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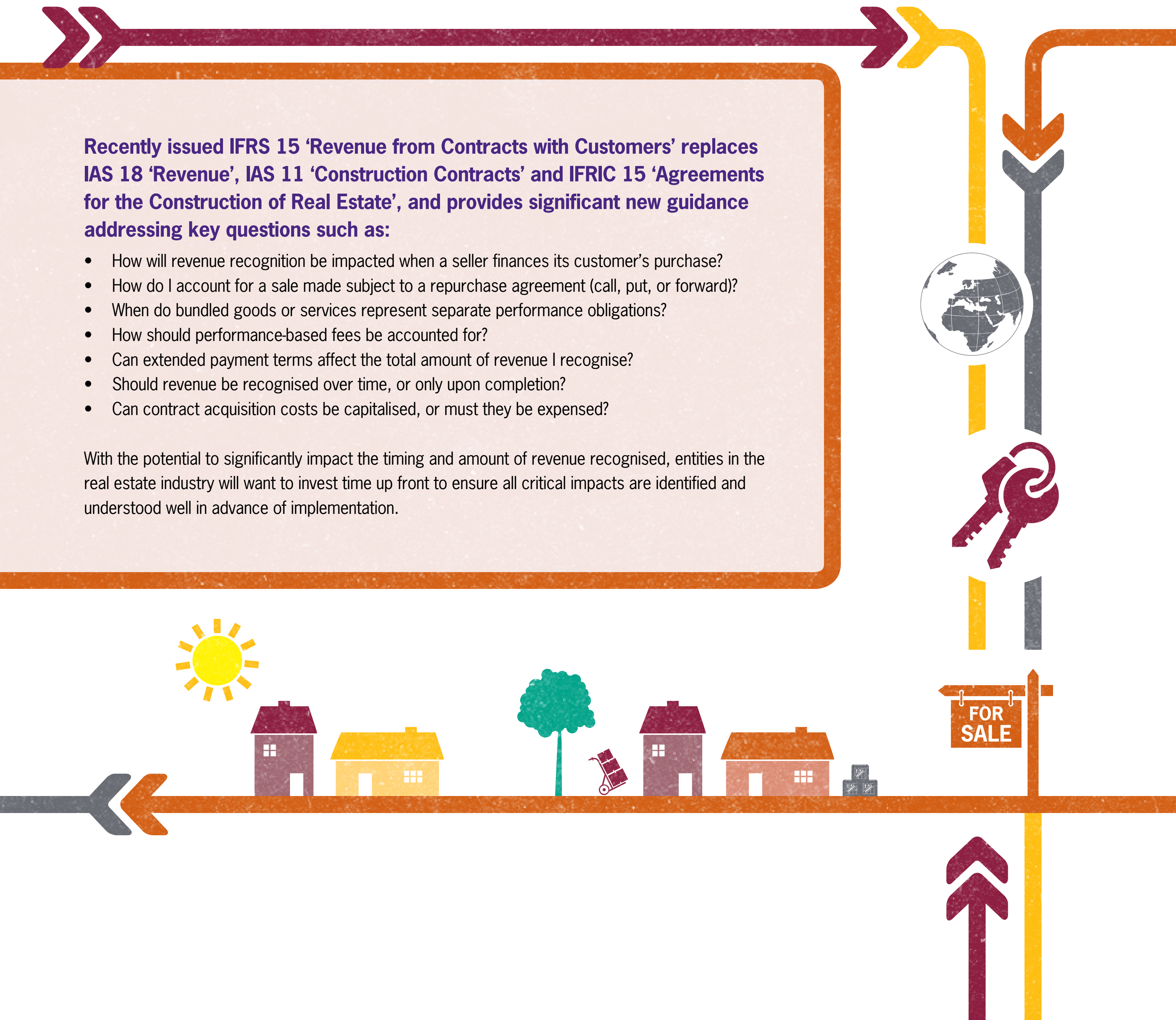
A new global standard on revenue

What this means for the real estate industry

The International Accounting Standards Board (IASB) and US FASB have issued their new Standard on revenue – IFRS 15 'Revenue from Contracts with Customers' (ASU 2014-09 or Topic 606 in the US). This bulletin summarises the new requirements and what they will mean for the real estate industry.



