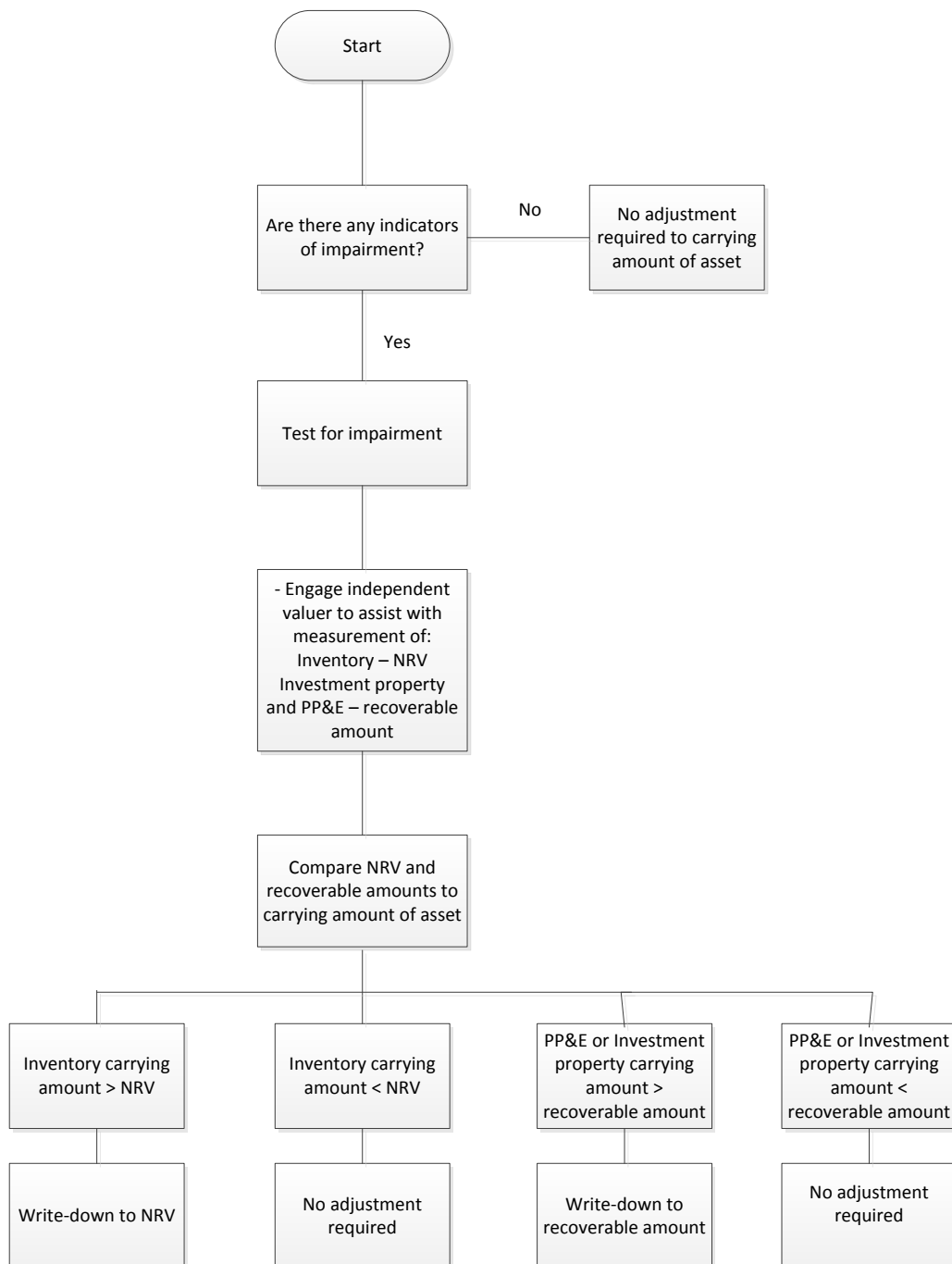
Indicators of impairment include both internal and external factors. For example they may include:

- Decline in market value of properties in a particular location/region
- Decline in demand for rental or acquisition of properties in a particular location
- Change in market interest rates
- Evidence of significant damage to or obsolescence of a property

If there are any indicators of impairment then, DHA performs an assessment of the appropriateness of the carrying amounts. Details of how this assessment is made is covered in Sections [9.1 and 9.2 below].

