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GAAP: Beyond the detail

Point of view

Real Estate Sector – New Revenue Standard could have a major impact on profile of revenue and profit recognition

In a nutshell

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, real estate companies will need to consider:
  - whether revenue should be recognised **over time** or at **a point in time**;
  - the extent to which **distinct goods or services** are supplied, which should be accounted for separately;
  - whether particular **costs relating to obtaining a contract** must be capitalised;
  - whether revenue must be adjusted for the effects of the **time value of money**;
  - how to account for **contract modifications**; and
  - the impact of new guidance where pricing mechanisms include **variable amounts**.
- The new Standard requires significantly more disclosures relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'). This is subject to EU endorsement. The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services. However, the new Standard does not apply to transactions that are instead within the scope of the leasing standard.

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. This is subject to EU endorsement. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for the real estate sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the real estate sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

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How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard
Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the real estate sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition.

This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require changes to cope with the new Standard
As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the real estate sector may require modifications to existing accounting systems and, in some cases, entities may conclude that they should develop new systems processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes.

What are the most significant changes?

Property developers and construction companies

Should revenue be recognised over time or at a point in time?
IFRS 15 introduces a new approach to determine whether revenue should be recognised over time or at a point in time. Three scenarios are specified in which revenue will be recognised over time – broadly, they are when (i) the customer receives and consumes the benefits of the seller's performance as the seller performs; (ii) the seller is creating a 'work in progress' asset which is controlled by the customer; and (iii) the seller is creating a 'work in progress' asset which could not be directed to a different customer and in respect of which the customer has an obligation to pay for the entity's work to date. If revenue is to be recognised over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. If a transaction does not fit into any of the three scenarios described above, revenue will instead be recognised at a point in time, when control passes to the customer.

This guidance is different from, and much more specific than, that previously included in IFRSs, and some entities may find that revenue previously recognised at a point in time should now be recognised over time, or vice versa. For example, revenue from an off- plan sale of real estate may be affected by the new Standard. Whether revenue should be recognised over time or at a point in time will often depend on a careful analysis of specific contract terms. Quite small differences between otherwise similar contracts could potentially have a fundamental impact on the timing of revenue recognition. In determining whether revenue on such sales is recognised at a point in time or over time, particular care will need to be given to whether the entity could have an alternative use for the asset under construction and the entitlement of the entity to be paid for the work performed to date. It will often be particularly important to focus on any contractual terms allowing the customer to cancel, curtail or significantly modify the contract and whether, if such circumstances arose, the seller would always be contractually entitled to adequate compensation for work performed to date. Assessment of these factors, and others, will need to be made in the context of both the contract terms and the local legal environment.

Where an entity concludes that revenue should be recognised over time, it will need to consider how to measure progress towards complete satisfaction of performance obligations. IFRS 15 specifies that the measure of progress shall exclude any goods or services for which the entity does not transfer control to the customer. As such, the measure of progress (and therefore the percentage of revenue to be recognised) may be affected by whether or not control of the land on which the property is being constructed is transferred to the buyer (and the timing of that transfer).

How are different goods and services within a contract identified?
Previously, given the lack of specific guidance in IFRSs, there was greater room for judgement when identifying the distinct goods and services within a contract. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15 and, in particular, the new rules on how revenue is allocated between different items. Construction companies often have multi-element contracts and IFRS 15 may affect the determination of whether certain elements of a contract are recognised separately, which may have a significant impact on the profile of revenue recognition.

For example, the new Standard may affect whether a parcel of land that is sold as part of a contract for the construction of a building is considered to constitute a distinct good to be accounted for separately. It may also affect the identification of separate service obligations (and the timing of recognition of the related revenue) included in a construction contract covering the design, construction, and operation phases of a real estate project. For example, should the services performed as part of the design phase be accounted for separately (because, for example, the developer frequently sells these services separately) or are they not distinct from the construction and/or operation phases of the contract?

Should contract costs be capitalised?
In addition to more prescriptive guidance on revenue recognition, the new Standard introduces specific criteria for determining whether to capitalise certain costs, distinguishing between those costs associated with obtaining a contract (e.g. sales commissions) and those costs associated with fulfilling a contract. This becomes an issue for construction companies where significant costs are incurred that are directly attributable to obtaining contracts with customers, for example, bid costs incurred prior to a contract being awarded. These may include costs related to fulfilling a contract or costs of obtaining a contract and accounting treatment will be dependent on the nature (or type) of costs incurred. For example, design costs which qualify as a cost of fulfilling a contract will generally be capitalised if they meet certain criteria, including an expectation that the costs will be recovered, whereas costs of obtaining a contract prior to the contract being awarded, such as legal costs, will usually be expensed as they are costs that will have been incurred whether or not the contract is obtained. In contrast to this, 'success fees' (i.e. commissions that are only payable if a contract is obtained) will be capitalised under the new Standard as they are incremental costs of obtaining a contract. At present, different entities might treat various types of cost differently so there may be an impact on operating profits.

The new Standard requires capitalised contract costs to be amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services. Entities will need to exercise judgement to determine the appropriate basis and time period for this amortisation.

Should revenue be adjusted for the effects of the time value of money?
IFRS 15 introduces new and more extensive guidance on financing arrangements and the impact of the time value of money. Sales by property developers or construction companies may include financing arrangements in that the timing of cash inflows from the customer may not correspond with the timing of recognition of revenue. Under the new Standard, the financing component, if it is significant, is accounted for separately from revenue. This applies to payments in advance as well as in arrears, but subject to an exemption where the period between payment and transfer of goods or services will be less than one year. This new guidance may change current accounting practices in some cases.

What is the impact if a contract is modified?
In the past, IFRSs included only limited guidance on how to account for modifications to a contract. IFRS 15 includes detailed guidance on whether a contract modification should be accounted for prospectively (as an adjustment to future revenues) or retrospectively (via an adjustment when the modification occurs). It is not uncommon for the scope or price of arrangements in the real estate sector to be modified, particularly for construction companies, and therefore these requirements may result in a change of practice for some entities.

<u>Property managers</u>

When should variable or uncertain revenues be recognised?
Property management contracts often include significant variable elements, such as performance bonuses, rental guarantees, profit sharing arrangements relating to the subsequent sale of real estate, etc. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals as a result of subsequent re-estimation. This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgement to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result.

What else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's Need to know publication available from www.ukaccountingplus.com. Further industry publications are also available here.

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