Recently issued IFRS 15 'Revenue from Contracts with Customers' replaces IAS 18 'Revenue', IAS 11 'Construction Contracts' and IFRIC 15 'Agreements for the Construction of Real Estate', and provides significant new guidance addressing key questions such as:

- How will revenue recognition be impacted when a seller finances its customer's purchase?
- How do I account for a sale made subject to a repurchase agreement (call, put, or forward)?
- When do bundled goods or services represent separate performance obligations?
- How should performance-based fees be accounted for?
- Can extended payment terms affect the total amount of revenue I recognise?
- Should revenue be recognised over time, or only upon completion?
- Can contract acquisition costs be capitalised, or must they be expensed?

With the potential to significantly impact the timing and amount of revenue recognised, entities in the real estate industry will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.

The new Standard at a glance

The new Standard replaces IAS 11, IAS 18, IFRIC 15 and other revenue-related Interpretations. All transactions within its scope will be analysed against a single, control-based model centred around the following 5-steps:

Step 1: Identify the contract with a customer

Step 2: Identify the performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations

Step 5: Recognise revenue when/as performance obligation(s) are satisfied

IFRS 15 changes the criteria for determining whether revenue is recognised at a point in time or over time. In addition, while the following points may vary in terms of their expected impact on the real estate industry, IFRS 15 has more guidance in many areas where current IFRSs are lacking such as:

- multiple-element arrangements
- contract modifications
- non-cash and variable consideration
- rights of return and other customer options
- seller repurchase options and agreements
- warranties
- principal versus agent (gross versus net)
- licensing intellectual property
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements.

IFRS 15 will require considerably more disclosure about revenue recognition including information about contract balances and changes, remaining performance obligations (backlog), and key judgements around the timing of and methods for recognising revenue.

Transition and effective date

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Transition is retrospective, subject to some simplifications including an option not to restate comparative periods. Early application is permitted.

What this means for the real estate industry

Accounting for revenue in the real estate industry involves unique challenges, from dealing with complex bundles of interrelated goods and services to vendor guarantees and financing and other forms of continuing involvement. The detailed guidance in IFRIC 15 has been replaced by new criteria and entities will need to apply their professional judgement when determining whether revenue from off-plan sales of residential units and other real estate transactions must be recognised over time or at a point in time.

Step 1: Identify the contract with a customer

The collectability assessment takes on added significance in situations where the seller finances the sale of real estate.

IFRS 15 applies to almost all contracts with customers to provide goods or services, although arrangements must meet additional criteria before the detailed guidance in IFRS 15 can be applied, including:

- the contract has commercial substance
- the parties have approved the contract
- the entity can identify each party's rights and the payment terms
- it is probable the entity will collect the consideration.

When amounts are received from a customer before all of the above are met, these payments must be presented as a liability either until the criteria are met, or one of the following occurs:

- performance is complete and all consideration received is non-refundable
- the arrangement has been cancelled and any consideration received is non-refundable.

Vendor financing

The collectability assessment noted above takes on added significance in situations where the seller finances the sale of real estate. In making its assessment an entity considers whether both parties are committed to performing their respective obligations under the contract. Assessing a buyer's commitment to acquire a property would include such things as evaluating both the adequacy of the down payment, and the creditworthiness of the buyer. If collection is not probable, then the remaining steps

in the model are not applied, and any cash received is accounted for as a deposit. This approach differs from current guidance which includes collectability as one of the main revenue recognition criteria within the IAS 18 and IAS 11 models. However, we do not anticipate this structural change will significantly impact the amount or timing of revenue for most entities.

Repurchase options/obligations

Under current guidance, a seller's right (call option) or obligation (forward or put option) to repurchase the property from the buyer must be carefully analysed to ascertain whether the significant risks and rewards have been transferred to the buyer. If the risks and rewards have been retained by the seller, then the contract is a financing arrangement and does not give rise to revenue.