At each reporting date (half-year and year-end), any impairment losses or reversals are tabled in a report with supporting analysis to the Board Audit Committee for approval prior to processing any adjustments. A summary of the impairment process is outlined in the following diagram.

²⁷ AASB 140 Investment Property paragraph 56



9.1 Inventory

The key principle for inventory measurement in accordance with AASB 102 is that inventories shall be carried at the lower of cost and net realisable value (“NRV”).

The following guidance considers the steps required to apply the accounting requirements of AASB 102:

- Step 1: Determine the unit of account for impairment testing of inventory
- Step 2: Determine how costs should be allocated to each unit of account
- Step 3: Determine if any impairment indicators exist
- Step 4: Determine NRV for each unit of account
- Step 5: Compare cost and NRV and record impairment or reversal of impairment if necessary
- Step 6: Make required disclosures

Step 1: Determine the unit of account for impairment testing of inventory

Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment.²⁸

DHA considers the intention for sale of the asset and classifies inventory according to the appropriate categories in accordance with the criteria set out in this manual:

- Completed properties – completed properties held for resale on normal trading cycle
- land held for future development or construction
- Work in progress – incomplete construction projects

In determining the unit of account of inventories for impairment testing, DHA considers the following:

Situation	Considerations	Implications
Completed properties held for resale on normal trading cycle	What is the intent for sale? Will these be sold separately or as one development?	Where titles for individual land lots have been issued and the intention is to sell the lots separately, the impairment testing is performed on the individual lots. Where: <ul style="list-style-type: none"> • titles have not been issued for individual land lots; or • the intent is to sell the lots on a combined basis then the impairment testing is performed on a combined lot basis.
Land held for future development or construction	What is the intent for sale? Will these be sold separately or as one development? Is there any infrastructure on the land? Does this form part of the inventory?	See above.
Work in progress – incomplete construction projects	See above.	See above.

Step 2: Determine how costs should be allocated to each unit of account

DHA's cost allocation methodology is covered at section 3.5 above.

Step 3: Determine if any impairment indicators exist

The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets shall not be carried in excess of amounts expected to be realised from their sale or use.²⁹

At each reporting period (half and full year), DHA assesses whether there are any indicators that the costs associated with the inventory may not be recovered and therefore the inventory may be impaired. At a minimum these assessments are performed by the project manager, reviewed by Finance and approved by the Project Control Group (PCG) and will cover a detailed assessment for the following situations:

²⁸ AASB 102: 'Inventories' paragraph 29

²⁹ AASB 102: 'Inventories' paragraph 28

- inventory has become damaged, for instance from vandalism or natural disasters;
- inventory is wholly or partly obsolete, for instance a change in construction standards leads to the dwellings no longer meeting industry requirements;
- selling price has declined, for instance a decline in market demand or increase in supply leads to estimated negative project/stage margins;
- costs to complete, or the estimated selling costs³⁰ have increased, for instance a local shortage of core construction materials leads to significant transport costs which leads to estimated negative project/stage margins .

In some cases this assessment will be simple and easily supported, whereas in other large and more complex developments it will require input from multiple subject matter experts. This step is important for setting expectations about the outcomes of NRV testing (refer following steps) if required.

Where no indicators of impairment exist, steps 4-6 are not required.

Step 4: Determine NRV for each unit of account

The components of NRV are:

- estimated selling price in the ordinary course of business
- (less) estimated costs of completion
- (less) estimated costs necessary to make the sale.

DHA takes the following characteristics are applied to each component when performing an NRV estimate:

- based on the most reliable evidence available
- take into account fluctuations of price or cost after the end of the period if this is evidence of conditions existing at the end of the period.
- take into account the purpose for which the inventory is held.