Under IFRS 15, however, the accounting for a repurchase agreement depends on the type of arrangement (forward, call option, or put option), the relationship between the repurchase price and the original selling price, and, in certain cases, the relationship between the repurchase price and expected market value of the repurchased asset at the repurchase date. In many instances, a contract that contains a repurchase agreement will be accounted for as a lease or as a financing arrangement. A careful analysis of these agreements will be required.

Step 2: Identify the performance obligations

The cornerstone of the IFRS 15 model is the fact that revenue is recognised upon satisfaction of 'distinct' performance obligations rather than the contract as a whole. A promised good or service is 'distinct' if both:

- the customer benefits from the item on its own or along with other readily available resources
- it is 'separately identifiable' (eg the supplier does not provide a significant service integrating, modifying, or customising the various performance obligations).

In the real estate industry it is fairly common for an entity to have some form of continuing involvement with a customer after a sale. This involvement can take many forms including repurchase arrangements, seller guarantees, or additional performance obligations. For example, entities may sell land with a commitment to then develop the land by designing and building a shopping centre on it. The entity will need to evaluate whether the sale, design and construction elements represent separate performance obligations or a single performance obligation using this new guidance.

In contrast, existing standards provide almost no guidance on how to identify the separately identifiable components of a transaction. In light of the significant new guidance provided, entities will need to review their customer contracts carefully before they are able to conclude how revenue will be impacted.

The entity will need to evaluate whether the sale, design and construction elements represent separate performance obligations or a single performance obligation using this new guidance.

Step 3: Determine the transaction price

In the real estate industry, payment terms may vary depending on the nature of the agreement, the financial resources of the customer and many other factors.

Under IFRS 15, the 'transaction price' for a contract is "…the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer…". This consideration may include fixed or variable amounts or both.

Variable consideration

Under IFRS 15, sellers must estimate the amount of variable consideration (for example, future profits from the sale of real estate or management fees based on performance) using either an expected value (probability-weighted) or most likely amount approach. This estimate is subject to a constraint such that the variable amounts are included in the transaction price only to the extent that it is highly probable that a significant reversal of cumulative revenue will not occur upon a change in the estimate. This differs from existing guidance that focused on whether it was probable that the related performance requirements would be met and the amount could be measured reliably. While significant judgement may be needed to assess variable consideration under the new model, we expect that for many entities these requirements will not have a significant impact.

Time value of money

In the real estate industry, payment terms may vary depending on the nature of the agreement, the financial resources of the customer and many other factors. Under IFRS 15, the transaction price is adjusted if payment terms give rise to a 'significant financing component'. IFRS 15 provides indicators to help an entity determine whether a significant financing component exists in a contract, including (among other things) the relationship between the promised consideration and the cash selling price, and the length of time between delivery of the promised goods or services and when the customer pays. Where the length of time between performance and collection is less than one year, the effects of financing may be ignored. Otherwise, the effects of a significant financing component are accounted for separately from revenue. Under IAS 18, the focus is on measuring the fair value of the consideration to be received, while under IFRS 15 the objective is to recognise revenue equal to the price the customer would have paid had they paid in cash.

Step 4: Allocate the transaction price to the performance obligations

> The extent to which an entity will be impacted by the new guidance will depend upon the accounting policy adopted under existing literature.

When an entity determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on relative stand-alone selling prices at contract inception.

Estimating stand-alone selling price

IFRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price. If not available (which we'd expect to be the case for many real estate and construction contracts), the entity estimates the stand-alone selling price using all available information, maximising the use of observable inputs. IFRS 15 suggests (but does not require) three possible methods:

- adjusted market assessment
- expected cost plus margin
- the residual approach.

When it comes to allocating revenue among the various performance obligations in a contract, IAS 18 provides very little guidance and IAS 11 provides even less. Therefore, the extent to which an entity will be impacted by the new guidance will depend upon the accounting policy adopted under existing literature.

Step 5: Recognise revenue when/as performance obligations are satisfied

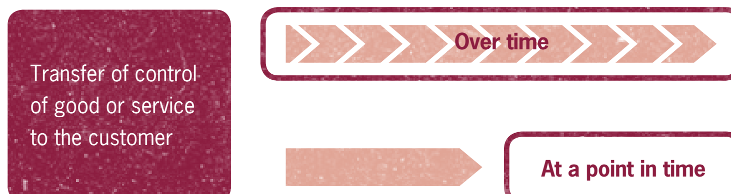
> Under existing IFRSs, an agreement for the construction of real estate may be within the scope of either IAS 11 or 18. That determination is a matter of judgement that depends on the terms of the agreement and related facts and circumstances.

Under IFRS 15 revenue for a performance obligation is recognised upon transfer of control of the promised good or service (ie the "asset"). This occurs either over time or at a point in time depending on whether any of three specific criteria have been met.

'Off plan' sales of residential real estate

Under IFRS 15, in order to recognise profits on the sale of residential real estate before construction has been completed and individual buyers have begun occupying their units, the seller must meet one of the three criteria indicating that control of the unit transfers over time:

- the customer receives and consumes the benefits as the entity performs
- the customer controls the asset as it is created or enhanced
- the asset has no alternative use to the seller and the seller is entitled to payment for performance-to-date.



If none of these conditions are satisfied, the entity recognises revenue at a point in time.

When assessing the third ('no alternative use') criterion, an entity should consider any contractual or practical impediments that would prevent it from redirecting the unit to another customer. These could include such things as contractual terms naming the specific unit being sold (eg "apartment #408"), or significant rework costs that would be required to make the unit suitable for another customer. With regards to its entitlement to payment for services performed to date, an entity considers whether it is entitled to enforce payment in the event the customer terminates the contract for reasons other than the entity's failure to perform. To satisfy the criterion, the right to receive payment should go beyond the mere reimbursement of costs incurred and reflect a normal selling price for performance to date (ie including profit margin). In making its assessment, an entity considers both the terms of the specific contract and any customary business practices and local legal precedents that may impact the enforceability of the contractual rights.

Under existing IFRSs, an agreement for the construction of real estate may be within the scope of either IAS 11 or 18. That determination is a matter of judgement that depends on the terms of the agreement and related facts and circumstances. IFRIC 15 provides guidance when assessing whether an agreement for the construction of real estate is within the scope of IAS 11 or 18 and whether related revenue is to be recognised at a point in time similar to a sale of goods, or over time. Based on the way that typical off-plan residential unit sales contracts are currently structured, we believe that the new guidance may require some entities to change their practices. The important thing to remember is that with the introduction of new guidance the boundary may have shifted and a careful examination of facts and circumstances including the contractual terms, local legal environment and customary business practices will be required.

Guarantees

In some real estate contracts, a seller guarantees the return of the customer's investment or a return on that investment for an extended period of time. In these situations, an entity should focus on whether control of the asset has transferred to the buyer. If the guarantee is structured in such a way that indicates control of the real estate has not transferred to the buyer, it is possible that no revenue could be recognised until the guarantee expires. If the seller guarantees the buyer's financing, the seller applies IFRS 15 in determining when it recognises the revenue from both the guarantee and from the sale of goods. Under existing IFRSs, similar principles apply (but using IAS 18).

Other guidance

Contract costs

IFRS 15 requires an entity to capitalise the incremental costs of obtaining a contract if it expects to recover those costs. 'Incremental costs' of obtaining a contract are defined as costs that an entity would not have incurred if it had not obtained the contract (eg, some sales commissions). Costs that an entity incurs regardless of whether it obtains a contract (eg tendering costs) are expensed as incurred, unless the costs are explicitly chargeable to the customer whether or not the entity obtains the contract.

Disclosures

All entities, especially those with contracts greater than one year in duration, will need to provide additional disclosures beyond those currently required. As a result, systems and processes will need to capture and summarise the incremental information required to comply with the new standard.

Costs that an entity incurs regardless of whether it obtains a contract (eg tendering costs) are expensed as incurred, unless the costs are explicitly chargeable to the customer whether or not the entity obtains the contract.

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