For example:

- A loss realised on a sale of a product after the end of the period may well provide evidence of the net realisable value of that product at the end of the period i.e. an increase in costs after period end may provide evidence of the costs existing at period end and this will impact the NRV estimate.
- Inventory held for a particular contract has its net realisable value based on the contract price, and only any excess inventory held would be based on current market prices i.e. the purpose for which inventory is held is taken into account in the estimate selling price, and costs necessary to make the sale, and this will impact the NRV estimate.
- Materials and other supplies held for use in the production of inventories are not written down below cost if the final product in which they are to be used is expected to be sold at or above cost (the purpose for which the inventory is held). This is the case even if these materials in their present condition have a net realisable value that is below cost and would therefore otherwise require write down
- if the NRV only looks at estimated selling value of a partly constructed building but does not include estimated costs of completion and the estimated costs necessary to make the sale (where the inventory category is a completed building), then the valuation is not considered to have been undertaken on an appropriate NRV basis.

³⁰ Selling costs are excluded from the cost of inventory and are expensed as incurred; of course, the selling price takes account of the expected costs of sale. Selling costs include direct costs that are only incurred when the item is sold, e.g. sales commissions, and indirect costs, which are those overheads that enable sales to take place, including sales administration and the costs of retail activities. If inventory is not impaired then the distinction between direct and indirect selling costs is not relevant as both are expensed as incurred. [AASB 102.16]. It is clear that costs to be reflected in the write down to NRV must be incremental but Paragraph 28 does not distinguish between direct and indirect costs. This allows for different interpretations. In practice there may be few incremental increases in indirect costs that will cause inventory to be sold at a loss.

Valuations can be undertaken for many purposes and it is therefore important to understand the distinction between NRV and the accounting requirements for fair value measurement in accordance with AASB 13:

- Fair value is defined, as in AASB 13, as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- Net realisable value is an entity-specific value, the amount that the entity actually expects to make from selling that particular inventory, while fair value is not. Therefore, net realisable value may not be the same as fair value less costs to sell.
- If there has been a downturn in a cyclical business such as real estate, an entity may argue that net realisable value is higher than fair value because the entity intends to hold the asset until prices recover. However, this is rarely supportable as the decline in fair value usually indicates that the price that will be achieved in the ordinary course of business has declined and time taken to dispose of assets has increased.

Due to the complexity of determining NRV, an AASB 102 compliant valuation by a valuation specialist, either externally or internally if expertise exists is undertaken for all NRV determinations. The valuation should be undertaken on an item-by-item basis of inventory, rather than by entire inventory category and costs of completion and sale costs also need to be attributed on an individual basis where this is the method to determine NRV.

Step 5: Compare cost and NRV and record impairment or reversal of impairment if necessary

Where NRV is below cost, DHA writes down for impairment. Any write-down in the carrying amount of inventory is recognised as an expense in the income statement with a corresponding credit to inventory (to reduce the value).

Writing inventory down to net realisable value is normally done on an item-by-item basis. AASB 102 specifically states that it is not appropriate to write down an entire class of inventory, such as finished goods, or all the inventory of a particular segment. However, it may be necessary to write down an entire product line or group of inventories in a given geographical area if the items cannot be practicably evaluated separately.

When the circumstances that previously caused inventories to be written down below cost no longer exist, or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed. The reversal cannot be greater than the amount of the original write-down, so that the new carrying amount will always be the lower of the cost and the revised net realisable value. [AASB 102.33]. The reversal is recognised in the income statement, net against any other impairment write-down of assets.

Step 5: Example

Example 1: Write-down to inventory carrying amount and subsequent reversal

DHA has property classified as inventory recorded at cost of \$100m in Canberra. During FY12, the demand for housing in this region in Canberra declined with a fall in market prices. At reporting date independent valuers estimated that the sales price for these properties was \$90m. DHA recognised a write-down in the carrying amount of the inventory to ensure that it would be recorded at the lower of cost and net realisable value at 30 June 2012.

Dr. Inventory write-down expense	\$10m
Cr. Inventory	\$10m

Subsequently, over the next few years market interest rates are lowered and demand for property and housing prices have been rising. DHA engages an independent valuer to estimate the sales cost of the property. The valuer measures the property as having a realisable value of \$105m.

DHA reverses the previous recognised write-down only to the extent that the carrying amount equals cost (i.e. the reversal is capped at property carrying amount of \$100m).

Dr. Inventory	\$10m
Cr. Inventory reversal	\$10m

DHA recognises inventory write-down and reversals on a net basis in the income statement (i.e. on the same line item).

Step 6: Make required disclosures

Requirements under AASB 102.36-39

36 The financial statements shall disclose:

- (a) the accounting policies adopted in measuring inventories, including the cost formula used;
- (b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
- (c) the carrying amount of inventories carried at fair value less costs to sell;
- (d) the amount of inventories recognised as an expense during the period;
- (e) the amount of any write-down of inventories recognised as an expense in the period in accordance with paragraph 34;
- (f) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance with paragraph 34;
- (g) the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34; and
- (h) the carrying amount of inventories pledged as security for liabilities.

37 Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may be described as work in progress.

38 The amount of inventories recognised as an expense during the period, which is often referred to as cost of sales, consists of those costs previously included in the measurement of inventory that has now been sold and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the entity may also warrant the inclusion of other amounts, such as distribution costs.

39 Some entities adopt a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognised as an expense during the period. Under this format, an entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

Step 6: Example.

Example 1 above has been expanded to show the disclosure required relating to the original impairment and the subsequent reversal.

Note the required disclosure in paragraph 36(g) i.e. “the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34”. This would include some narration of the state of the market in the particular development to explain any reversal.

Example 2: Sample disclosures

Example of accounting policy note:

Significant accounting judgements, estimates and assumptions

Classification of property

The Company determines whether a property is classified as investment property or inventory property:

- Investment property comprises land and buildings (principally offices, commercial warehouse and retail property) that are not occupied substantially for use by, or in the operations of, the Company, nor for sale in the ordinary course of business, but are held primarily to earn rental income and capital appreciation. These buildings are substantially rented to tenants and not intended to be sold in the ordinary course of business.
- Inventory property comprises property that is held for sale in the ordinary course of business. Principally, this is residential property that the Company develops and intends to sell before or on completion of construction.

Estimation of net realisable value for inventory property

Inventory property is stated at the lower of cost and net realisable value (NRV).

NRV for completed inventory property is assessed by reference to market conditions and prices existing at the reporting date and is determined by the Company, based on comparable transactions identified by the Company for properties in the same geographical market serving the same real estate segment.

NRV in respect of inventory property under construction is assessed with reference to market prices at the reporting date for similar completed property, less estimated costs to complete construction, estimated costs to complete construction and an estimate of the time value of money to the date of completion.

Summary of significant accounting policies

Inventory property

Property acquired or being constructed for sale in the ordinary course of business, rather than to be held for rental or capital appreciation, is held as inventory property and is measured at the lower of cost and NRV.

Cost includes:

- Freehold and leasehold rights for land
- Amounts paid to contractors for construction
- Borrowing costs, planning and design costs, costs of site preparation, professional fees for legal services, property transfer taxes, construction overheads and other related costs

Non-refundable commissions paid to sales or marketing agents on the sale of real estate units are expensed when paid.

NRV is the estimated selling price in the ordinary course of the business, based on market prices at the reporting date and discounted for the time value of money if material, less costs to completion and the estimated costs of sale.

The cost of inventory property recognised in profit or loss on disposal is determined with reference to the specific costs incurred on the property sold and an allocation of any non-specific costs based on the relative size of the property sold.

Example of inventory note (extension of example 1)

FY12 disclosure:

	FY12	FY11
Inventory write-down	(10)	0
Inventory reversal	0	0

FY13 disclosure:

	FY13	FY12
Inventory write-down		(10)
Inventory reversal ¹	10	

1. The inventory impairment reversal in FY13 of \$10 (FY12, \$0) is due to the lower market interest rates and subsequent rising demand for property and increasing housing prices. DHA engages an independent valuer to estimate the sales cost of the property. The valuer measures the property as having a realisable value of \$105m.

In addition, at each reporting date (half-year and year-end), any impairment losses or reversals are tabled in a report with supporting analysis to the Board Audit Committee for approval prior to processing any adjustments.

9.2 Investment Property and PP&E

The recoverable amount of an investment property and PP&E is the higher of its fair value less costs to sell and its value in use. Value in use is the present value of the future cash flows expected to be derived from the asset.

DHA engages independent valuers, whom are members of the *Institute of Valuers of Australia* to measure the fair value/recoverable amount of investment property and PP&E.

The value in use calculation measures the future benefit a property provides to DHA by forecasting the future discounted cash flows over the life of the property. The components of the model and the methodology are to be consistent with the guidance provided within AAS (AASB 136 *Impairment of Assets*). The model uses DHA's weighted average cost of capital (WACC) as its discount rate and capital and rental growth assumptions are derived from DHA's annual revaluation data, recent 10 year corporate forecast, and from an independent market research data provider (Residex)³¹.

As part of its impairment process, DHA will review its WACC to ensure that current market conditions and DHA's operational activities are appropriately captured. DHA engages an independent expert where necessary to assist with the calculation of the WACC.

Where the fair value and the value in use calculation for an individual property is less than its cost, the carrying value of the property should be written down to the higher of the two valuation methods. The write-down is recognised as an expense ('write-down and impairment of assets') in the income statement.

Where there has been impairment on the property in previous years and there is an increase in the recoverable amount, prior year impairment losses can be written back to the extent that the carrying value of the property returns to cost. The reversal is recognised in the income statement, net against any other impairment write-down of assets.

³¹ RESIDEX 12 Months Growth % sourced from the Median House Sales figure in monthly Market Commentary Reports
Defence Housing Australia: Land Development Accounting Manual

Further Analysis: WACC Formula

The Weighted Average Cost of Capital is calculated by the following formula:

$$WACC = \frac{E}{V} \times Re + \frac{D}{V} \times Rd \times (1 - Tc)$$

Where:

Re = Cost of equity, (return expected on equity)

Rd = Cost of Debt

D/V = Gearing ratio, percentage of financing that is debt

E/V = (1 – Gearing ratio), percentage of financing that is equity

Tc = Tax rate

Example: Write-down to investment property carrying amount and subsequent reversal

DHA has acquired a property that it plans to hold for the next 10 years to generate rental income. DHA classifies it as investment property with a cost of \$100m. The property will be depreciated over a 10 year useful life (i.e. \$10m p.a).

At the end of year 2, an independent valuer measures the recoverable amount to be \$75m. This is less than the net carrying amount of \$80m (i.e. \$100m less 2 years of depreciation). As such the property is impaired and DHA writes down the property to its recoverable amount of \$75m.

Journal entries:

Year 0

Dr. Investment property	\$100m		
Cr. Cash		\$100m	

Year 1

Dr. Depreciation expense	\$10m	Investment property carrying amount	\$90m
Cr. Accumulated depreciation	\$10m		

Year 2

Dr. Depreciation expense	\$10m	Investment property carrying amount	\$80m,
Cr. Accumulated depreciation	\$10m	written down to	\$75m

Dr. Impairment expense	\$5m		
Cr. Investment property		\$5m	

The revised carrying amount of the investment property is \$75m. DHA reassesses the depreciation charge over the remaining 8 years (i.e. \$75m / 8yrs = \$9.4m).

Therefore during year 3 to year 6 inclusive, depreciation expense of \$37.5m is recognised. Net carrying amount of \$37.5m.

At the end of year 7, DHA notes that market rentals and demand for property has increased. DHA's independent external valuer measures the fair value of the investment property to be \$40m.

Year 7:

Dr. Depreciation expense	\$9.4m	Investment property carrying amount of	\$28.1m
Cr. Accumulated depreciation	\$9.4m		

Example: Write-down to investment property carrying amount and subsequent reversal

The previous impairment on the investment property can only be reversed to the extent of the carrying amount that would be recorded had there been no impairment. Therefore, although recoverable amount is \$40m, it is to be recorded at the lower of cost or recoverable amount which would be \$30m

Profile of depreciation with impairment charge

Profile of depreciation if there had been no impairment charge

Year	Depn Charge	Carrying Amount
0		100
1	-10.0	90.0
2	-10.0	80.0
3	-9.4	65.6
4	-9.4	56.3
5	-9.4	46.9
6	-9.4	37.5
7	-9.4	28.1
8	-9.4	18.8
9	-9.4	9.4
10	-9.4	0.0

Year	Depn Charge	Carrying Amount
0		100
1	-10	90
2	-10	80
3	-10	70
4	-10	60
5	-10	50
6	-10	40
7	-10	30
8	-10	20
9	-10	10
10	-10	0

Dr. Accumulated depreciation \$1.9m
 Cr. Depreciation expense \$1.9m

Restated carrying amount at end of year 7 of \$30m

Depreciation is recalculated for the remaining 3 years to be \$10m p.a. (\$30m / 3yrs).

10. Investment properties held for sale

DHA holds a proportion of its investment properties as held for sale. Investment properties are deemed eligible for sale if identified as a sale and lease back property, or when they have below average capital growth expectations; carry high repairs and maintenance expenditure; are permanently privately leased out; have no redevelopment opportunities or have low rental yield.

DHA ceases depreciation on investment properties held for sale and carries them in the balance sheet at the lower of cost and fair value less costs to sell. Refer to section [9.2 above] for details on measurement of fair value less costs to sell.

Further the held for sale investment properties are disclosed on a separate line item in the balance sheet from other investment properties and assets.

Example Financial Statement Extract

Defence Housing Australia
Consolidated Balance Sheet
As at 30 June 20XX

ASSETS

Current assets

Cash and cash equivalents	XXX
Trade and other receivables	XXX
Other current asset	XXX
Inventories	XXX
Investment properties	XXX
Investment properties held for sale	XXX
Total Current Assets	XXXX

11. Asset Retirement Obligations and Provision for Makegood

11.1 Provision for Makegood

Recognition of a provision for makegood is only relevant to sale and lease back transactions. Refer to section 8.2.7 for further discussion on these arrangements.

Where a lease term of a property is six years or greater, DHA undertakes to 'make-good' the property at the expiration of the lease and any extension options. DHA estimates the costs that will be incurred to refurbish the property to return it to the required condition as set out in the Lease Agreement.

The costs are recognised as a provision and discounted to present value using a pre-tax discount rate (incremental borrowing rate). Any risks and estimates taken into account in estimating the future cashflows are not also adjusted in the discount rate. As the discount is 'unwound' to the end of the lease term, DHA recognises a finance cost element in the income statement. The cost of make-good is included in the cost base of a leasehold improvement asset (PP&E) and capitalised to the balance sheet at the same time as recognising the provision and depreciated over the lease term.

11.2 Restoration Obligations

Further, as a condition of developing and constructing a site, DHA may be contractually required to restore the site to a particular condition (e.g. rectify any environmental damage). The rectification will often occur subsequent to all dwellings being completed.

Where DHA assesses that it is probable (more likely than not) that costs to restore will be incurred in the future and it can reliably estimate these, DHA recognises a provision balance to reflect the future obligation. The costs provided for continue to be capitalised if they were a condition of being permitted to construct and sell the properties i.e.

Dr. Inventory
 Cr. Provision

If they were not a condition of the construction and disposal of the properties then the costs will be expensed immediately to the income statement when incurred. Refer to section 3 for further details on capitalisation of costs.

If however, the potential expenditure is not considered probable or DHA is unable to estimate the potential expenditure, DHA will disclose the potential obligation as a contingent liability in the notes to the financial statements. Even if the contingent liability is considered remote, DHA still makes disclosure in accordance with the PGPA.